GLOBAL BANKING

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Second Edition

Roy C. Smith
Ingo Walter

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Preface

Few sectors of the global economy have experienced the dynamic and structural change that has occurred over the past 20 years in banking and financial services. Regulatory and technological changes have been among the main catalysts, making entrenched competitive structures obsolete and mandating the development of new products, new processes, new strategies, and new public policies toward the industry. This rapid evolution in one of the most important yet least understood international industries gave rise to the first version of this book, published in 1990, followed by a second published by Oxford University Press in 1997.

Since that time developments have accelerated. Financial centers, in vigorous competition with each other, have undergone further regulatory change in efforts to capture greater shares of international trade in financial services. Also, common efforts at the regional and global level have tried to support safety and soundness and a reasonably level competitive playing field. Accordingly, banks, insurance companies, asset managers, and securities firms have had to devise and implement new strategies—sometimes leading events or (perhaps more often) responding to them—and the financial services industry has seen an unprecedented wave of consolidation in all parts of the world. The dominant strategic cliché of the 1990s was "universal banking," and most banks believed that to be better they had to be bigger.

Meanwhile, the environment for global banking services experienced a 20-year period of growth and expansion unknown to its history. During this time, stock price and volume data for the United States and Europe indicated a rate of growth twice that of the real economy. But with this transactional intensity came an onslaught of competition for which the staid banking institutions of the past were unprepared. Client relationships were now fiercely contested. Clients expected banks to be more innovative and to provide better-priced services. Technology constantly changed what was possible and what was on offer from competitors.

The transaction volumes made markets volatile and sometimes difficult to read. Several banking firms failed or had to be rescued by takeovers. A banking crisis and prolonged economic stagnation battered the industry in Japan. A vigorous bull market and continuing restructuring needs induced a boom in mergers and acquisitions (M&A) and initial public offering (IPO) activity in the United States and Europe, forcing banks to staff up quickly to keep up with them, only to be sharply reversed early in the new millennium. Financial crises rocked the emerging markets again, but this time the accumulated amount of debt and equity securities outstanding in these countries drove the crises into the capital markets. Financial services were separating into two distinct halves, wholesale and retail, and the wholesale part was almost entirely dominated by capital market activity.

Much of the conventional wisdom of the late 1980s and 1990s (such as the expected dominance of Japanese banks in the global financial system) proved to be wrong just as, no doubt, much of today's conventional wisdom will lose meaning in an industry whose reconfiguration has some way to go. In short, the pace of change soon made it necessary for us to think about another edition of our 1997 book.

Here we attempt to reassess this continuing transformation process—its causes, its course, and its consequences. We begin with an overview of recent developments. We then consider in some detail the major dimensions of international commercial and investment banking, including money and foreign exchange markets, debt capital markets, international bank lending, derivatives, asset-based and project financing, and equity capital markets. We next consider the various advisory businesses—mergers and acquisitions, privatization, institutional asset management, and private banking. In each area we make an effort to identify the factors that appear to distinguish the winners from the losers. This is brought together in the final section of the book, which deals with problems of strategic positioning and execution, as well as with some of the critical regulatory issues.

The book is intended for two more or less distinct audiences. The first is made up of banking and finance professionals and executives in nonfinancial firms who would like a "helicopter" view of developments in this industry that affect their vital interests either because they are in it or because they want to understand patterns of competition among suppliers of financial services. The second is made up of university students in courses, either at the advanced undergraduate or graduate level and in executive development programs on international banking and financial markets. Participants in such courses usually find it very helpful to understand both the structure and the dynamics of the global banking and securities industry as they prepare for or develop their professional careers.

We are grateful to colleagues at New York University who have provided valuable feedback on the earlier editions, as well as various drafts of the manuscript for this book. An equal measure of thanks go to colleagues at other institutions who used the earlier editions as a textbook in courses on global banking. Our own students, several hundred per year, have pro-

vided sometimes merciless critiques and will no doubt be pleased by this much shorter, heavily reworked, and streamlined text. The subject is complex and requires some slogging. This is certainly no novel that's impossible to put down. But we think the reader will be well rewarded for the effort required to work through the discussion.

Finally, we are especially grateful to Gayle DeLong of the Baruch School, City University of New York, and Ann Rusolo of New York University, both of whom helped immeasurably in preparing the manuscript for publication.

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The World of Global Banking

Financial people know in their bones that their profession goes back a long way. Its frequent association with "the world's oldest profession" may simply be because it is almost as old. After all, the technology of finance is very basic, requiring little more than simple arithmetic and minimal literacy, and the environment in which it applies is universal—that is, any situation that involves money, property, or credit, all of which are commodities that have been in demand since humankind's earliest days.

These financial commodities have been put to use to facilitate trade, commerce, and business investment and to accommodate the accumulation, preservation, and distribution of wealth by states, corporations, and individuals. Financial transactions can occur in an almost infinite variety, yet they always require the services of banks (whether acting as principal or as agent) and financial markets in which they can operate.

Banks, too, therefore have a long history: a history rich in product diversity, international scope, and, above all, continuous change and adaptation. Generally, change has been required to adjust to shifting economic and regulatory conditions, which have on many occasions been drastic. On such occasions banks have collapsed, only to be replaced by others eager to try their hand in this traditionally dangerous but profitable business. New competitors have continually appeared on the scene, especially during periods of rapid economic growth, opportunity, and comparatively light governmental interference. Competitive changes have forced adaptations, too, and in general have improved the level and efficiency of services offered to clients, thereby increasing transactional volume. The one constant in the long history of banking is, perhaps, the sight of new stars rising and old ones setting. Some of the older ones have been able to transform themselves into players capable of competing with the newly powerful houses, but many have not. Thus the banking industry has much natural similarity to economic restructuring in general.

It is doubtful, however, that there has ever been a time in the long history of banking that the pace of restructuring has been greater than today's. Banking and securities markets during the 1980s and 1990s in particular have been affected by a convergence of several exceptionally powerful forces—deregulation and reregulation, rapidly increasing competition and disintermediation, product innovation and technology—all of which have occurred in a spiraling expansion of demand for financial services across the globe. Bankers today live in interesting, if exhausting and hazardous, times.

Before examining these issues in detail in this book, a brief look at where we have come from should be useful in orienting ourselves to the present.

The Legacies of Global Banking

History has revealed that both bankers and credit were plentiful and active in the ancient world. The recorded legal history of several great civilizations started with elaborate regulation of credit, such as the Code of Hammurabi, ca. 1800 B.C., where the famous Babylonian set forth, among other laws, the maximum rate of interest for loans of grain (33⅓%) and of silver (20%).

In the Ancient World

Maritime trade abounded in the Mediterranean and was already highly developed by the Greeks and the Phoenicians in 1000 B.C. Such trade involved long-distance shipment of commodities that were not locally available. Wherever trade occurred, there had to be a means of payment acceptable to both sides, often obtained only through the good offices of a bank represented in both countries acting as a foreign exchange or bill broker.

Banks also helped the merchants, shipowners, and, later, public officials manage their money—sometimes by accepting it on deposit; sometimes by investing it for them in precious metals, precious stones, or the financial assets of the day. One could make money on money long before Alexander the Great.

By the time of the second century A.D., the Romans, then at their peak, had reorganized everything. Their power in the Mediterranean was absolute, peace reigned along its shores, piracy had been eliminated, trade flourished, and coinage was available throughout the Roman Empire. Bankers and financiers prospered. Will Durant described them as follows:

> One of the streets adjoining the forum became a banker's row, crowded with the shops of the moneylenders and moneychangers. Money could be

> borrowed on land, crops, securities, or government contracts, and for financing commercial enterprises or voyages. Cooperative lending took the place of [commercial] insurance; instead of one banker completely underwriting a venture, several joined in providing the funds. Joint-stock companies existed chiefly for the performance of government contracts. . . . They raised their capital by selling their stocks or bonds to the public in the form of *partes* or *particulae*, i.e. "little parts," or "shares" [or "partnerships" or "participations"].[1]

Under other circumstances, this financial and commercial infrastructure might have grown to produce large international banking and trading companies of the kind that exist today. It didn't happen in the Roman period, largely because it seemed that the state, focused as it was on conquest and strict control of its empire through efficient administration, reserved for itself the principal financial powers in the society. As the state was the principal holder of capital, it became the principal dispenser of it, too, lending out large sums to the public, no doubt accompanied by some degree of corruption. Perhaps to preserve this convenient arrangement, the Roman senate did not permit limited liability companies to be formed, thus keeping the private wealth of the empire where it could be best controlled: among individuals.

In any case, large banks and commercial houses never emerged in the Roman days, although banking transactions themselves were plentiful on a small scale. This may have proved to be a contributing cause to the decline of the empire, which, along with political deterioration, suffered acute economic decay. In the third century, much economic difficulty was experienced, including the "great crash" of A.D. 259, after the Emperor Valerian had been taken captive when markets collapsed and there were runs on banks in various parts of the empire.

During the following century, Rome's economic decline was irreversible. Coinage and gold bullion was leaving the empire in a great payment drain (it ended up mostly in the Near East and in India). The population was declining, and barbarians had to be brought in to replenish the dwindling supply of workers. Wealth had become highly concentrated at the top, and the nouveau riche had been suppressed. Society's savings were dissipated in consumption; military conquests were no longer being undertaken to resupply the state with plunder and slaves; and the empire itself was breaking into two parts, with most of the action taking place in the eastern capital, Constantinople. What was left of the smart money moved there.

After the Romans

The rest, sadly, we know—although one eminent historian of the period, Harold Mattingly, a distinguished Cambridge University scholar and expert on Roman finance, makes a curious observation:

> The possibilities at the disposal of an all-powerful state are enormous, if it can [utilize] its resources in money, natural wealth and manpower. If the Roman State could have been administered by a syndicate of men of modern capacity in banking and industry, there might have been rationalization on a magnificent scale. The State might have been able to meet all demands upon it and still have left its subjects to enjoy a very fair measure of prosperity. If it failed to realize all these possibilities, that will have been due to lack of knowledge as well as lack of interest.[2]

This thought brings to mind the Communist "empire" of our century, the collapse of which in the late 1980s equally might have been avoided if its rulers (like the Chinese) had understood free-market capitalism just a little better.

The Roman Empire collapsed in the fifth century. It was succeeded by the Byzantine Empire, which ruled in the eastern Mediterranean until the Arab conquests of the seventh century, which, in turn, diminished its scope and power.

In the western Mediterranean, absent the Romans, trade between the great ports and up the rivers leading into them was sporadic, interrupted by pirates, and almost totally lacking in financing. After the Arab conquests, trade flourished around the Mediterranean while for all practical purposes, European trade was in limbo for several hundred years. From the point of view of European bankers and financiers, these truly were the Dark Ages.

Where there was little trade, economic life collapsed back upon villages or counties. People consumed what they grew or raised or made and no more. There were no surpluses beyond local needs. There were no markets to send them to nor was there any way to send them. No trade, no money, no finance—there was nothing to do with money anyway. From this stagnant condition the feudal system emerged, digging its roots deeply into European life.

Christian Capitalism

The Catholic Church appeared as a major social and economic force in Europe around this time. Founded when the brutality of the all-conquering Romans was at its peak as an institution devoted to Christ's teaching of brotherly love and human equality before a single, caring and redemptive God, the church had profound influence in establishing the way people should live and treat each other. Naturally, people behaved much as before, but now they were told what was right and what was wrong according to a supreme being, and what would happen to them if they offended God and were not subsequently forgiven.

Christ was not just a prophet, the church declared; he was the Son of God and therefore the sole authoritative source for these new teachings, which instructed mankind in God's will. According to the teachings, everyone was a sinner, but sinners could be forgiven. Men were supposed to

treat their neighbors kindly and not take advantage of them or to climb over them on their way up. These teachings, as further interpreted by preachers and teachers over the years, came to establish the standards of Christian morality, of good and evil, of right and wrong in everyday life. How one had lived one's life would be judged at its end and rewarded either in Heaven or in Hell. It was a powerful notion because of the hope it contained, especially for a future life better than the miserable one that most people then lived. It spread throughout Europe.

The teachings of the medieval church began with the idea that everyone should know his or her place and not unduly strive to improve it at the expense of others. Peasants should be happy enough as peasants. Upward mobility was not encouraged. One's future would be secure in the next life if one served God and trusted completely in him. Kings and their associated nobles were people designated by God (through divine right) to rule. They should be obeyed and not interfered with (or revolted against).

The late Barbara Tuchman, in her fascinating report on the catastrophic fourteenth century—when a great famine, the Black Death, and the Hundred Years' War all fell in one century—notes that the Christian attitude toward commerce during the Middle Ages was "actively antagonistic":

> It held that money was evil, business was evil, that profit beyond a minimum necessary to keep the dealer alive was avarice (a sin), that to make money from the lending of money was usury (also a sin), and buying at wholesale and selling at retail was immoral and condemned by canon law. In short, as St. Jerome said: "A man who is a merchant can seldom, if ever, please God."[3]

Thus, business people, merchants, and bankers were not simply conceived in original sin, they were made to live in it daily or otherwise be prohibited from just about everything that an ambitious person trying to get ahead might think to do.

However, as Tuchman also points out: "As restraint of initiative, this was the direct opposite of capitalist enterprise. It was the denial of economic man, and consequently even more routinely violated than the denial of sensual man."[4] The ways of man and those of heaven were in stark contrast to one another. Violations would occur, naturally. But these would have to be atoned for, thus resulting in the enormous accumulation of wealth and financial power in the church itself.

This took some time to happen. While western Europe suffered the dismal period in the years from A.D. 500 to 1000 the conflict was moot, there being very little commerce to tempt people into sin. However, the Vikings began voyages in the eighth century, and for 200 or 300 years sailed and rowed their way up the rivers and into the lakes and seas of Europe, replanting the seeds of commerce and trade in their fearsome wake. After a while, it became easier and much more profitable to trade with their counterparts than to slaughter them, and economic life in the north and

west of Europe was reborn. At about the same time, Venice emerged as a principal entrepôt of trade and finance within southern Europe and between Europe and the Arab and Asian worlds.

By the beginning of the twelfth century, the Crusades had begun, during which military-religious expeditions were sent into the Holy Land of Palestine to reclaim Jerusalem for Christian society. These expeditions, never really successful, lasted for 200 years. During this time, the participants were guided by the religious order of the Knights of the Holy Temple of Jerusalem (called Knights Templar), who collected vast sums of money and property from well-to-do supporters in Europe. The knights invested the money, making loans, and buying and selling property throughout the Middle East. They evolved into possibly the first full-fledged modern bankers through careful development of their unique franchise.

Upward Mobility in the Middle Ages

With the rekindling of trade, of course, came opportunity for those seeking it—often, no doubt, those on the bottom rungs of society as it was then inflexibly cast.

A French historian of the Middle Ages, Henri Pirenne, repeats the story of one St. Godric of Finchale as an example of the way the "nouveau riche" were formed in the latter part of the eleventh century. Godric was born of poor peasant stock in Lincolnshire and forced, no doubt, to leave his parents' meager holdings to make his own way. He became a beachcomber, looking for wrecks, which were numerous at the time. Finding one, he put together a peddler's pack, and set out on the road, where in due course he fell in with a band of "merchants" (possibly bandits). In time he amassed enough money to form a partnership with others, owning a ship engaged in coastal trade, which subsequently branched out into long-distance trade, merchanting and banking. He became very rich, subsequently made his peace with God, and became a saint, leaving much of his fortune to the church. Pirenne noted that there were many Godrics operating at the time in Europe, although few among them were saints. They emerged as the *bourgeoisie*, and the commercial rebirth of Europe was soon an accomplished fact.[5]

By the late twelfth century, business schools were in operation for those seeking a career in commerce to learn basic reading, bookkeeping, and arithmetic. By the thirteenth century, banking and finance had become quite sophisticated. Great textile factories were established in Flanders, furnished with wool from Britain and flax from Egypt, and the cloth was sold all over Europe with financing provided by expatriate Italian bankers speaking French. By the fourteenth century, long-term credits were available, offered by merchants seeking to place their excess cash or by bankers acting on their behalf.

Public authorities and noblemen were also borrowers as, for example, when they needed to buy grain during a famine or outfit a regiment to be

sent off to the Crusades. It became easier to borrow from moneylenders than to send one's plate to the mint.

The Italian Era

By the fifteenth century, the mighty house of Medici reigned supreme in Italy, with its various branches throughout Europe acting as bankers, merchants in wool and cloth, dealers in spices and silks, goldsmiths, shipowners, deposit takers, and currency brokers. The influence of the Medicis and other houses like them reached into the papacy and the church, as well as to princes and noble families all over the continent.

By this time the modus operandi of relations between merchants and the church was reasonably well fixed, if complicated. To redeem his soul, the merchant would make contributions to the church and its charitable works and almshouses, perhaps leaving a substantial part of his fortune to the church upon his death. He would also suffer, as an ordinary cost of doing business, numerous fines and other charges for violating religious laws restricting commerce. He could purchase benefices or indulgences from the church to expunge his guilt. Before long, literally hundreds of such benefices were offered for sale by the church. He might also, as a lowly member of the bourgeoisie, have to renounce high social position in his community, though it is unlikely that Lorenzo de Medici ever did so.

Having done these things to the extent required, the merchant would also be left alone to grow as rich as he was able, to likewise ascend in society, and to leave most of his fortune to his heirs. It was a delicate balance, perhaps, but one that was efficient for both the church and the emerging middle class. Each became mutually supportive of the other, despite the unbridgeable chasm of their intellectual and spiritual positions, and each prospered.[6]

The more developed Italian banking became during the Renaissance, the more it was exposed to the great risks of the times, which included sudden shifts in political and religious power. These were in constant turmoil during the sixteenth century, and even the Medicis couldn't last. After the Reformation, they were succeeded in the world of merchant-financiers by German and Swiss Protestant bankers, many of whom developed ties in Britain, Holland, and France. The modern era developed in which commercialism and finance were substantially freed of the stern admonitions from the church.

Financial Markets Appear

The Dutch moved especially quickly and had set up organized markets for trading in financial instruments by 1602. The Amsterdam Stock Exchange followed in 1611, on which trading and speculation in securities of all types developed rapidly. "Tulip mania," in which the prices of bulbs temporarily reached extraordinary levels (one traded as high as £20,000), came in 1636.

The Amsterdam market permitted various forms of short-selling, puts and calls, and futures transactions in many different commodities (tulip bulbs being one) and securities, including shares of the dominant and prosperous Dutch East India Company. Insider trading was first made an illegal practice in Amsterdam in the seventeenth century. The shrewd and profit-minded Dutch traders already knew that insider trading was not, in fact, a victimless crime.

By the beginning of the eighteenth century, trading in bills of exchange and other financial instruments, including shares of a limited number of corporations, took place daily in the city of London in an area called Exchange Alley. This was the scene in 1720 of the "Great South Sea Bubble," in which thousands of British investors developed a mania for shares of a new company that would have monopoly rights to trade off the east coast of South America, the prospects for which were never much better than dim. Many people had bought their shares on margin, an early example of financial leverage at work. The bubble burst, of course, followed by financial ruin for many.

British Capitalism

During the latter part of the eighteenth century, the American and the French Revolutions had occurred, changing forever the way ordinary people would think about their lives and how much they would come to value the freedom to take one's own chances and venture one's own capital on a better, more prosperous future. Also at this time Adam Smith's influential work, *The Wealth of Nations*, appeared and helped to ensure nearly 100 years of prosperous laissez-faire economic policy in Great Britain.

Britain's defeat of Napoleon at the battle of Waterloo in 1814 set the stage for nearly a century of economic dominance. It also was the occasion for the House of Rothschild to complete its lengthy rise from obscurity to supreme prominence from the great killing it made in the market by getting the jump on the outcome of the battle and the defeat of Napoleon—and then wrong-footing everybody else on the Exchange by at first selling, then buying, large amounts of British paper. The Rothschilds had earlier amassed a smaller fortune in buying and selling commercial bills from both sides all during the war. None of their activities were either illegal or considered improper at the time, although both would be condemned today.

With the end of the Napoleonic era came a great era of capitalism that was nourished by the industrial revolution and the ascendancy of "the people" (i.e., democracy) in Europe and America. The result was unprecedented levels of growth and prosperity, despite periodic wars and economic recessions. Indeed, in those areas of the world still ruled by despots or by religious groups, not much general improvement in prosperity was experienced at all. And in those areas where old regimes were toppled by peoples' (i.e., communist) revolutions and capitalism was stamped out, only a

limited amount of economic growth and prosperity became possible—and much of that was shown to be superficial as these regimes themselves came to be set aside in the later twentieth century.

The Roots of Modern Banking

Our modern economic and financial heritage begins with the coming of democratic capitalism, around the time of Adam Smith (1776). Under this system the state does not intervene in economic affairs unnecessarily, removes barriers to competition and subsidies to favored persons to allow competition to develop freely, and in general, does not prevent or discourage anyone willing to work hard enough—and who also has access to capital—from becoming a capitalist.

Some 100 years after Adam Smith, England was at the peak of its power. Politically, it ruled 25% of the Earth's surface and population. The British economy was by far the strongest and most developed in the world. Its traditional competitors were still partly asleep. France was still sorting itself out after a century of political chaos and a war with Prussia that had gone wrong. Germany was just starting to come together politically but still a had quite a way to go to catch up with the British in industrial terms. The rest of Europe was not all that important. There was a potentially serious problem, however, from reckless and often irresponsible competition from America that fancied itself as a rising economic power. Otherwise, the horizon was comparatively free of competitors. British industry and British finance were very secure in their respective positions of world leadership in the 1870s.

English financial markets had made it all possible according to Walter Bagehot, the editor at the time of *The Economist*, who published a small book in 1873 entitled *Lombard Street,* which described these markets and what made them tick. England's economic glory, he suggested, was based on the supply and accessibility of capital. After all, he pointed out, what would have been the good of inventing a railroad back in Elizabethan times if there was no way to raise the capital to build it? In poor countries, there were no financial resources anyway, and in most European countries money stuck to the aristocrats and the landowners and was unavailable to the market. But in England, Bagehot boasted, there was a place in the city of London—called Lombard Street—where "in all but the rarest of times, money can be always obtained upon good security, or upon decent prospects of probable gain." Such a market, Bagehot continued, was a "luxury which no country has ever enjoyed with even comparable equality before."[7]

However, the real power in the market, Bagehot went on to suggest, is its ability to offer the benefits of leverage to those working their way up in the system, whose goal is to displace those at the top. "In every district," Bagehot explained, "small traders have arisen who discount their bills

largely, and with the capital so borrowed, harass and press upon, if they do not eradicate, the old capitalist." The new trader has "obviously an immense advantage in the struggle of trade":

> If a merchant has £50,000 all his own, to gain 10 percent on it he must make £5,000 a year, and must charge for his goods accordingly; but if another has only £10,000 and borrows £40,000 by discounts (no extreme instance in our modern trade), he has the same capital of £50,000 to use, and can sell much cheaper. If the rate at which he borrows be 5 percent, he will have to pay £2,000 a year [in interest]; and if, like the old trader he makes £5,000 a year, he will still, after paying his interest, obtain £3,000 a year, or 30 percent on his own £10,000. As most merchants are content with much less than 30 percent, he will be able, if he wishes, to forego some of that profit, lower the price of the commodity, and drive the old-fashioned trader—the man who trades on his own capital—out of the market.[8]

Thus, the ambitious "new man," with little to lose and access to credit through the market, can earn a greater return on his money than a risk-averse capitalist who borrows little or nothing. The higher return enables the new man to undercut the other man's prices and take business from him. True, the new man may lose on the venture, and be taken out of the game, but there is always another new man on his way up who is eager to replace him. As the richer man has a lot to lose, he risks it less, and thus is always in the game, continually defending himself against one newcomer or another until finally he packs it in, retires to the country, and invests in government securities instead.

"This increasingly democratic structure of English commerce," Bagehot continued, "is very unpopular in many quarters." On the one hand, he says, "it prevents the long duration of great families of merchant princes . . . who are pushed out by the dirty crowd of little men."

> On the other hand, these unattractive democratic defects are compensated for by one great excellence: no other country was ever so little "sleepy," no other was ever so prompt to seize new advantages. A country dependent mainly on great "merchant princes" will never be so prompt; there commerce perpetually slips more and more into a commerce of routine. A man of large wealth, however intelligent, always thinks, "I have a great income, and I want to keep it. If things go on as they are, I shall keep it, but if they change I *may* not keep it." Consequently he considers every change of circumstance a bore, and thinks of such changes as little as he can. But a new man, who has his way to make in the world, knows that such changes are his opportunities; he is always on the lookout for them, and always heeds them when he finds them. The rough and vulgar structure of English commerce is the secret of its life.[9]

In 1902, a young American new man named Bernard Baruch took Bagehot's essay to heart and made himself the first of many millions in a Wall Street investment pool, buying control of a railroad on borrowed money. The United States had come of age financially around the turn of

the century, and Wall Street would soon displace Lombard Street as the world's center of finance.

The Rise of the Americans

Early in the century, J. P. Morgan organized the United States Steel Corporation, having acquired Carnegie Steel and other companies in a transaction valued at $1.5 billion—an amount worth perhaps $30 billion today. This was the largest financial deal ever done, nor surpassed until the RJR-Nabisco transaction in 1989, and it occurred in 1902 during the first of six merger booms to take place in the United States during the twentieth and first years of the twenty-first century. Each of these booms was powered by different factors. But in each, rising stock markets and easy access to credit were major contributors.

By the early 1900s, New York was beginning to emerge as the world's leading financial center. True, many American companies (especially railroads) still raised capital by selling their securities to investors in Europe, but they also sold them to American investors. These investors, looking for places to put their newly acquired wealth, also bought European securities, perhaps thinking they were safer and more reliable investments than those of American companies. By the early years of the twentieth century, European issues in the New York market were commonplace. This activity proved especially beneficial when World War I came; both sides in the conflict sought funds from the United States, although the Allied Powers raised by far the larger amounts. Earlier, various U.S. government needs, from financing of wars to Thomas Jefferson's Louisiana Purchase, were partly provided by European capital markets.

After World War I, American prosperity continued while Europe's did not. Banks had a busy time, raising money for corporations, foreign governments, and investment companies and making large loans to investors buying securities. Banks were then "universal"—that is, they were free to participate in commercial banking (lending) and investment banking, which at the time meant the underwriting, distribution, and trading of securities in financial markets. Many of the larger banks were also involved in a substantial amount of international business. There was trade to finance all over the world, especially in such mineral-rich areas as Latin America and Australia. There were securities new issues (underwritings) to perform for foreign clients, which in the years before the 1929 crash aggregated around 25% of all business done. There were correspondent banking and custodial (safekeeping) relationships with overseas counterparts, along with a variety of financial services to perform for individuals, both with respect to foreigners doing business in the United States and the activities abroad of Americans.

The stock market crash in 1929 was a global event—markets crashed everywhere, all at the same time, and the volume of foreign selling orders was high. The Great Depression followed, and the banks were blamed for

it, although the evidence has never been strong to connect the speculative activities of the banks during the 1920s with either the crash or the subsequent depression of the 1930s. Nonetheless, there were three prominent results from these events that had great effect on American banking. First was the passage of the Banking Act of 1933 that provided for the Federal Deposit Insurance system and the Glass-Steagall provisions of the act, which completely separated commercial banking and securities activities. Second was the depression itself, which led in the end to World War II and a 30-year period of banking being confined to basic, slow-growing deposit-taking and loan-making within a limited local market only. Third was the rising importance of the government in deciding financial matters, especially during the postwar recovery period. There was little for banks or securities firms to do until the late 1950s and early 1960s.

By then, international business had resumed its rigorous expansion and U.S. banks, following the lead of First National City Bank (subsequently Citicorp, now part of Citigroup), resumed their activities abroad. The successful recovery of the economies of western Europe and Japan led to pressures on the fixed-rate foreign exchange system set up after the war. The Eurodollar market followed, then the Eurobond market and the reattraction of banks and investment banks to international capital market transactions.

Global Banking Emerges

Next came the 1971 collapse of the fixed exchange rate system in which the dollar was tied to gold and other currencies were tied to the dollar. Floating exchange rates set by the market replaced this system, obviating the need for government capital controls. In turn, this led to widespread removal of restrictions on capital flows between countries and the beginnings of the global financial system that we have today.

This system, which is based on markets setting prices and determining the flow of capital around the world, has drawn many new players—both users and providers of banking and capital market services. Competition among these players for funds, and the business of providing them, has greatly increased the stakes of individual institutions and, indeed, the risks of the banking and securities businesses.

The effects of competitive capitalism have been seen and appreciated during the past decades as they have not been since 1929. The 1980s witnessed further rounds of deregulation and privatization of government-owned enterprises, indicating that governments of the industrial countries around the world have found private-sector solutions to problems of economic growth and development preferable to state-operated, semi-socialist programs. There have been radical changes in Europe, where massive deregulation of financial markets in the United Kingdom and several other countries has occurred, and where the Single Market Act and Economic and Monetary Union initiatives of the European Union (EU) promised sim-

ilar effects on European business and finance. Deregulation in Japan has (rather more gradually) freed vast sums of capital to seek investment overseas and to create active global securities markets in Tokyo.

Most large businesses are now effectively global, especially financial businesses. Banking and capital market services have proliferated, and numerous new competitors have emerged on the scene—many of which are not banks at all. Indeed, some, like General Electric Capital Services, are customers of (and suppliers to) banks. New regulations are constantly being introduced and old ones changed. Telecommunications provides an ease of access to information that separated banks from their clients, pushing much of today's business into trading markets in which advice and service are less valuable than the latest quotation posted by securities and foreign exchange traders. It is a time of great and widespread change, affecting everyone. It is a time of massive restructuring for all financial service firms.

This book attempts to wade into the chaos and confusion of today's global banking and capital market environment and strip out the central parts of it, so that each can be examined separately. The purpose is to gain a better understanding of the evolution of international banking and finance, the services represented in today's market, the competitive processes involved, and the impact these have on the prominent public policy issues of the day.

Evolving Competitive Strategies

Our main emphasis is on the issues of formulation, implementation, and evaluation of competitive strategies (that is, strategies that succeed because they are ultimately shown to be competitive) of banks and capital market institutions. Each financial services business will have to reformulate its own global competitive strategy over the coming years. There is no single strategy that will work for all. Indeed, there are so many different types of firms, from different countries and possessing different strengths and weaknesses that an enormous variety of different strategies are likely to result. Our effort in this book is aimed at making clear the process of strategic determination in this period of enormous change, with its inescapable requirement for rethinking how individual business fit into the totality of global finance—rending that process more understandable to students of the subject and to practitioners.

Notes

1. Will Durant, *Caesar and Christ* (New York: Simon and Schuster, 1948), pp. 79–80.

2. Harold Mattingly, *Roman Imperial Civilization* (Garden City, N.Y.: Doubleday Anchor Books, 1957), p. 229.

3. Barbara W. Tuchman, *A Distant Mirror* (New York: Alfred A. Knopf, 1978), pp. 37–38.

4. Ibid.

5. Henry Pirenne, *Economic and Social History of Medieval Europe* (London: Routledge and Kegan Paul, 1936), pp. 47–168.

6. Ibid.

7. Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: Henry S. King, 1873), p. 7.

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I

COMPETING IN GLOBAL DEBT AND EQUITY MARKETS

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2

International Money and Foreign Exchange Markets

International money market and foreign exchange transactions deal with the issuance and trading of money market instruments in various currencies outside domestic markets. As long ago as the fifteenth century, organized international money and foreign exchange markets existed. Merchants in Italy, for example, wanting to import tapestries made in Belgium from wool produced in England, had to find ways to finance transactions that occurred outside their own country. Italian banks, such as those run by the Medici, set up foreign branches to effect payments and arrange for the delivery of the goods on behalf of their clients. The banks had to deal in currency exchange and in deposit collecting and lending in other countries and states. These activities have continued throughout the nearly 500 years of modern banking history. The past 30 years have been especially marked by new developments, growth and change. These include Eurocurrencies, Euro-CDs and Euro commercial paper, floating rate notes, note issuance facilities, revolving underwriting facilities, and many others.

Origins of Eurocurrencies

The history of the international money market, since its modern (postwar) rebirth in the 1960s, is a confluence of three parallel and mutually influential events: (1) major changes in the international monetary system, (2) the evolution of a large international investor base, and (3) continuing deregulation of domestic capital markets in major countries to align them with competitive international alternatives to domestic financing vehicles.

At the end of World War II, the capital markets outside the United States were virtually nonexistent. In 1944, the Allied Powers agreed to a

postwar international monetary system at Bretton Woods, New Hampshire, in which the dollar would be the principal reserve currency (i.e., used as reserves by other countries). The dollar was to be pegged to gold, at the rate of $35 per ounce, and all other currencies were to be fixed to the dollar. When balance of payments difficulties arose, it was understood to be the obligation of both the deficit and the surplus countries to modify their domestic fiscal and monetary policies to reduce the problem. Governments periodically intervened in foreign exchange markets to help the process along, and they usually relied on broad economic policy changes to affect adjustment. If the imbalance could not be redressed after suitable effort, the currency's exchange rate could be reset to the dollar, after which it would have to be defended at the new rate. To make the system work required a world in which the principal economies were growing at about the same rate and shouldering the world's military and other burdens equally. It also required, at the national level, strict economic discipline and controls and a voting public that refrained from blaming others for its problems and understood that it was necessary from time to time to take bitter medicine in the interest of the country's health over the long run. These conditions were not commonly found in the 1950s and 1960s, any more than they are now.

In 1971, after several years of large U.S. balance of payments deficits, the Bretton Woods system collapsed. It was replaced by a floating-rate mechanism, in which all currencies were to be priced continually by the market and economic imbalances would generate corrective pressures on exchange rates. The mechanism obviated the need for capital market controls that restricted cross-border transfers, as harsh policies were no longer necessary: the market would administer the medicine that countries were unable to administer themselves. In time, all of the major industrial nations removed their controls on international capital movements. By the early 1980s, users and providers of capital could look overseas for capital market opportunities that were superior to what was available at home. It also meant, however, that interest rate and exchange rate volatility would be much greater in the new floating exchange rate environment than in the old fixed-rate regime. As we see later in this chapter, increased volatility led to great opportunities for banks and other market makers to expand trading activities and hedging strategies.

The postwar investor population was affected by these events, and by the rapid institutionalization of markets in the United States, the United Kingdom, and some other European countries. There was also a large increase in the population of otherwise law-abiding Europeans who wanted to transfer funds into foreign bank accounts that were beyond the scrutiny of tax authorities in their home countries. Additionally, government officials, people engaged in capital flight, and shady characters of various kinds were accumulating irregular or illegal funds in tax haven countries. The institutional investors were not subject to tax concerns, but they were sophisticated asset-allocators looking for underpriced investments. Individu-

als, mostly investing through banks in Switzerland, Luxembourg, and other European centers, were highly focused on preserving their anonymity. Together, these investors were looking for opportunities that were not available in the United States. Eventually, local corporations, European subsidiaries of non-European companies, central banks, and other financial institutions discovered that they could deposit dollars they had accumulated outside the United States with certain banks in London that would retain them as dollars and pay dollar interest rates.

Eurodollars First

Thus was born the "Eurodollar," which was simply a dollar-denominated deposit in a bank or branch located outside the United States. Such deposits were beyond the U.S. regulatory umbrella so that neither liquidity reserves nor deposit insurance premiums had to covered. Original depositors included the financial arm of the Soviet Union and other East-bloc states wanting to hold dollars but avoid placing their holdings in the United States. Additional dollars were accumulating in Europe as a result of increased economic growth and investment, and the increasing U.S. balance of payments deficits, with many central banks preferring to hold dollars, but not in the United States. Eurodollar investments could be made in the form of bank deposits. Eurodollar interest rates were related to U.S. domestic deposit rates, but only loosely at first—interest rate differentials of 100 basis points or more were not uncommon. Such disparities encouraged American banks to arbitrage the market. Despite the lower deposit rates, depositors were happy to use these accounts to avoid the costs of transferring the money back and forth across the Atlantic and also to avoid disclosing information about themselves and their financial affairs to U.S. authorities. In time, a small group of Eurodollar banks set deposit and lending rates for the market and established the convention of a daily posting of a London Interbank Offered Rate (LIBOR). This was the rate at which banks would lend Eurodollars to each other and is the rough equivalent of the federal funds rate in the Euromarket—the rate a major bank will offer for a loan to another major bank for a specified maturity, such as 30 or 60 days.

Major banks post their own rates daily. The rate to be paid on a deposit from another bank is expressed in terms of the London Interbank Bid Rate (LIBID). A nonbank borrower can expect to pay a premium over LIBOR (e.g., LIBOR + ¼%), and a nonbank depositor would receive a rate reflecting a discount (LIBID − ¼%). The spread between these rates, LIBOR and LIBID, has generally been about ¼% or less, much less than the difference between U.S. prime rate and passbook deposit rates. Without this spread, Euromarkets could not exist. Generally speaking, neither depositors nor borrowers would be enticed to leave their home countries unless they receive a higher deposit rate or lower loan rate abroad. Deposit and lending rates are for customers closely tied to LIBOR, which is quoted in most

Table 2-1 London Interbank Rates

Aug. 1	Short Term	7 Days' Notice	One Month	Three Months	Six Months	One Year
Euro	4 9/16–4 1/2	4 9/16–4 15/32	4 17/32–4 7/16	4 15/32–4 3/8	4 3/8–4 1/4	4 9/32–4 1/8
Danish krone	5 1/8–4 5/8	5 1/16–4 3/4	4 15/16–4 13/16	4 27/32–4 11/16	4 11/16–4 9/16	4 5/8–4 15/32
Sterling	5 1/4–5	5 5/16–5 3/16	5 5/32–5 3/32	5 5/32–5 3/32	5 5/16–5 3/16	5 7/16–5 5/16
Swiss franc	3 1/2–3	3 9/32–3 7/32	3 5/16–3 3/16	3 3/16–3 1/8	3 1/8–3 1/16	3 1/16–2 15/16
Canadian dollar	4 1/4–4 1/8	4 7/32–4 3/32	4 7/32–4 1/16	4 3/16–4	4 3/16–3 15/16	4 5/16–4 1/8
U.S. dollar	3 29/32–3 13/16	3 27/32–3 3/4	3 3/4–3 5/8	3 5/8–3 17/32	3 5/8–3 17/32	3 25/32–3 21/32
Japanese yen	1/8–1/32	1/8–1/32	1/8–1/32	1/8–1/32	3/32–1/16	5/32–1/16
Singapore dollar	2 1/4–2	4 7/32–4 1/32	3 1/8–2 29/32	2 21/32–2 15/32	2 9/16–2 11/32	2 17/32–2 11/32

Note: Short-term rates are called for the U.S. dollar and Japanese yen; others have two days' notice.

Source: *Financial Times*, August 2, 2001, p. 23.

major currencies. Newspapers such as the *Financial Times* of London publish averages of these posted rates daily as shown in Table 2-1.

Other Eurocurrencies

Banks also quote rates for loans and deposits in other currencies, which in a way they manufacture synthetically. They do this by adding the cost or benefit of a forward foreign exchange contract for the prescribed maturity in the desired currency to the U.S. dollar LIBOR rate. If a customer wants a loan based on 60-day sterling LIBOR, the bank first acquires the required amount of sterling in the spot market. The bank then sells sterling forward against dollars for delivery in 60 days, and the cost or benefit of this transaction (in percentage) is added to the dollar LIBOR cost.

The Eurocurrency market has formed an informal, unregulated, over-the-counter market made up of banks and other professional dealers from around the world transacting in instruments not available in national markets. Occasionally, the Eurocurrency market would devise a financial instrument that would attract a large volume of activity on the part of nationals in various countries. Soon the pressure to deregulate domestic markets to make the same type of financing available became too great for officials to contain. Often involuntarily, most countries have had to give in to the process of imported innovation. The result was a large increase in the number and type of financial instruments available in international markets.

Euromarket participants have tended to be very sophisticated. They understand investment opportunities around the world, foreign exchange effects, and derivative instruments such as warrants and options to purchase or sell securities. With approximately 500 international banks and investment banks involved in the market, it is highly competitive. Indeed,

many firms compete on the basis of innovation and bold initiative. As a result, the Euromarket saw the first significant use of the floating-rate note, the dual-currency bond, the zero coupon bond, the warrant-bond, the swapped foreign currency bond, the first ECU (European currency unit) and euro-denominated securities, and a variety of other new ideas. It also saw the first use of the "bought deal," an issue fully underwritten by one bank; the "tap" issue (sold on demand, not all at once); and the "note-issuance facility" for distributing "Euro-commercial paper." More recently, the Eurobond market has begun to accept some of the more complex and controversial products of the U.S. bond market, such as asset-backed issues and non-investment-grade or "junk bonds."

Eurobond Markets

Banks, especially U.S. banks, were eager to build up their eurodollar deposits as a source of funding for their growing international activities. The deposits could be used to fund eurodollar bank loans or loan participations. They could be lent to branches in the United States to support lending activity there, if and when the rates were right. And they could serve as a means of diversifying the banks' wholesale source of funding for its overall deposit base. Investors were other banks (there were more than 400 foreign bank branches in London in 1980, all looking to "buy" assets in the interbank market), multinational institutions, and corporations with temporary funds to invest.

The Eurobond market has been a constant source of innovation, with new instruments being introduced as soon as changing regulatory environment or investor preferences dictated. The first Eurobond was offered in 1963 and was sold to investors who were willing to extend their investment horizon to 15 years, at somewhat higher rates. Eurobonds were in "bearer" form (identity of purchaser not disclosed) and were free of withholding taxes on interest. Inevitably, Eurobonds were introduced in other currencies besides the dollar. The Eurobond market soon took off on a continuous expansion that has made it into one of the world's principal sources of finance. We discuss the Eurobond market extensively in chapter 3.

Money Market Instruments

The money market, however, developed much more slowly than the Eurobond market. In part this was because, in the Euromarket, well-known international banks had a lock on the market for short-term funds. The banks were also prepared to offer CDs of whatever maturity an investor might wish. Mostly, there was little demand for trading these instruments. The investors were happy to hold them to maturity unless a special requirement to sell them arose.

Once established, however, the market grew. The various instruments

now available (directly or through simultaneous swaps) in most major currencies, constitute a family of Eurosecurities that makes up a broad and diverse money market. The volume of outstanding paper in these instruments, as well as the secondary market trading in them, has increased steadily, as shown in Table 2-2. At the end of 2001, approximately $2 trillion of such securities (exclusive of bank CDs) were outstanding.

The following is a description of the different international money market instruments traded in the Euro money markets.

Euro Certificates of Deposit

Euro certificates of deposit (ECDs), like domestic CDs, are time deposits in a bank. They are issued in countries outside the home country of currency by banks directly or through dealers or brokers. Like Eurobonds, they are issued in bearer form and are free from withholding tax on interest. In 1961, Citibank devised the first transferable ECD. This was a major innovation that soon encouraged secondary market trading in dollar instruments eventually and led to the creation of the Euromoney market. Although banks do not always want their paper traded in the secondary market, especially when they are issuing new paper that could compete with their older issues in the secondary market, they have bowed to competition. Banks prefer to sell their own ECDs to their clients and correspondent relationships, but often, to extend the market and increase the volume of ECDs outstanding, they resort to dealers to sell the paper for them, for a modest commission. The banks post their own rates for a spectrum of maturities. Banks will often negotiate with large customers for special rates for CDs with custom-made maturities or other terms. A bank's posted rates may be slightly higher or lower than rates posted by similar banks, reflecting its greater or lesser desire to take in funds at particular maturities. Such decisions are made by the bank's treasury department, which has to balance the entire bank's requirement for funds and currencies at particular maturities. For most banks, the treasury function in the London branch will conduct most of these Euro-funding operations, generally in close contact with the central office.

The secondary market in ECDs is very active. Banks maintain markets in their own CDs and encourage their customers to trade with them. As rates change, banks will either increase their issuance of ECDs or attempt to buy in outstanding paper. Brokers may work with the banks as agents, on a nonexclusive basis, to place or buy in ECDs for a commission of a few basis points. Such brokers do not take positions in the bank's ECDs for their own account. Often the brokers represent investors seeking the best rates for deposits. Dealers, in contrast, purchase and sell bank ECDs for their own account. They hope to create opportunities for gains from trading in the ECDs, as they would in any money market instrument. Dealers will call the bank in the morning and offer to buy or sell ECDs at particular rates. Then they lay off their positions to customers or hold them

Table 2-2 *Volume of European Money Market Instruments Outstanding (amounts outstanding at year end, $ billion)*

	Market Opening	1986	1990	1995	1996	1997	1998	1999	2000	2001	Compounded Growth Rate
Euro commercial paper and other short-term notes (NIFs and RUFs)	Mid 1980s	44.1	89.4	132.5	171.6	183.9	194.5	249.6	333.8	397.2	14.7%
Euro medium-term notes	Mid 1980s	0.4	21.9	461.3	662.5	736.7	925.5	1,228.9	1,573.1	1,736.3	55.83%
Total		44.5	111.3	593.8	834.1	920.6	1,120.0	1,478.5	1,906.9	2,133.5	25.82%

Source: Bank for International Settlements, International Banking and Financial Market Developments, Tables 13 and 14, various issues.

for a few days to wait for an expected market change to occur. Large dealers offer ECDs along with a complete menu of other Euromoney market instruments to customers on a continuous basis.

As an example, a dealer such as Citigroup might be aware that Mitsui Life Insurance Company is seeking to place $100 million in high-grade short-term investments tomorrow morning, Tokyo time. Mitsui actually wants the investments to have a maturity of 75 days. The posted rate for 60-day ECDs might be 4% and for 90 days, 4.3%. Citigroup will call a dozen or more high-grade banks during the evening before the next day's opening in Tokyo to offer to buy 75-day ECDs at a rate of 4.25%, in order to offer them at, say, 4.20% to Mitsui Life. Many banks will turn Citigroup down, but one or two may have a need of their own for a large placement of 75-day ECDs and thus be willing to pay the somewhat higher rate. Such intense market coverage, together with the willingness of dealers to position paper of all types, has greatly improved the efficiency of the Euromoney market in recent years. The improving efficiency of the market largely explains its rapid growth since the early 1980s.

Floating Rate Notes

In the 1980s, many banks began to offer floating-rate notes (FRNs) as a supplement to their funding activities. These notes were not deposits and therefore were subordinate to them. The FRNs might have a maturity of 10 years, but interest would be reset every 90 days at three-month LIBOR (say, 4.5%) plus a small spread (say, ⅛%). Because of the continuous resetting, the price of the notes was expected to return to par (100%) every 90 days, assuming that the reissue rate continued to be LIBOR + ⅛%. An investor was now given a choice between 90 day ECDs (say, at 4.3%) and purchasing and reselling an FRN 90 days later at a rate of 4.625%, a difference of 32.5 basis points. The investor would have to realize that there was a risk that the FRNs could not be sold at 100% 90 days later, so part of the 32.5 basis points would represent a reserve to protect against selling it at a price below par, plus commissions. The investor might ask a dealer to quote it a repurchase rate at which the firm would agree to buy the FRNs back 90 days hence. If a positive spread still existed (and the investor was willing to take the credit risk of the dealer meeting his obligation 90 days later), the investor might prefer the FRN trade to the ECD. However, the investor may prefer to remain a depositor in the bank, rather than a general creditor, and therefore accept a lower rate for the increased security.

To some extent, therefore, the FRN market has traditionally competed with the ECD market. As fear about the credit quality of banks emerged in the early 1980s, however, there was less assurance about the ability of bank's to roll over funding at the same spread over LIBOR, and the FRN market weakened considerably. So did the market in ECDs, relative to other instruments.

Euro Commercial Paper

Commercial paper (CP) constitutes short-term unsecured notes issued by a corporation. CP has been issued actively in the United States since the 1860s, but it first appeared in Europe only in the early 1970s. It was aimed initially at U.S. corporations, which were required at that time by government regulations to finance all overseas investments with foreign borrowings, to provide a money market alternative to bank borrowing. The effort was not successful, despite the advantages of Euro commercial paper (ECP) over domestic CP. For example, U.S. CP is limited by law to borrowings up to 270 days and can be used only for working capital. Furthermore, it is subject to income tax withholding on interest and is issued in book-entry form. ECP, by constrast, is exempt from maturity and use-of-proceeds restrictions, is not subject to withholding taxes, and is offered in bearer form. Thus a substantial difference exists between domestic CP and ECP denominated in dollars. Often the difference results in an interest rate differential. Commissions and set-up expenses added costs when the ECP market was first established, however, so that the cost of funds to the issuer was about the same as the cost of a comparable LIBOR-based bank loan. Moreover, Euro market investors were cautious. They were hesitant to buy the paper of companies that were not already well known and unimpressed by the limited liquidity in the market. Investors were extremely quality conscious at a time when limited international investment-grade rating information was available. Unlike domestic markets, the U.S. and European governments did not offer short-term securities internationally, so investors had to make do with the banks and other corporate issuers that they knew.

In 1974, the regulations requiring U.S. companies to finance overseas were repealed, and the market died away. The economics were simply not there: there was very little benefit to using the market at the time.

If they were prepared to go out a bit in maturity, investors could buy outstanding or newly issued Eurobonds of high-grade, well-known issuers, including some major European governments. The issuers began to shorten the maturities of their bonds (e.g., to two or three years in some cases) in order to attract these investors, as well as to avoid the extremely high longer-term interest rates of the late 1970s. As trading volume increased in the secondary markets, investors began to accept that they could rely on the liquidity in the market to facilitate a sale of Eurobonds before maturity.

Eurobonds, however, had certain characteristics that limited the flexibility that many issuers wanted. The bonds were of a fixed amount, underwritten, and sold all at once, and they involved considerable expense, which became quite concentrated as the average maturity of the bonds was reduced. Some issuers instead preferred continuous offerings of their paper to the market on a non-underwritten basis. They wanted to simply post rates for a range of different maturities, based on advice from one or more dealers, and then see how many notes the dealers could sell. They could

raise or lower the rates based on demand. This is the mechanism used in the U.S. commercial paper market, and in the early 1980s it was applied to the Euromarket in a second attempt to develop a market for ECP.

The second attempt met with greater success. This time the initiative was aimed at bank investors that needed higher and safer returns on their money market investments. Potential clients also included corporate and institutional investors, who were increasingly concerned by the deterioration in bank credit ratings in the United States and wanted to diversify their cash management programs into nonbank investments. Dealers, aware of these concerns, began to approach European money managers with proposals that they switch from ECDs or FRNs to ECP of "name" companies like GE or Exxon. They were only earning 25 basis points less than LIBID from their bank deposits, but they could diversify into higher grade paper, such as that issued by companies with AAA bond ratings at, for example, LIBID less 10 basis points. Or, if they were prepared to take corporate bond ratings of AA or A (with top-grade U.S. commercial paper ratings of A1 and P1), they could look for a higher rate—for example, the mean between LIBID and LIBOR.

In 1985, as bank credit worries increased, and a greater supply of nonbank paper was offered, the market began to develop in earnest. As it did, the recognized rating agencies, Moody's and Standard and Poor's, increased their involvement in ECP ratings, and investors became more aware of them. To be rated, issuers had to be able to demonstrate that they had unused bank lines of credit available to provide liquidity to an issuer should a major market interruption occur in which it would not be possible to roll over maturing ECP. Committed credit facilities in same-day funds, called "swinglines," must be in place to cover a few days of the maturities, with "backup" lines, often uncommitted, available for the rest of the maturities.

Unrated paper soon required up to 10 basis points higher interest rates than lower rated (A2, P2) ECP, which itself required 5 to 10 basis points more interest than A1 and P1 rated paper. Ratings became increasingly important after several major defaults in 1989 to 1990. By 1990, the ECP market had increased to about $70 billion of outstanding issues. Citibank, a major ECP dealer, estimated at the time that banks comprised about 44.7% of the investor market, corporations 27.8%, and money managers and financial institutions 27.5%. Among the banks were those which managed substantial investment funds for their clients.

From the issuer's point of view, ECP provided cheaper funds because the market was pricing it and the issuer did not have to pay significant commitment fees to banks. Accessing the ECP market permitted an issuer to tap into the main investor base in the Euromarket and represented a diversification of the issuer's sources of funding.

Dealers initially were enthusiastic about the rapidly expanding ECP market. They wanted to assist existing and new clients for Euromarket services, to appear well placed in the competitive rankings (league tables) and to profit from the growth in the new market. Intense competition

forced spreads down, squeezed commissions, and spread too many programs among several dealers. Profits were hard to come by. Of the top 10 dealers at the end of 1987, four (Merrill Lynch, CS First Boston, S.G. Warburg, and Salomon Brothers) had withdrawn from the market by the end of 1990. Subsequently, competitive conditions settled down into a rated-only market with fixed commissions of 3 to 5 basis points paid by issuers to dealers.

ECP market developments also affected domestic markets. By the mid 1980s, it was possible for issuers to swap dollar-denominated commercial paper into paper denominated in any other major currency. Thus a market grew in "synthetic" Euro-DM, Euro-sterling, and other Eurocurrency commercial paper, including the predecessor to the Euro, the ECU. Such paper began to appeal to issuers from various European and other countries, and this, in turn, put pressure on local regulators to permit the development of domestic CP markets in several countries, such as Japan, Germany, Britain, and France, that had never had commercial paper markets before. Table 2-2 shows the growth in ECP outstandings from 1989 to 2000.

The development of the ECP market has been one of the more significant innovations in international finance during the past two decades. The market developed to fill a need by international investors for a spectrum of bearer money market paper that was free from withholding and other taxes. Gradually, the spectrum widened to include lesser-quality names, including some speculative Latin American issuers that were appropriately priced by the market. The new market was successful enough to generate further innovation, standardized documentation, and (in time) mature pricing and distribution methods. Its reach extended into note issuance facilities and medium-term notes (MTNs; discussed later in this chapter) and stimulated the development of domestic CP markets almost immediately all over the world. These impressive achievements are examples of the fungibility of money in a marketplace in which capital movements are not restricted and transactions flow to where they may be most efficiently effected.

NIFs and RUFs

Meanwhile some of the large wholesale banks began to see ECP as a threat to their basic business, providing short-term credit to major industrial and government borrowers. As their clients moved into ECP, they left their bank loans behind. Although the banks furnished the backup credit lines and swinglines needed to access the ECP market, the profitability of these facilities was small in relation to customary bank loans. Banks began to fear a repeat of their experience in the United States, in which the commercial paper market grew rapidly at the expense of bank lending.

To remain competitive in offering short-term credit to their customers, the banks introduced a family of revolving credit facilities, called note issuance facilities (NIFs). NIFs allowed clients the choice of drawing down

a loan at an agreed spread over LIBOR or selling notes (ECP) through the banks at a lower rate. Clients saw NIFs as a souped-up version of an ordinary ECP program, in which all of the benefits of ECP were retained while still securing the benefits of a committed bank facility. Competition among banks for NIFs resulted in a tightening of the market. Fees (a one-time fee for arrangement, and annual fees for participation and commitment) were squeezed, as were the lending spreads over LIBOR on loans drawn down under such facilities.

A NIF works as follows. An issuer enters into an agreement with a bank for a $200 million revolving credit facility for, say, seven years. The lead bank syndicates the facility with other banks, according to the normal syndication process described in chapter 5. Funds drawn down under the facility can be repaid at will, without penalty. The issuer agrees to obtain commercial paper ratings, which in this case we can assume are A1 and P1. If the issuer decides to draw down $100 million for six months, probably to roll it over continually, it has two choices. The issuer notifies the bank that it wishes, as of a prescribed date, either to take down a six-month loan at the rate provided in the loan agreement, say LIBOR + ¼%, or to issue promissory notes in ECP form to a predetermined group of banks and dealers (usually led by the NIF's arranging bank) at whatever rate the dealer group may offer for distribution to investors. If an ECP alternative superior to the bank loan does not materialize, the banks are obligated to make the loan. Thus, for a modest set of fees, the issuer can have his cake and eat it too. That is, he can have the lower rates of the ECP market, and the guaranteed assurance that funds will be forthcoming, regardless of market conditions.

NIFs come in various forms and with different features. The principal difference in form is in the method by which the ECP market is accessed. Most NIFs have "tender panels"—a group of banks and dealers selected by the lead bank (and the issuer) who are obligated to bid for the ECP at an auction to be held when the notes are issued or to be renewed. Another approach is through a revolving underwriting facility (RUF), which differs from a NIF mainly in using a designated placement agent(s) to distribute the notes at market rates. Members of the tender panel and the placement agents can bid whatever rates they want, so their role is largely best efforts, but they can be replaced by the issuer if they fail to perform satisfactorily. The idea is, however, to get enough competent dealers to participate so that the auction process will result in bids that will provide money market rates to the issuer. As discussed earlier, money market rates for ECP may be substantially less than the lending rates offered by banks. In an aggressive market environment, the issuer described here may be able to receive bids of $100 million of ECP at a rate of LIMEAN (halfway between LIBOR and LIBID) or less, thus saving ⅜% to ½% on the alternative bank loan. If the annualized fees are no more than the normal 10 basis points or so, the issuer is still well ahead of the game. Figure 2-1 illustrates the Euronote issuance process.

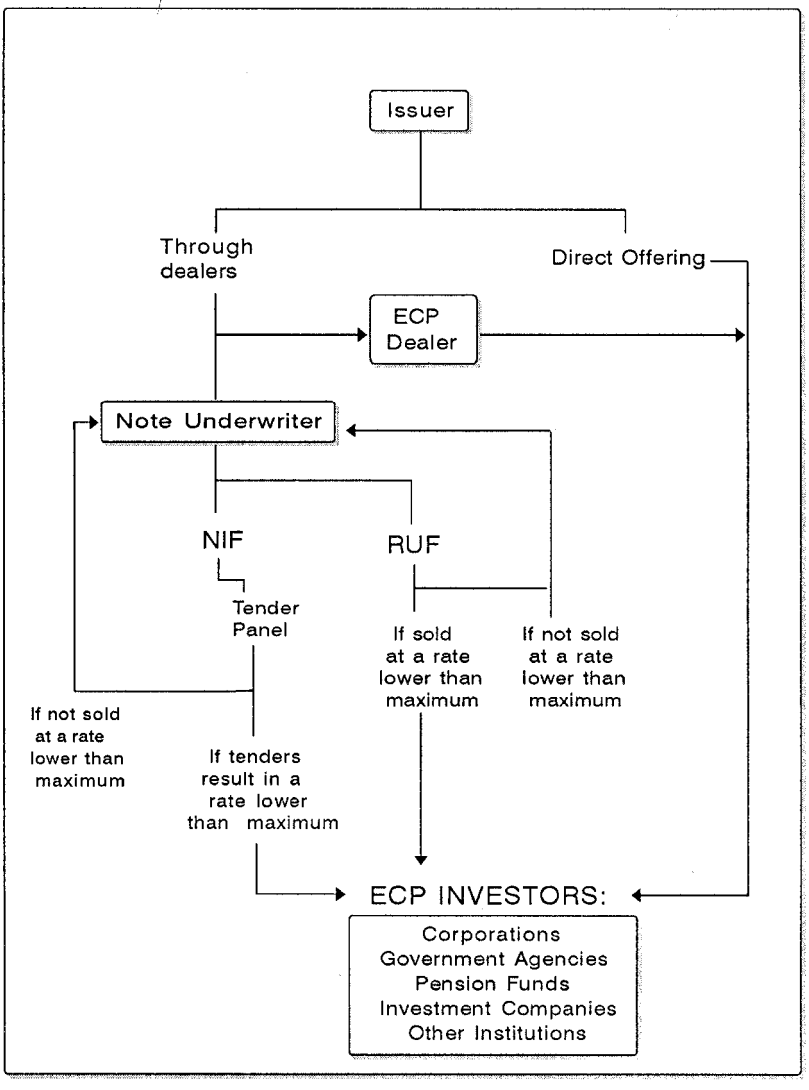


Figure 2-1. Euronote issuance process. ECP = eurocommercial paper, NIF = note issuance facility; RUF = revolving underwriting facility.

Well-known, highly rated issuers may decide to forego the underwriting feature offered by NIFs and rely on their ability to continually resell maturing ECP. Such issuers save the arrangement and participation fees charged by the banks, but they must still pay something for backup and swinglines. Over the years, the market has developed efficient pricing for the underwriting function.

A variety of additional NIF features have been introduced by innovative banks since the mid-1980s. Among these are the ability to use NIFs

more comprehensively—that is, for notes issued either in the U.S. commercial paper or the ECP market, for nondollar denominations of drawdown or rollovers, and for bank letters of credit to be used to provide credit backing for issuers who are unable to obtain satisfactory ratings. "Tap" features have also been provided to allow notes to be issued frequently in small amounts to satisfy dealer demand. Such issues can involve "continuous tender panels" in which the placement agent announces daily a rate level at which all bids will be accepted. Aggressive dealers will bid below that rate to be sure to obtain some of the paper being auctioned.

Large U.S. commercial paper issuers, especially those issuing directly (without dealers) often use the tap issue method to obtain the best rates and to spread maturities widely. Direct issuers in the United States account for more than half of all U.S. commercial paper outstandings. Direct issuance is much less common in the ECP market, but, increasingly, large issuers are resorting to self-underwritten tap issues to achieve the most efficient use of the market.

Euro Medium-Term Notes

Next in the continuous evolution of new money market products was the Euro medium-term note (EMTN), which followed in the wake of an expanding ECP market and the development of enhanced market activity for medium-term notes in the United States. EMTNs cover maturities from less than 1 year to about 10 years. They were issued, like Eurobonds, by large corporations and by governments and their agencies from all around the world. Though EMTNs had longer maturities, they retained some of the characteristics of commercial paper. EMTNs offer an extension of ECP market practices over greater maturities and have had the effect of erasing the traditional boundaries between the short-term money market and bond markets.

MTNs have been available in the United States since the early 1970s, but initially they were limited in use because of registration requirements and a lack of a well-developed investor base for one- to five-year maturities. The introduction in 1984 of Rule 415, providing for "shelf registration" in the U.S. market, made it possible to offer MTNs continuously in the public bond market. Distribution was through dealers or directly by large issuers such as General Motors Acceptance Corporation. Increased volatility in the fixed-income securities market, the steep yield curves prevalent in the 1980s, and the increasing sophistication of fixed-income traders attracted many investors to MTNs in the mid-1980s. Further innovations in product design by dealers and issuers—such as offering floating-rate as well as fixed-rate returns, deep-discount zero coupons, and multicurrency options—made the MTN into a highly flexible and desirable investment vehicle. The domestic U.S. MTN market matured during the period 1988–1992, during which new issue volume rose from $38 billion to $192 billion; in 2001 it was $430 billion.

This growth was largely because of the flexibility that MTN programs offer to large, frequent borrowers, which in the Euromarket tend to be sovereign governments and multinational institutions such as the International Finance Corporation (an affiliate of the World Bank) or the European Bank for Reconstruction and Development (EBRD). Such borrowers have continuous financing requirements and use the full spectrum of the yield curve to obtain it. Changes are frequently made in their borrowing "strategies," which result in changing the maturities of outstanding liabilities to pursue opportunities for lower funding costs or to hedge against expected interest rate or foreign exchange movements. In considering how to obtain the lowest overall cost of borrowing, such issuers must also consider the cost of issuance. EMTNs involve very low documentation costs and standardized legal documentation, and they may be issued on a continuous non-underwritten basis in which the issuer only pays a commission of a few basis points or distributes the notes itself.

In a normal Eurobond offering, an issuer must pick a time, an amount, and a currency and then auction the bonds off to the highest bidder—that is, at the lowest interest rate. The issue will be large enough (typically $200 to $300 million) to satisfy financing requirements for at least several months, and it will involve payment of underwriting and placement commissions to an underwriting group. In an EMTN program, the issuer announces to the market a program for the issuance of debt securities (PIDS) through continuous offerings over an extended period during which it hopes to raise up to a maximum amount of funds, often as much as several billion dollars. A document similar to a U.S. Rule 415 shelf registration provides details of the program, and a one-page supplement is produced when securities are issued under it. The program is rated by the agencies, and sometimes a road show is put together to inform potential investors about the issuer. When the program is ready to go, the issuer can bring out large "tranches" (say $200 to $300 million each) under normal Euromarket underwriting methods or resort to tap issues, or both. The issuer can post rates or have dealers post them, at which it is willing to take all offers. Alternatively, it can auction them off one day at a time, in any eurocurrency it likes. If the market fails to take the paper at a maximum rate and the issuer has a NIF, it can require its syndicate of banks to take it. If the U.S. market is cheaper, it might go there if a shelf registration is in effect. There are a great many options.

Treasury Securities

International money markets also include domestic short-term securities that are purchased by international investors. Mainly such investors are interested in government (treasury) bills and notes because of their liquidity and high quality. These securities are available in all industrialized countries and many less-developed countries. Except during brief periods when foreign exchange markets are in turmoil pending some sort of currency re-

alignment, foreign investors rarely comprise more than a nominal percentage of the investment demand for domestic government securities. It is true, however, that foreign buying can be concentrated for a time on single auctions of newly issued paper. During such episodes, foreign demand can have a significant effect on the price of the paper being sold. Nonetheless, such concentrations of buying (or selling) power rarely last very long.

Investors acquire foreign treasury securities for essentially two reasons. One is to take a position in a liquid instrument that is subject to an expected price change because of changing interest or exchange rates. Such investments are "uncovered," or unhedged, positions. The investor *wants* the risk that the euro will increase in value relative to the dollar and that foreign "speculators" will bid up the price of German treasury securities, which are denominated in euros. The other reason is to take a "covered" position, through which the investor might pick up several basis points of yield. If the investor can buy a six-month German treasury bill, which, when swapped from euros into dollars, yields more than six-month U.S. Treasury bills, he or she may be better off. A well-informed investor will scan the world's treasury and swap markets frequently looking for such opportunities. For a start, the investor can consult the daily posting in the *Financial Times* of world "money rates" shown in table 2-3. These rates reflect the secondary market prices for Treasury bills in the various cities (i.e., countries) indicated.

Wholesale banks in most countries are very actively involved in domestic and international treasury securities. A substantial portion of the large volume of trading profits reported by large U.S. commercial banks come from trading in U.S. government securities. Originally, these banks entered into the business to provide services to customers and to effect their own transactions in the government securities market. Later, trading for the banks' own accounts became a major business. The substantial market liquidity and the wide range of securities available make these securities ideal for trading. Large universal banks in most European countries and large investment banks also trade extensively in the government securities markets of several countries, often serving as a registered market-maker. Several foreign banks are registered primary market dealers in U.S. government securities.

Effect of the Euro on International Money Markets

By converting their currencies into euros, the 11 original euro-zone countries automatically established a large and liquid market in the new currency. This action generated an interest by non-Europeans in holding euros. Although the euro performed poorly against the dollar from its launch at the beginning of 1999 through 2001, several portfolio shifts were expected. Nonparticipating European countries and non-European central banks would invest a portion of their reserves in euro-denominated investments. Moreover, major European institutional fund managers would adjust their

Table 2-3 Example of Money Rates Table

Official Rates

Aug 1	Rate	Current	Since	Last	Month Ago	Year Ago
U.S.	Fed funds	3.75	06-27-01	4.00	4.00	6.00
Europe	Repo	4.50	05-10-01	4.75	4.50	4.25
U.K.	Repo	5.25	05-10-01	5.50	5.25	6.00
Japan	Overnight call	0.00	03-19-01	0.15	0.00	0.15
Switzerland	LIBOR target	2.75–3.75	03-22-01	3.0–4.0	2.75–3.75	3.0–4.0

Interest Rate Futures

Aug 1		Open	Sett	Change	High	Low	Est. Vol.	Open Int.
Euribor 3m*	Sep	95.75	95.76	+0.01	95.77	95.74	78,102	429,310
Euribor 3m*	Dec	95.95	95.95	+0.01	95.97	95.94	61,576	341,635
Euribor 3m*	Mar	96.06	96.06	—	96.08	96.05	52,475	296,965
Euribor 3m*	Jun	95.90	95.96	−0.01	95.98	95.95	26,852	147,765
Euribor 3m*	Sep	95.85	95.83	−0.01	95.86	95.81	20,271	139,205
Euroswiss 3m*	Sep	96.95	96.96	—	96.97	96.95	6,240	72,429
Euroswiss 3m*	Dec	97.14	97.15	+0.02	97.16	97.12	4,044	45,772
Sterling 3m*	Sep	94.80	94.78	−0.03	94.81	94.77	17,163	162,673
Sterling 3m*	Dec	94.79	94.77	−0.05	94.82	94.76	28,835	139,685
Sterling 3m*	Mar	94.69	94.65	−0.06	94.71	94.64	34,454	135,217
Sterling 3m*	Jun	94.51	94.47	−0.06	94.52	94.46	16,099	89,811
Sterling 3m*	Sep	94.33	94.31	−0.05	94.36	94.29	5,110	71,336
Eurodollar 3m†	Aug	96.41	96.42	—	96.42	96.39	4,880	27,301
Eurodollar 3m†	Sep	96.46	96.47	—	96.47	96.45	96,044	703,360
Eurodollar 3m†	Dec	96.31	96.33	—	96.33	96.25	113,797	667,358
Eurodollar 3m†	Mar	96.18	96.19	−0.01	96.21	96.14	128,804	493,772
Eurodollar 3m†	Jun	95.88	95.87	−0.02	95.91	95.88	96,170	537,271
Eurodollar 3m†	Sep	95.53	95.53	−0.03	95.56	95.48	75,223	414,479
Eurodollar 3m†	Dec	95.16	95.16	−0.02	95.160	95.16	46,188	334,185
Fed Fnds‡	Aug	96.350	96.360	+0.005	96.360	96.350	2,267	26,826
Fed Fnds‡	Sep	96.510	96.510	−0.010	96.520	96.510	4,418	44,140
Fed Fnds‡	Oct	96.610	96.610	−0.010	96.630	96.605	4,217	23,773
Euroyen 3m‡‡	Sep	—	99.900	—	—	—	—	284,834
Euroyen 3m‡‡	Dec	—	99.860	−0.005	—	—	—	223,130
Euroyen 3m‡‡	Mar	—	99.850	—	—	—	0	120,124

Market Rates

Aug 1	Over-night	Change Day	Change Week	Change Month	One Month	Three Months	Six Months	One Year
US$ LIBOR[a]	3.90375	−0.062	+0.085	—	3.74000	3.65625	3.66875	3.79813
Euro LIBOR[o]	4.53125	−0.096	−0.009	−0.009	4.50375	4.42738	4.31600	4.21500
£ LIBOR[a]	5.75000	−0.186	+0.500	+0.042	5.24750	5.25000	5.25875	5.39500

{continued)

Table 2-3 Example of Money Rates Table (continued)

Market Rates Aug 1	Over-night	Day	Change Week	Month	One Month	Three Months	Six Months	One Year
Swiss Fr L	3.30333	+0.010	+0.022	−0.060	3.25833	3.18667	3.12500	3.03833
Yen LIBOR[a]	0.06000	+0.001	+0.001	−0.004	0.06813	0.08563	0.09563	0.11000
US$ CDs	—	—	—	—	3.55	3.39	3.35	3.50
Euro CDs	4.520	−0.080	−0.010	—	4.470	4.385	4.285	4.175
SDR Int rates	3.53	—	+0.010	−0.030				
EONIA	4.51	—	+0.060	+0.050				
EURONIA	4.5753	—	+0.056	+0.054				
SONIA	5.8914	—	+0.387	+0.247				

Sources: *LIFFE. †CME. ‡CBOT. ‡‡TIFFE; *Financial Times*, August 2, 2001, pp. 22–23. Other data sources: US & Euro CDs: dealers; SDR int rate: IMF; EONIA: ECB; EURONIA & SONIA: WMBA.

[a]Libor rates come from BBA (see www.bba.org.uk) and are fixed at 11 a.m. U.K. time.

portfolios to reflect the investment outlook that the euro-denominated instruments presented to them. There was some concern that the euro may be significantly less inflation-proof than the now departed deutschemark and that such a concern may generate higher rates, on the one hand, or greater demand for non-euro (such as Swiss franc) investments, on the other. Some economists believed that the euro could emerge as a better long-term reserve asset than either the deutschemark or the French franc. Accordingly, many investors, including non-Europeans (especially from the United States and the Far East) were anxious to take up euro positions as a part of their overall portfolio-diversification efforts. To them, a larger, more liquid market in euro-denominated securities than existed in the fragmented national markets they replaced should be welcome. Moreover, the European Central Bank (ECB) absorbed all of the reserves of the euro-zone participating countries (for all EU members, official reserves excluding gold totaled $370 billion in December 1996. Even after netting euro-zone countries' holdings of other member's currencies, this development could lead to a condition of excess reserves for the ECB.

What would be done with the surplus? Unless it were returned to the countries in the form of a cash distribution, the expectation is that the conservative European Central Bank will hang onto the surplus to provide a fund to stabilize the euro against the dollar and the yen. Might this mean a much more active intervention policy on the part of the new central bank, which would push the euro above its equilibrium level? Any interventionist activity would, however, also be of great interest to foreign-exchange speculators who are inclined to take the opposite side of the market from government operators. The euro had to fall almost 25% from its initial value of $1.17 to $0.86 in September 2000 before the ECB intervened by buying euro. In fact, the ECB has been quite reluctant to intervene, despite the large reserves and despite a further decline in the euro in 2001.

Foreign Exchange Markets

Dealing in foreign exchange has become an increasingly important activity for all international bankers and money market investors. The importance is due to the continuous increase in world trade and cross-border financial flows in support of the real economy in a time of high volatility in foreign-exchange markets. Customers of banks need assistance in managing and hedging their international cash flows, and banks have long been in the business of assisting them. In addition, funds flows in support of cross-border financial investments have increased substantially as a result of greater appreciation of international investment opportunities and easier mechanics through which to make them. Investors need to fund these investments and to hedge them from time to time. Market-making by banks in foreign exchange has been an essential and profitable service to customers in both the manufacturing and financial sectors. Finally, banks and investment banks, and some investment funds—notably hedge funds—have found dealing for their own accounts to be an attractive source of potential profits. As in most trading markets, high volume and volatility create an ideal environment for skillful participants.

Some years ago, government officials, in discussing the foreign exchange markets, referred to participants as "legitimate" commercial users versus "speculators," presumably indicating this group as being something other than legitimate. This distinction, probably never very useful, is no longer used as market practices have become better understood. All players are simply "investors." Some have mundane reasons for playing, perhaps, and others have more sophisticated ones. But they cannot be distinguished in the market, which attracts transactions of whatever kind because of changing investment conditions.

Increasing Turnover

The large and active foreign-exchange market is like any other "free" marketplace, except for one important difference: governments, through their central banks, sometimes intervene to influence exchange rates. Their purchases and sales, especially when there is international coordination, can make a significant difference in rates and (more important sometimes) in the expectation for future rates. Most nongovernment players see the government role as placing an artificial limit on price movements in one direction or another, and thus they attempt to position themselves to benefit from it. Playing against the governments, in other words, can be extremely profitable for dealers and investors, and this (during a time of significant amounts of government intervention) has helped increase the volume of turnover in the world foreign-exchange markets considerably. As of the end of April, 2001 (after the consolidation of 12 European currencies into the euro), average *daily* foreign exchange turnover was approximately $1.7

Table 2-4 Net Foreign Exchange Market Turnover ($ billion per day)

	March 1986	April 1989	April 1992	April 1995	April 1998	April 2001
United Kingdom	90	187	300	460	637	804
United States	59	129	192	240	350	253
Japan	48	115	128	160	149	147
Singapore	—	55	74	102	139	101
Switzerland	—	57	68	100	82	71
Hong Kong	—	49	61	98	79	69
Germany	—	—	57	96	94	88
France	—	26	35	85	72	48
Australia	—	30	30	35	47	52
Canada	9	15	22	28	37	42

Source: International Monetary Fund, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, various issues.

trillion. Thus, the foreign exchange market is by far the world's largest financial market, as shown in table 2-4.

Market Organization

The foreign exchange market is an informal, over-the-counter market organized into trading centers around the world. The market has no central clearinghouse or exchange, and it operates mainly through dealers. Interdealer transactions constitute approximately 75% of all trading in the major centers. The dealer market is highly concentrated, with the ten leading dealers in each major center accounting for roughly 40% of the market. Dealers sometimes specialize in only a few currencies, although some are more broadly active. Dealers make markets in a variety of foreign exchange (forex) products, including spot and forward rates, swaps, and other derivatives.

Although the foreign exchange market is unregulated, central banks are active participants and are able to keep an eye on the behavior of banks, to which regulatory controls apply, and other players from their countries. The leading center for foreign exchange trading is London, mainly because London is the center of the eurocurrency market and overlaps both the New York and Tokyo time zones. In 2000, London accounted for about 30% of global forex turnover. The United States accounted for about 19%, Japan 13%, and Switzerland and Singapore 7% each of 2000 global forex turnover.

Market Functions

Transactions in the "spot" market reflect simple buying and selling of currencies for immediate delivery. The spot rates reflect the daily exchange rates between currencies. Spot rates between various currencies comprise

"cross rates," a table of which is published in financial newspapers daily and is available on screens to market-markers in real time. "Forward" rates are spot rates plus (or minus) a "premium" that reflects the discount differential in interest rates between the currencies for the period involved. Market-makers will buy and sell forward contracts if they get out of line with covered interest parity through arbitrage transactions.

Table 2-5 shows dollar spot and forward rates, along with exchange cross rates for August 1, 2001. In addition to spot and forward rates, dealers also trade in currency swaps and currency options, futures, and customized currency derivative securities. We discuss these instruments in chapter 4.

Beating the System

As noted, dealers—on their own behalf and for the benefit of customers—often propose forex trading strategies that are intended to take advantage of the market intervention activities of central banks. Such intervention, which can be in market purchases of spot and forward contracts or in futures or options markets, can also involve resetting domestic interest rates to affect forex rates. Intervention can occur whenever policyholders of one or more countries are unhappy with the foreign exchange between their currencies and seek to adjust it. Intervention usually takes place when a currency is fixed to another. In such systems, the central bank is required to support its currency when it falls below the stated rate. Intervention can also occur in the U.S. dollar market, relative to major currencies, such as the yen or the euro, when such currencies move toward extreme values relative to the dollar. In recent years, the U.S. government has resisted intervention in order to let market forces work to effect stabilizing changes in trade flows, even at the "cost" of a weaker or stronger dollar.

During periods of currency intervention, great sums can be invested by central banks in support mechanisms, and great fortunes can be made by bold investors who invest heavily against them. Before the introduction of the euro, 12 European countries fixed their currencies to each other. In September 1992, the central banks of Britain and Germany spent approximately £50 billion in an unsuccessful attempt to support sterling. A prominent American investor (a hedge fund manager) is thought to have made profits of $1 billion from the sterling crisis. Many banks and dealers made large profits as well.

There are principally two trading strategies used by private investors during such crises. One is to sell the vulnerable currency forward for one or two months, often against the stronger currency. Large positions must be taken to make meaningful profits, because even if the weaker currency is devalued, it may not be by more than a few percent. The investor typically borrows the weaker currency and buys government securities in the stronger currency. The investor then enters into a forward contract, which does not require a cash outlay until the maturity date. When the contract

Table 2-5 Dollar Spot, Forward, and Cross Rates against the Dollar

	Aug. 1, 2001	Closing Mid-point	Change on Day	Bid/offer Spread	Day's Mid High	Day's Mid Low	One Month Rate	One Month %PA	Three Months Rate	Three Months %PA	One Year Rate	One Year %PA	J. P. Morgan Index
Dollar Spot Forward Against The Dollar													
Europe													
Austria*	(Sch)	15.6554	−0.0716	509–598	15.7027	15.5836	15.6657	−0.8	15.6871	−0.8	15.7176	−0.4	99.4
Belgium*	(BFr)	45.8956	−0.2098	825–086	46.0340	45.6850	45.9257	−0.8	45.9882	−0.8	46.0778	−0.4	98.9
Denmark	(DKr)	8.4746	−0.0392	720–772	8.5005	8.4378	8.4834	−1.2	8.5001	−1.2	8.5434	−0.8	100.6
Finland*	(FM)	6.7646	−0.0309	627–665	6.7850	6.7336	6.7691	−0.8	6.7782	−0.8	6.7914	−0.4	76.9
France*	(FFr)	7.4630	−0.0341	608–651	7.4855	7.4287	7.4679	−0.8	7.478	−0.8	7.4927	−0.4	100.1
Germany*	(DM)	2.2252	−0.0102	246–258	2.2319	2.2150	2.2267	−0.8	2.2297	−0.8	2.234	−0.4	97.6
Greece*	(Dr)	387.679	−1.7720	568–789	388.850	385.900	387.933	−0.8	388.461	−0.8	389.218	−0.4	56.9
Ireland*	(I£)	1.1161	+0.0051	157–164	1.1212	1.1127	1.1154	−0.8	1.1138	0.8	1.1117	0.4	—
Italy*	(L)	2202.94	−10.0700	231–356	2209.60	2192.83	2204.38	−0.8	2207.39	−0.8	2211.68	−0.4	72.0
Luxembourg*	(LFr)	45.8956	−0.2098	825–086	46.0340	45.6850	45.9257	−0.8	45.9882	−0.8	46.0778	−0.4	98.9
Netherlands*	(FI)	2.5072	−0.0115	065–079	2.5148	2.4957	2.5089	−0.8	2.5123	−0.8	2.5171	−0.4	97.6
Norway	(NKr)	9.1075	−0.0308	015–135	9.1199	9.0580	9.1352	−3.7	9.1934	−3.8	9.428	−3.5	94.3
Portugal*	(Es)	228.093	−1.0420	028–158	228.780	227.050	228.242	−0.8	228.553	−0.8	228.998	−0.4	89.7
Spain*	(Pta)	189.301	−0.8650	247–355	189.870	188.430	189.425	−0.8	189.683	−0.8	190.052	−0.4	73.1
Sweden	(SKr)	10.5717	−0.0552	636–798	10.5800	10.5320	10.5777	−0.7	10.5932	−0.8	10.6512	−0.8	74.3
Switzerland	(SFr)	1.7172	−0.0102	160–184	1.7262	1.7104	1.7165	0.5	1.7152	0.5	1.7039	0.8	108.4
Turkey	(Lira)	1329500	−250	000–000	1342000	1315010	—	—	—	—	—	—	—
U.K.	(£)	1.4320	+0.0068	318–322	1.4329	1.4253	1.4302	1.5	1.4264	1.6	1.4111	1.5	106.0
Euro	(€)	0.8790	+0.0040	787–792	0.8831	0.8762	0.8784	0.8	0.8772	0.8	0.8756	0.4	—
Special drawing right (SDR)	—	0.79320	—	—	—	—	—	—	—	—	—	—	—

Americas													
Argentina	(Peso)	0.9997	—	996–997	0.9997	0.9995	—	—	—	—	—	—	—
Brazil	(R$)	2.4920	+0.0645	910–930	2.5010	2.4780	—	—	—	—	—	—	—
Canada	(C$)	1.5370	+0.0086	369–371	1.5376	1.5331	1.5377	−0.5	1.5392	−0.6	1.5447	−0.5	79.4
Mexico	(New Peso)	9.2000	+0.0600	950–050	9.2070	9.1950	9.2505	−6.6	9.371	−7.4	10.015	−8.9	—
U.S.	($)	—	—	—	—	—	—	—	—	—	—	—	121.2
Pacific/Middle East/Africa													
Australia	(A$)	1.9397	−0.0317	395–399	1.9681	1.9335	—	—	—	—	—	—	71.1
Hong Kong	(HK$)	7.7997	—	996–997	7.7997	7.7995	7.799	0.1	7.7988	0.0	7.8014	0.0	—
India	(Rs)	47.1100	−0.0200	600–600	47.1600	47.0600	47.2863	−4.5	47.668	−4.7	49.4025	−4.9	—
Indonesia	(Rupiah)	9625.00	+125.00	000–000	9650.00	9400.00	—	—	—	—	—	—	—
Israel	(Shk)	4.2140	+0.0020	090–190	4.2190	4.2090	—	—	—	—	—	—	—
Japan	(¥)	124.755	−0.1300	730–780	125.210	124.480	124.35	3.9	123.61	3.7	120.235	3.6	138.5
Malaysia†	(M$)	3.8000	—	000–000	3.8000	3.8000	—	—	—	—	—	—	—
New Zealand	(NZ$)	2.4053	−0.0269	038–067	2.4266	2.3981	—	—	—	—	—	—	—
Philippines	(Peso)	53.7500	+0.2000	500–500	53.8500	53.6500	54.055	−6.8	54.646	−6.7	58.005	−7.9	—
Saudi Arabia	(SR)	3.7504	—	502–506	3.7506	3.7502	3.7508	−0.1	3.7513	−0.1	3.7546	−0.1	—
Singapore	(S$)	1.8037	+0.0018	032–042	1.8068	1.0821	1.8026	0.7	1.7986	1.1	1.7796	1.3	—
South Africa	(R)	8.2476	−0.0202	426–526	8.2716	8.2426	8.2936	−6.7	8.3746	−6.2	8.6921	−5.4	—
South Korea	(Won)	12.96.75	−1.2500	600–750	1298.00	1296.00	—	—	—	—	—	—	—
Taiwan	(T$)	34.7200	−0.0300	700–700	34.7700	34.6700	34.795	−2.6	34.94	−2.5	35.32	−1.7	—
Thailand	(Bt)	45.7200	+0.0200	900–500	45.7700	45.6900	45.87	−3.9	46.29	−5.0	47.545	−4.0	—

(continued)

Table 2-5 Dollar Spot, Forward, and Cross Rates against the Dollar (continued)

Cross Rates and Derivatives Aug 1		BFr	DKr	FFr	DM	I£	L	F.I	Nkr	Es	Pta	SKr	SFr	£	C$	$	¥	€
Exchange Cross Rates																		
Belgium*	(BFr)	100	18.47	16.26	4.848	1.952	4800	5.463	19.84	497.0	412.5	23.03	3.742	1.522	3.349	2.179	271.8	2.479
Denmark	(DKr)	54.16	10	8.806	2.626	1.057	2599	2.958	10.75	269.1	223.4	12.47	2.026	0.824	1.814	1.180	147.2	1.343
France*	(FFr)	61.50	11.36	10	2.982	1.201	2952	3.360	12.20	305.6	253.7	14.17	2.301	0.936	2.060	1.340	167.2	1.525
Germany*	(DM)	20.63	3.809	3.354	1	0.403	990.0	1.127	4.093	102.5	85.07	4.751	0.772	0.314	0.691	0.449	56.06	0.511
Ireland*	(I£)	51.22	9.458	8.329	2.483	1	2459	2.798	10.16	254.6	211.3	11.80	1.917	0.779	1.715	1.116	139.2	1.270
Italy*	(L)	2.083	0.385	0.339	0.101	0.041	100	0.114	0.413	10.35	8.593	0.480	0.078	0.032	0.070	0.045	5.663	0.052
Netherlands*	(FI)	18.31	3.380	2.977	0.888	0.357	878.6	1	3.633	90.97	75.50	4.217	0.685	0.279	0.613	0.399	49.76	0.454
Norway	(NKr)	50.39	9.305	8.194	2.443	0.984	2419	2.753	10	250.4	207.9	11.61	1.885	0.767	1.688	1.098	137.0	1.249
Portugal*	(Es)	20.12	3.715	3.272	0.976	0.393	965.8	1.099	3.993	100	82.99	4.635	0.753	0.306	0.674	0.438	54.69	0.499
Spain*	(Pta)	24.24	4.477	3.942	1.175	0.473	1164	1.324	4.811	120.5	100	5.585	0.907	0.369	0.812	0.528	65.90	0.601
Sweden	(SKr)	43.41	8.016	7.059	2.105	0.848	2084	2.372	8.615	215.8	179.1	10	1.624	0.661	1.454	0.946	118.0	1.076
Switzerland	(SFr)	26.73	4.935	4.346	1.296	0.522	1283	1.460	5.304	132.8	110.2	6.156	1	0.407	0.895	0.582	72.65	0.663
U.K.	(£)	65.72	12.14	10.69	3.186	1.283	3155	3.590	13.04	326.6	271.1	15.14	2.459	1	2.201	1.432	178.6	1.629
Canada	(C$)	29.86	5.514	4.855	1.448	0.583	1433	1.631	5.926	148.4	123.2	6.878	1.117	0.454	1	0.651	81.17	0.740
U.S.	($)	45.89	8.475	7.463	2.225	0.896	2203	2.507	9.108	228.1	189.3	10.57	1.717	0.698	1.537	1	124.8	1.138
Japan	(¥)	36.79	6.793	5.982	1.784	0.718	1766	2.010	7.300	182.8	151.7	8.474	1.376	0.560	1.232	0.802	100	0.912
Euro	(€)	40.34	7.449	6.560	1.956	0.788	1936	2.204	8.005	200.5	166.4	9.292	1.509	0.614	1.351	0.879	109.7	1

Source: *Financial Times*, August 2, 2001, p. 23

*EMU member.

†Official rate set by Malaysian government.

‡: Danish kroner, French franc, Norwegian kroner, and Swedish kronor per 10; Belgian franc, yen, escudo, lira, and peseta per 100.

Note: The WM/Reuters rate for the valuation of capital assets is 3.80 MYR/USD. Bid/offer spreads in the dollar spot table show only the last three decimal places. U.K., Ireland, & Euro are quoted in U.S. currency. J. P. Morgan nominal indices as of Sep 31: Base average 1990 Bid, offer, mid spot rates and forward rates in both this and the pound table are derived from THE WM/REUTERS 4pm (London time) CLOSING SPOT and FORWARD RATE services. Some values are rounded by the F.T. The exchange rates printed in this table are also available on the internet at http://www.FT.com.

comes due, the investor buys the weaker currency in the spot market at a new, hopefully lower, price. The investor delivers the weaker currency and receives the stronger one. A large gain could occur if, say, sterling depreciates relative to the euro by 5–10% over a three-week period. The costs of the position are principally the costs of borrowing sterling at a high interest rate (the burden of the weaker currency) minus interest income from, say, German treasury bills; denominated in euro, which could carry relatively low interest rates during such a currency crisis, plus transaction and margin costs. If the investor bets right, there is an ample margin to fund the interest differential and transaction costs, but if sterling manages to resist depreciation, the investor's loss will be limited to the interest differential. Once the crisis is past, however, sterling might rally relative to the euro, so that it will be important to be flexible enough to get out of the position on a timely basis.

Another strategy is to establish interest rate positions in the weak currency (e.g., through purchases of bonds or through forwards or futures contracts) once a currency crisis has begun. Here the investor expects interest rates in the weaker currency, pushed up during the effort to prevent depreciation, to drop sharply, thus causing a corresponding increase in bond values. The value of the bonds the investor bought at the beginning of the crisis is expected to increase.

The two strategies are different and involve different risks. To make money, however, both depend on the weaker currency actually depreciating. Other strategies that bet on the weaker currency surviving the crisis unchanged are also possible. Such a strategy, for example, could involve borrowing euros (at relatively low rates) to buy U.K. treasury bills at relatively high rates.

Effects of the Euro on Foreign Exchange Markets

The introduction of the euro in 1999 has greatly lowered the need for foreign exchange trading. Some of the lost revenue is regained by an increased volume of trading in euros against other currencies—those of other European countries and the rest of the world, especially the dollar and the yen. Other costs will be incurred to introduce and maintain the euro, and it will be a while before we know how these costs and benefits balance out. Meanwhile, other market effects have already been felt that suggest that the overall foreign exchange market has shrunk significantly because of the euro.

Indeed, the Bank for International Settlements (BIS) reported as early as 1997 that implied exchange rates calculated out to ten years forward, based on yields on interest-rate swaps, indicated that the currencies of a number of European countries were expected to be stable against the DM, pending the 1999 launch of the euro. It also reported that the volatility of many intra-European exchange rates declined significantly during 1996—

the implied volatility in the French franc/DM averaged 2% in 1996, compared with 7% in April 1995—and foreign exchange volume diminished somewhat as a result. These factors suggested to the BIS that approximately 10% of the foreign exchange market (based on its 1995 survey of foreign exchange trading in 26 countries) could disappear with the advent of the euro. In fact, the market shrinkage was even larger and had several effects on market participants.

First, foreign exchange trading opportunities for banks, already squeezed by reduced volatility and efficiency-enhancing developments like electronic trading, were reduced further, driving some traders and market-makers into new markets or out of the business. This significantly increased competition for smaller market players in individual countries (like Belgium), which had the local market largely to themselves before the introduction of the euro.

Second, dealers were driven to expand their business in riskier, or higher-margin, areas, such as trading derivatives or trading the euro against emerging market currencies. This, too, was disadvantageous to smaller, national players without the necessary experience or an adequate international infrastructure. The BIS estimated that such displaced business might represent over one-third of the volume of the intra-European trading that disappeared with the euro.

Currency trading between the prospective euro-zone had already contracted from 13% to 6% of global foreign exchange turnover between 1995 and 1998. According to the BIS, the dollar remained the dominant vehicle currency in international finance, appearing in 94% of all global currency transactions in spot and forward foreign exchange contracts. The euro was being used in about half of all foreign exchange dealings in the euro-zone countries, with its future as a transaction currency depending on its perceived value as a reserve, investment, and reference currency.

Competing in Money Market and Foreign Exchange Trading

There are a great many competitors in the international money and foreign exchange markets. Some firms specialize in these activities, but most conduct them as a part of a broader commitment to financial market-making. Commissions are very thin in these high-volume markets, and most firms make their money from trading.

In money markets in particular, trading success depends on an effective distribution system through which positions can be bought and sold at reasonable prices. This usually means being closely in touch with investors, corporations, and end-users in general. (Nobody gets rich trading only with market-makers like Citigroup.) It also depends on having good information, through sales-force feedback and from contact with other dealers and

Table 2-6 Foreign Exchange Trading Income of Major U.S. Banks[a]

	1983	1990	1999	2000
Bank of America	102	207	569	524
Bankers Trust	28	425	139	30
Chase Manhattan Bank	117	217		
Chemical Bank	40	207		
Manufacturers Hanover	27	106		
Citibank	274	657		
Citigroup[b]			1,405	1,243
Continental Bank Corp	24	187		
First Chicago	36	103		
Bank of New York	13	48	137	215
Marine Midland	19	3		
J. P. Morgan & Co.	74	309		
J. P. Morgan Chase			1,199	1,465
Republic New York Corp.	8	77		
Total	762	2,547	3,449	3,477

Source: Annual Reports/10Ks/Call Report Data.
[a]Millions of dollars exclusive of translation income.
[b]Includes translation gains and losses.

issuers. Telecommunications systems have to be as modern as possible to stay in contact with market players all around the world; indeed, these are so important that many firms regard their own as "key competitive weapons."

Foreign exchange trading inevitably means substantial position-taking, if a dealer expects to make much money. This is a risky and volatile business for most dealers, and all ways possible to minimize risk by hedging and using derivatives and technical trading strategies are utilized. Most of the larger players are commercial banks, which have a natural competitive advantage in comparison to nonbank dealers in the daily foreign exchange order flow from their customers. Being able to trade with customers in large volumes helps protect the bank's overall dealer spread (between the buy and sell rates quoted) and serves to ensure at least a minimal level of profitability. Adding more aggressive trading for the bank's own account, in which large speculative positions are taken, can boost trading revenues considerably. Table 2-6 shows the foreign exchange trading income of several major U.S. banks from 1983 through 2000.

Consultants and other experts who offer services predicting market behavior, or access to "inside thinking" on the part of government officials, make a good living, but there is little evidence that they know any more than the market reveals in the price of the instruments and contracts. Technical trading strategies can be successful, but like all trading, success seems mainly to depend on discipline, courage, capital, technical skills, and experience. Most market-makers would also add that good luck plays a major role in successful trading. Most of their supervisors would add that effective internal control procedures are no less essential.

Summary

International money and foreign exchange markets have expanded rapidly since the early 1980s, as market liquidity has increased by the removal of capital controls and the encouragement of cross-border investment flows. Increased interest rate and foreign exchange volatility has also made these markets more active. A full array of international money market instruments, closely comparable to the United States, now exists. Linkages through swaps and foreign exchange contracts have served to integrate money markets in the world's major countries. The success of ECP and EMTNs has caused many governments to adopt similar instruments in their own domestic markets.

The story of euronote programs and eurocommercial paper is one of rapid change at all levels. The competitive structure of the market has undergone substantial modification with bargaining power tending to shift away from borrowers to investors. In the early days, top and lesser-quality names alike benefited from the intense competition among banks that resulted from deregulation and disintermediation. They profited as well from a lack of investor sophistication. Today, most corporate and institutional investors have a full understanding of the workings of the market and what is available to them. And distributive power has been concentrated in the hands of a few houses, which are more interested in volume and profitability than in the number of dealerships they hold. Gone are the days of loss-leading for a place in the market. Attention is on courting the investor base in search of greater diversification of funding.

Other changes have occurred as well. Distribution methods have been modified to suit new conditions and demands. The use of ratings has increased in the ECP market, with the need for investors to react quickly in fast-moving markets. The very nature of the instrument has evolved, with the non-underwritten ECP now predominating over euronote programs. These changes will continue. as new economic conditions will give rise to new requirements and new responses. The euronote grew as a substitute for syndicated loans, floating rate notes in the Eurobond market, and euro certificates of deposit issued by banks. Its success came in part from the events shaping the financial world at the time. As increasing globalization brought increasing competition, so the pace of product innovation has quickened.

As the euronote market deepened, it became obvious that prime borrowers could dispense with underwritten facilities altogether, thus reducing costs. ECP provided greater flexibility for borrowers and investors alike. It offered a faster and more efficient method of placement. These advantages led to a widening of the investor base and, consequently, further reduced costs and increased flexibility. Euronote programs and subsequently ECP have had substantial success. They are perhaps best viewed as a complement to rather than a replacement for more traditional forms of bank fi-

nance—an additional financial string to the borrower's bow, offered as part of an increasingly efficient international money market.

Foreign exchange market volatility, and government intervention (especially in the EU during the early 1990s) to prevent it, has provided traders with many opportunities to make large fortunes. The foreign exchange market is the world's largest and most liquid financial market, although about three-quarters of its turnover is through inter-dealer transactions. The power of this market is enormous, and even large-scale government intervention has been ineffective in controlling it. Future government intervention, therefore, may be far less than in the past, with trading opportunities diminished accordingly. The introduction of the euro in 1999 reduces opportunities even further. Not only have the number of currencies fallen, but so has the volatility of exchange rates.

3

Global Bond Markets

While the international money market provides short-term money, the bond market provides medium- to long-term financing. In the international arena, Eurobonds are the principal form of such financing.

Before 1963, the method used to raise long-term capital from international sources was to float a bond issue in some other country, denominated in the currency of that country and issued in accordance with the standard procedures of the bond market there, usually at a premium interest rate that reflected the foreign nature of the borrower and/or the possibilities of difficulties in collecting payments due. Such issues have long been called "foreign bonds."

Today when foreigners issue dollar-denominated bonds registered with the U.S. Securities and Exchange Commission (SEC), they are called "Yankee bonds"; those registered with the Japanese Ministry of Finance and denominated in yen are "Samurai bonds"; those involving sterling issues in the U.K. are "Bulldog bonds"; and so on. They are all, however, foreign bonds. Each must comply with the capital market registration and distribution requirements of the country concerned. This usually means publication of a prospectus in the language of the country, adherence to disclosure and accounting requirements, and adoption of local underwriting and securities distribution methods.

The total annual volume of foreign bonds averaged only $2.6 billion during the period from 1964 to 1974. Then, after the removal of U.S. capital market controls in 1974, volume jumped sharply and averaged about $16 billion annually for the rest of the 1970s. By the end of the 1980s, foreign bonds, stimulated by the appearance of the Samurai market in Japan and much greater usage of the Swiss market (the Swiss did not allow Swiss franc–denominated Eurobonds to be issued), accounted for about $30 to $40 billion of new issues each year and about twice that amount just a few years later. Although current volumes are large by for-

eign bond standards, they still represent a relatively small part of the total international bond market.

The growth of foreign bonds was hampered by a number of disadvantages to issuers and investors alike. International issuers had to meet local registration disclosure requirements at considerable expense; delays were usually involved while issuers prepared the necessary documents and translations or waited for permission to proceed. Underwriting fees and other expenses of issuance were often high. The effect of these requirements and practices led issuers to look for other ways to raise funds abroad.

Pioneering Days

By the early 1960s, an alternative form of bond issue had developed, the "Eurobond," which minimized these disadvantages while offering international investors a better selection of currencies, maturities, and familiar names. The Eurobond market became the preferred international market for most issuers after 1980. Today this market is far larger than the foreign bond market (together these two types of bonds—foreign and Euro—are referred to as "international bonds") and is comparable in size to the U.S. investment-grade corporate bond market (see figure 3-1). The combined U.S. bond market includes U.S. Treasuries, corporate bonds of varying quality, various forms of collateralized securities, and tax-free municipal securities (see table 3-1).

Eurobonds originally were fixed-rate, unsecured promissory notes denominated in U.S. dollars that were issued by a corporation or government entity. They were issued outside the United States and therefore were not required to be registered with the SEC or any other national securities

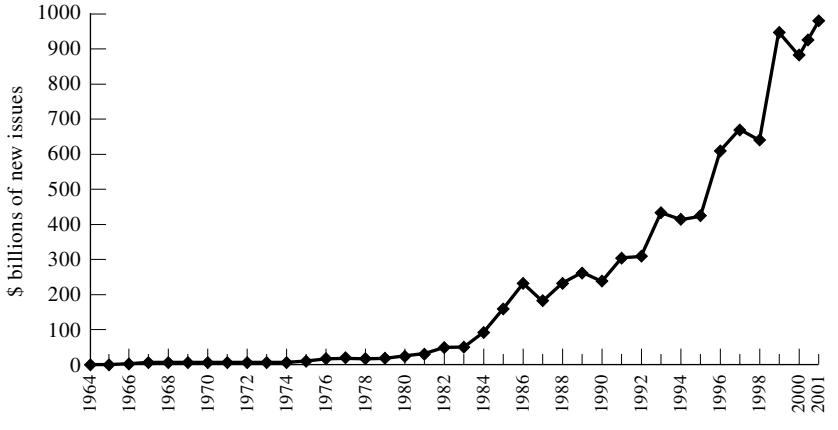


Figure 3-1. Increase in new issues of Eurobonds, 1964–2000 (Source: Thomson Financial Securities Data).

Table 3-1 The Maturing Eurobond Market Volume of New Issues ($ billions)

	1996	1997	1998	1999	2000	2001
U.S. Bonds, Total	***1,999.7***	***1,847.8***	***2,776.1***	***2,822.1***	***2,496.2***	***3,686.6***
Corporate (Baa and above)	961.9	1,492.3	2,164.0	2,341.1	2,183.0	2,930.3
International Bonds	***612.9***	***673.1***	***640.7***	***933.4***	***886.3***	***1,061.3***
Eurobonds	515.8	575.5	569.3	859.8	817.0	936.2
Foreign bonds	97.1	97.6	71.4	73.6	69.3	125.1

Source: Thomson Financial Securities Data.

authority. Not being registered with the SEC, however, these bonds could not be sold in the United States or to U.S. citizens. Instead, they were sold to non-U.S. residents, principally wealthy individuals and international institutions who wanted to invest in high-grade U.S. dollar–denominated securities. Investors paid for the bonds by charging a eurodollar deposit account in a European bank or a European branch of a U.S. bank. As discussed in chapter 2, the dollar deposits in banks had accumulated outside the United States (because of the growing U.S. balance of payments deficit and regulatory factors) and since most of these were in Europe, they became known as eurodollar deposit accounts, or "Eurodollars."

Once Eurodollars came into existence, they had to be invested in loans or other instruments. Banks sought out Eurodollar borrowers, and soon the Eurodollar certificate of deposit appeared. It was only a matter of time before a fixed-rate, medium-term, high-grade instrument denominated in Eurodollars would appear.

Inspired by U.S. Capital Controls

These were the days of the Breton Woods fixed exchange-rate system in which the non-Communist world's currencies were linked to the U.S. dollar and the dollar was pegged to gold. Countries often defended their exchange rates by the imposition of foreign exchange and/or capital controls. In 1963, in an attempt to halt the "hemorrhaging" of capital flowing out of the country (the flows, in fact, were quite modest, and the United States had plenty of gold), the U.S. administration initiated the "interest equalization tax." This required foreign borrowers to restore to the U.S. Treasury any interest-rate benefits they obtained from issuing securities in the United States. The tax, of course, killed the foreign bond market in the United States. Later, controls imposed by the Commerce Department's Office of Foreign Direct Investment (OFDI) required U.S. companies investing abroad to raise the money outside of the United States. So a demand by borrowers—Europeans who could no longer borrow in the United States, and U.S. companies who now had to borrow outside the United States—met with a growing supply of funds in the form of eurodollars.

The First Eurobond

The first Eurobond was a $15 million issue for Autostrade, an Italian toll road authority guaranteed by an Italian government agency. The issue was managed in June 1963 by the London firm of S. G. Warburg and was co-managed by banks in Belgium, Germany, the Netherlands, and Luxembourg. It was underwritten according to the U.S. underwriting system, in which the issue is announced, syndicated, and marketed for about two weeks before it is priced (as opposed to the British system in which the issue is priced, syndicated, and then offered to subscribers, in that order, with the underwriters liable for the unsubscribed portion of the issue). The banks could not offer the bonds to the general public (they were not registered in any of the European countries) but did make them available "privately" to their investment clients, many of whom had granted discretion over their investments to the banks involved. The bonds were listed on the Luxembourg Stock Exchange, where the banks and their investors could check secondary market prices from time to time.

The Autostrade issue became the prototype for many other issues by various European entities, almost entirely government-related credits. U.S. investment banks with sales offices throughout Europe became active participants in the market, having sharpened their selling skills by distributing foreign bonds issued in the United States by European governments and agencies to investors elsewhere in Europe.

Investor Anonymity

U.S. corporate bonds were held in high esteem by European investors, and when they and their bankers volunteered responsible standards of disclosure and investor protection, these were accepted without question. However, most of the early investors were wealthy families or privately owned businesses whose financial affairs were managed by banks in Switzerland, Luxembourg, Belgium, France, and to some extent in the U.K. Many such investors were unwilling to purchase U.S. corporate securities, despite their high regard for the corporation issuing the paper. Their reluctance came partly from the fact that in the United States issuers were required to withhold part of the required interest payments to foreign investors (to ensure that any U.S. taxes due would be paid). The amount withheld could be reclaimed by filing a tax return in the United States, but few European investors were willing to do that. They were also reluctant to purchase "registered bonds," which required them to disclose their name and address to the issuing company. They preferred bonds that were payable to "the bearer," which did not require any such disclosure of the identity of the investor. In the United States, only registered bonds were available. Eurobond buyers, however, were concerned that the Internal Revenue Service, the corporation, or some other entity might someday pass information on file about them to the tax officials of their home countries and reveal wealth

or other transactions that the investor was trying to conceal. To attract these investors, there could be no withholding tax and no registered bonds, which meant that American companies would have to issue their bonds in bearer form through subsidiaries in various tax-haven jurisdictions, usually the Netherlands Antilles, guaranteed by the parent companies. The United States repealed the withholding tax on interest paid to foreigners in 1984, thus ending the requirement for issuing Eurobonds through tax haven subsidiaries.

Eurobonds after the Collapse of Bretton Woods

Thus the Eurobond market had an early assist from regulations imposed by the U.S. government. Exchange controls erected to assist in managing the balance of payments forced both U.S. and non-U.S. issuers to use the Eurobond market, despite the fact that interest rates were higher there than in the United States. The incorporation of issuing subsidiaries outside the United States enabled corporations to avoid the withholding tax, as a result, it substantially increased investment demand for the securities, even though the rates the investors would receive would be below comparable rates available in the home market.

The pool of eurodollars did not dissipate after the collapse of Bretton Woods. Owners of dollars were permitted to sell them in the market, transfer them to accounts in New York, or purchase other assets with them. Many holders of dollars, particularly individuals, retained them in eurodollar investments for their tax and secrecy advantages. In the aftermath of the first oil shock of October 1973, the trade surpluses of the London-oriented Organization of Petroleum Exporting Countries (OPEC) became a primary source of Eurodollar balances. The Eurobond market then began in earnest, as liquidity built up and trading in Eurodollars and other instruments increased. These conditions, in turn, began to attract European and multinational institutional (as opposed to individual) investors to the market in a significant way.

The Eurobond Boom, 1981–1985

By 1980 institutional participation in the market was at such a high level that an infrastructure began to develop to support it. Providers of services such as bond brokerage (arranging for the sale and purchase of bonds between dealers), "when issued" trading (or "grey market trading"—i.e., buying and selling of primary securities before the actual offer date), and bond market research began to arrive in London like waves of an assault force. More capital was committed, more traders and salesmen were hired, and it became important to many banks to be "seen" in the right issues. Some of this was nonsense, but it expanded the market nevertheless. As the dollar turned, after tighter monetary policies were introduced in 1979

and Ronald Reagan was elected president in 1980, from a scorned and underappreciated currency to a much admired and eventually an overvalued one, the Eurobond market soared. The dollar became one of the world's strongest currencies, and unlike strong currencies in the past, yielded very high rates of interest, so the demand for Eurobonds rose to a point where European investors would pay more for a U.S. corporate obligation than American investors would.

Lower Rates Offered to Issuers

This enthusiasm for Eurobonds was spurred by competition and by the expectation that total investment profits would include attractive foreign exchange gains. But it was also greatly influenced by the fact that investors could buy Eurobonds of top-grade U.S. companies free from withholding taxes on interest, although they could not buy U.S. Treasury securities on the same basis. So, high-grade corporates became the substitutes for U.S. government securities in the eyes of Eurobond investors. In the end, a kind of competitive bidding between investors to get the top names developed, and the retail investors, as might be expected, won out—that is, they bid the highest prices, or the lowest interest yields, for the bonds. So during the 1981–1985 period, it was quite common for U.S. companies rated AA and better to borrow 5- to 10-year money in Europe more cheaply than they could in the United States, and in some cases, more cheaply than the U.S. Treasury could borrow. This condition resulted in a surge of Eurobond issues. In 1982, for example, several U.S. investment banks found that they had sold more corporate bonds at new issue in London than they had in New York—a fact many firms found hard to believe and few would duplicate in the years after 1983.

Participation by Institutions

This feeding frenzy, however, occurred at a time when U.S. real interest rates and the dollar were rising. Treasury securities were certainly not unavailable in the United States, as the growing fiscal deficit brought the government to market more and more often—if not crowding U.S. companies out, then perhaps nudging them toward Europe. It was not important whether an issuer was known as a multinational corporation—many companies that were entirely domestic, including some U.S. public utilities and even savings and loan associations, came in. And the investors began to include insurance companies from Birmingham, bond funds from Lyon, pension fund managers in Melbourne, and agricultural cooperatives in Osaka. Some of these investors had only recently been allowed to invest overseas by their home governments, which were following patterns of financial liberalization elsewhere and dismantling overseas investment restrictions. These institutions were increasingly interested in secondary market liquidity and sophisticated trading ideas, neither of which had been

especially important to the retail customer base, which wanted simple issues of well-known companies that they could hold until maturity.

During the 1980s, the effort to involve the institutions resulted in much emphasis on new investment ideas and market making. Bonds with warrants to purchase additional bonds, zero coupon bonds, and floating rate notes appeared at this time. New-issue volume increased, and so did the size of individual issues, from an average below $100 million in 1983 to over $200 million by the end of 1992. Market-making, however, was difficult, in part because of the high volume of aggressively priced new issues that often were out of line with secondary market price levels, and because the float in Eurobonds was thin. Although no precise data exist as to the extent of this participation, certain Swiss banks have estimated that during the 1980s, 40% to 60% of all Eurobonds ultimately found their way into Swiss-managed accounts of individuals, where for the most part they were held until maturity. By contrast, fewer than 5% of U.S. corporate bonds are ever bought by individuals. During this period, opportunities for hedging and borrowing bonds for short-selling by market-makers were limited.

The World's Only Unregulated Capital Market

The Eurobond market is virtually unregulated. However, it is subject to self-imposed standards of practice. Eurobonds are typically listed on the London or Luxembourg stock exchange in order to attract investors, and each stock exchange has its own specific disclosure requirements. The issues themselves are typically made subject to U.K. law. And the Association of International Bond Dealers (AIBD), a nongovernmental industry association, sets minimum trading standards.

These standards differ from legal requirements. Whereas individual firms may be regulated by their national authorities, there are no legal requirements on the part of the issuer or bankers to provide for investor protection, orderly markets, or courts of law in which to deal with disputes or abuses. Until 1987, there were no financial regulations that applied to the market, such as queuing, capital requirements for underwriters, or margin rules. However, the Financial Services Act, passed by the British Parliament in 1987, provides for certain capital and other requirements for all Eurobond market participants using London as a base. Later, there was an EU directive covering minimum capital requirements for securities dealers that paralleled the capital adequacy standards adopted for banks, especially in the area of swaps and other derivative securities (see chapter 13).

Market conduct has been self-regulated and as such has performed remarkably well. As distinct from normal domestic securities markets, however, the Eurobond market is substantially a wholesale market in which sophisticated issuers and investors participate and offenders can only be punished by rejection. The market is easy to enter as a competitor, and competition between dealers has always been sharp. Frequent issuers shop

around for the lowest rates; banks will often deliberately take losses on deals to show their importance as an underwriter in published "league" tables, or they will stuff poorly priced deals into passive customer accounts to get rid of them. As long as the client has other concerns, like staying ahead of the taxman, complaints about a little underperformance are likely to be few. Risk-taking and new product innovation, and quick copying, has been as well developed in the Euromarket as anywhere in the world. To make money in this market, a substantial commitment of talent and capital is needed. Thus it has tended to be dominated by about 25 primary players who have set the rules and procedures that the market must follow. The market as a whole has a practical bent. Emphasis has always been on doing what works in a manner that will permit doing it again. Eventually, large U.S. institutional investors have found the Eurobond market attractive as a source of non-dollar investments and arbitrage opportunities to buy securities at larger yield spreads over treasuries than what is available in the U.S. market for comparable securities (or vice versa).

The absence of regulation, the lack of barriers to competition, and the variety of players have made the Eurobond market a hothouse for innovation. Many of the best ideas to influence the U.S. bond markets had their origin in the Eurobond market: the "bought deal," the zero coupon bond, the floating-rate note, currency option bonds, bonds with swaps, and convertible put bonds are just some of the successful innovations in Europe that have been copied in New York. The Section 415 underwriting rules introduced by the SEC in 1984, which provide virtually immediate access by companies to the U.S. bond market (which permitted the bought deal to be imported into the United States) is also a result of imported innovation that led to significant domestic deregulation. Similar rule revisions have occurred in other countries, especially Japan, which has imported almost all of its new capital market products during the past 20 years or so.

The Market Matures

These new investors included European pension and insurance funds of U.S. and other companies, bank trust departments, investment companies, supranational financial institutions such as the World Bank and central banks of various countries, and increasingly, after 1973, Middle East funds managed by Western financial institutions. After the election of Margaret Thatcher in 1979 and the removal of British exchange controls soon thereafter, U.K. investors also began to enter the market, although modestly at first.

Although Eurodollar bond issues have been floated throughout the past 40 years during times of both a strong and a weak dollar, the bulk of market activity has remained in dollars, even during times when the currency has been weak. The foreign exchange situation has always had a significant effect on the Eurobond market, which is, of course, not the case

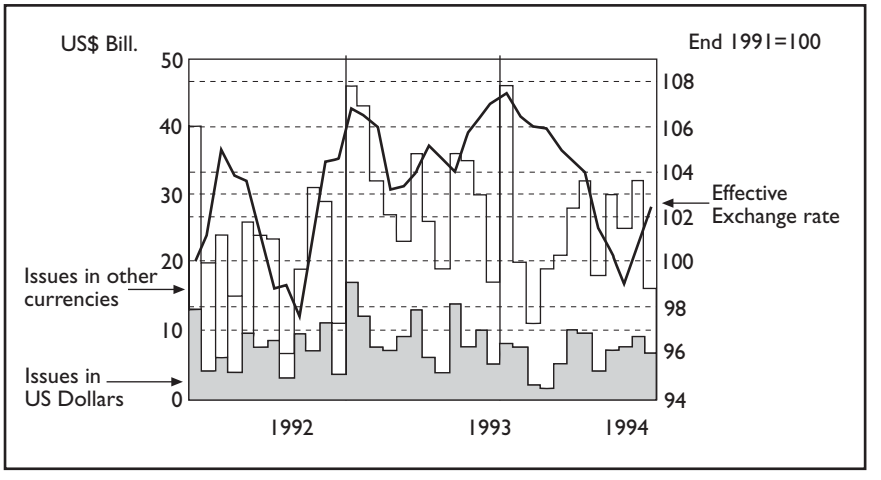


Figure 3-2. Issuing activity in the bond market (straight fixed-rate issues, on an announced basis) and the U.S. dollar effective exchange rate (Source: Bank of England and the Bank for International Settlements).

in the U.S. domestic bond market. Figure 3-2 shows how the market for non-dollar issues increases during periods of a weak dollar—as best demonstrated in 1991, when fewer than 40% of all new Eurobond issues were denominated in U.S. dollars.

The Eurobond market began to broaden during the late 1980s, as globally oriented institutions began to participate more actively, especially in the non-dollar sector. These institutions were capable of bond arbitrage, using options and futures to hedge positions and managing portfolios according to the latest techniques. In addition, they were offered an increasing supply of interesting and relatively liquid investment opportunities in DM, yen, ECUs, and other non-dollar instruments. The Eurobond market, noted the *Institutional Investor* in a December 1993 article commemorating its thirtieth year, is "maturing into a more efficient, forthright citizen of the globe. What the first dealers knew as an offshore dollar market with a retail investor base of tax-dodging Continental coupon clippers is now something else altogether. [Dealers] . . . think in terms of world-wide capital flows, powerful institutional investors and a broader mix of borrowers than exists in any domestic market."

Eurobond Issuers

Eurobond issuers represent a vast variety of different governmental and corporate organizations, from all over the world, which find capital-raising opportunities in this market to be superior, or supplementary, to markets

at home. Supranational institutions (such as the World Bank and entities of the European Union) are frequent borrowers, as are agencies of European, Asian, Australasian, Latin American, and other governments. Large banks have used the floating-rate note (FRN) market, which accounts for about 40% of all new issues, to fund their own lending books or for swaps. FRNs pay a rate tied to the London Interbank Offered Rate, (LIBOR) and are repriced every three months or so, in order to allow the notes to trade at par. Industrial corporations and their captive finance subsidiaries are also active borrowers.

Bonds are issued in fixed-and floating-rate form, in a variety of currencies, often accompanied by interest rate or currency swaps. Maturities tend to be less than 10 years, averaging around 5 to 6 years. Most bonds are offered in "plain vanilla" form—that is, with no early call provisions and no sinking funds. Bonds with special features, called "bells and whistles," are less frequent but do appear in force when market conditions are ripe. Most bonds are rated by Moody's and Standard and Poor's, even those issued by non-U.S. companies and governments.

Tables 3-2 and 3-3 show the volume of Eurobonds in 2000, broken down by types of securities and country of issuance and by currency of issuance, respectively.

The *Financial Times* of London on April 2, 2001, listed more than 29 bonds in its daily "New International Bond Issues" table, including issues in 11 different currencies; see table 3-4.

Japanese companies were among the heaviest Eurobond issuers. They faced a highly regulated and expensive corporate bond market in Tokyo and, as a result, made heavier use of the Euromarket than their domestic alternative. During the period 1984–1990, Japanese corporations floated issues of straight and convertible bonds, along with bonds with equity purchase warrants, in the Eurobond market totaling ¥62.6 trillion (approximately $500 billion), as compared to issues totaling ¥54 trillion in the Tokyo market. Japanese companies were attracted by convertible debentures and issues of debt with stock purchase warrants that enabled them to either "repay" the debt in the future when the investors convert the debentures or exercise their options to acquire more shares by turning in their bonds. While Japanese stock prices were high and rising, this method of financing was thought to be too good to resist; however, after the fall of the Japanese equity market beginning in December 1989, the repayments had to be made in cash because the share prices were too low for the bonds to be converted. Nevertheless, some companies still found this method of financing attractive well into the 1990s.

Japanese corporations were able to avoid restrictions in the Tokyo market by issuing securities abroad—often at lower cost than in Tokyo—through Japanese securities firms in London. In turn, these firms sold all or most of the securities to Japanese investors in Tokyo. Because of this recycling capacity, many Japanese companies avoided using the Japanese

Table 3-2 Country versus Type of Security, Eurobond New Issues, 2000

	All Issues		Straight Bonds		Floating Rate Notes		Equity Related Convertibles		Equity Warrants	
	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues
United States	94.0	407	79.5	349	14.5	58				
Supra/Multinat'l	91.9	494	54.7	340	36.3	149	0.9	5		
United Kingdom	68.9	302	29.8	160	36.5	136	2.4	5	0.2	1.0
Netherlands	34.0	212	26.0	174	8.0	38				
Germany	27.7	211	18.8	172	8.9	39				
Sweden	18.4	109	8.2	61	8.7	43	1.5	5		
France	17.6	98	13.4	76	4.2	22				
Australia	16.1	147	6.2	96	9.1	47	0.8	4		
Finland	8.9	40	7.3	30	1.6	10				
Argentina	8.8	31	8.7	30	0.1	1				
Canada	7.3	43	3.2	26	3.8	16	0.3	1		
Brazil	7.2	34	7.2	34						
Austria	6.4	45	5.2	37	1.2	8				
Italy	5.8	27	4.0	18	1.8	9				
Japan	4.8	33	4.6	23	0.2	10				
Norway	4.3	35	2.3	25	2.0	10				
Mexico	3.7	8	3.7	8						
Denmark	3.4	26	2.2	21	1.2	5				
Spain	2.5	14	1.1	5	1.4	9				
Belgium	2.2	16	2.0	14	0.2	2				
Switzerland	2.1	8	0.6	6	0.5	1	1.0	1		
Others	43.4	238	31.8	144	9.1	86	2.1	7	0.4	1
Total	479.4	2578	320.5	1849	149.3	699	9.0	28	0.6	2

Source: Thomson Financial Securities Data.

Table 3-3 *Currency versus Type of Security, Eurobonds/International Issues through December 31, 2000*

	All Issues		Straight Bonds		Floating Rate Notes		Equity Related Convertibles		Equity Warrants	
	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues	Amount (US$ B)	No. of Issues
Euro	474.2	1540	242.5	718	223.5	780	7.6	39	0.6	3
US $[a]	189.8	792	96.0	385	87.3	393	5.8	12	0.7	2
Pound Sterling[b]	108.6	606	74.8	410	33.7	195			0.1	1
Japanese Yen[c]	74.3	420	67.3	365	5.2	45	1.8	10		
Swiss Franc	21.8	170	18.9	145	2.8	23	0.1	2		
Hong Kong $	8.6	272	7.6	247	1.0	25				
Australian $	2.9	39	1.8	22	1.0	14	0.1	2	0.0	1
Polish Zloty	2.1	70	2.0	69	0.1	1				
New Zealand $	1.3	20	1.3	20						
Czech Koruna	1.3	47	1.2	45	0.1	2				
South African Rand	1.3	47	1.3	47						
Swedish Krona	1.1	13	0.9	9	0.2	4				
Canadian $	0.8	11	0.5	10	0.3	1				
Danish Krone	0.4	8	0.4	8						
Other	8.3	69	8.3	69						
Total	896.8	4124	524.8	2569	355.2	1483	15.4	65	1.4	7

a. Including Yankee issues.
b. Including Bulldogs.
c. Including Samurai and Shibosai issues.
Source: Thomson Financial Securities Data

Table 3-4 New International Bond Issues

Borrower	Amount (m.)	Coupon (%)	Price	Maturity	Fees (%)	Spread (bp)	Book Runner
U.S. Dollars							
Dana Corporation	575	9.00#(I)	100.00	Aug 2001	1.625	+395(Feb11)	Deutsche/JP Morgan
Wells Fargo Financial	600	5.875#(I)	99.953	Aug 2008	undiscl	+105(May08)	Banc One/BNPP/Merrill
Euros							
Lusitano Glbl CDO 1, A1(b)‡	350	(b1,I)	100.00	Dec 2015	0.25	—	Deutsche/Merrill
Lusitano Glbl CDO 1, A2(b)‡	623.8	(b2,I)	100.00	Dec 2015	0.25	—	Deutsche/Merrill
Dana Corporation(a)	200	9.00#(I)	99.186	Aug 2011	1.625	+429(Jul11)	Deutsche/JP Morgan
Bayerische Landesbank(c,p)	500	5.25	100.983	Mar 2009	0.12	+33(3¾Jan09)	BayerLB & 11 others
Sterling							
Lloyds TSB Bank plc(d.S)	250	6.50	103.609	Undated	0.625	+135(Dec28)	ABN Amro/UBS Warburg
Abbey National plc(g1,S)	100	7.50	107.872	Undated	0.625	+145(Dec15)	Morgan Stanley
Abbey National plc(g2,S)	100	7.125(I)	109.744	Undated	0.625	+145(Dec28)	Morgan Stanley
Danish Kroner							
GECC	550	4.75(s)	100.00	Oct 2002	0.05	—	Dresdner KW
GECC	600	4.80(s)	100.00	Feb 2003	0.05	—	Dresdner KW
Swedish Kroner							
GECC	300	4.85(s)	100.00	Feb 2003	0.05	—	Dresdner KW

Source: Financial Times, August 2, 2001, p. 23.

Note: Final terms, noncallable unless stated. Yield spread (over relevant government bond) at launch supplied by lead manager.

‡ Floating-rate note. #Semi-annual coupon. R: fixed reoffer price; fees shown at reoffer level.

(a) Makewhole call at govts +35bp.

(b) Backed by Portuguese domestic bonds and credit default swaps originated by BESI. (b1) Av life: 1.36 years, 3-mth Euribor +25bp. (b2) Av life: 4.04 yrs. 3-mth Euribor +45bp. (b3) Also: Classes B of €42.3m and C of €25.2m. (c) Fungible with €1bn. Plus 146 days accrued. (d) Fungible with £200m. Plus 37 days accrued. Callable on 16/7/29 and every 5 yrs at par. If not called coupon steps to 5yr gilt +278bp. (e) Spreads relate to German govt bonds. (g1) fungible with £325m. Plus 312 days accrued. Callable on 28/9/15 and every 5 yrs at par. If not called coupon steps to 5yr gilt +340bp. (g2) Fungible with £175m. Plus 312 days accrued. Callable on 30/9/15 and every 5 yrs at par. If not called coupon steps to 5 yr gilt +340bp. (I) Long 1st coupon. (p) Oeffentliche Pfandbriefe. (s) Short 1st coupon. (S) subordinated.

capital market altogether. This has brought considerable pressure on Japanese government officials to further deregulate new issues procedures to reattract Japanese issuers.

Eurobond Investors

The Eurobond market today is broad and complex, with various different and changing components that tend to be defined by investor types or their location.

Retail Investors

The term "retail investor" means a private individual who usually entrusts his money to a bank that invests it for him, according to some general instructions. The typical retail investor in Europe used to be described by the market as a "Belgian dentist"—that is, a middle-class European professional who had been able to move some money for investment outside of his or her home country. He or she would invest in round lots of 100 bonds through a bank in Switzerland or other tax havens in which a private account is maintained. Such accounts often can be maintained with very high degrees of secrecy, and therefore they are attractive to various types of individuals and corporations seeking to hide funds from the eyes of others. Retail investors have grown to include wealthy individuals from all over the world whose money is invested for them anonymously by banks in Europe. Some of these clients have included well-known if notorious figures, such as the former shah of Iran, Mr. and Mrs. Ferdinand Marcos, Panamanian General Manuel Noriega, Nigerian strongman Sadi Abacha, and Congolese dictator Mobuto Sese Seko. Swiss banks are the best-known and largest institutions managing offshore investment accounts, although they have their equivalents in all the other European countries. They charged relatively high fees for their services and did not have an outstanding reputation for investment performance, since their true function is to preserve capital and confidentiality.

Retail portfolio managers have a strong preference for "household" issuer names because their cautious and risk-averse customers insist on dealing only with well-known companies or governments. The portfolio managers do have more than a little discretion in handling their customers' accounts, however, and, accordingly, they also participate in the occasional special or less well known situation, especially if the issue is being managed by the bank.

Wealthy Japanese individuals likewise became bond market participants, particularly in zero-coupon issues where—under the Japanese tax code—they did not have to pay taxes on the imputed interest. Japanese demand for zero-coupon Eurobonds became so strong that the Japanese Ministry of Finance imposed a regulation restricting the percentage of any

issue that could be sold into Japan. Japanese individuals invest in Eurobonds mainly through Japanese securities firms, whose role in the Euromarket expanded, reflecting the strong demand for Eurobonds of all types in Japan during the 1980s.

Institutional Investors

The institutional sector of the Eurobond market is not too different from its counterpart in the United States. London has long been a center for professional money managers, who, for example, manage corporate and other pension funds, mutual funds, and private wealth. Other European financial institutions, such as the European Investment Bank and other EU entities, central banks, insurance companies, banks (including foreign banks without an active customer base in Europe which needs to acquire its lending opportunities in the market), a growing array of European and American mutual funds, and corporations with excess cash have a trading and performance orientation that is similar (though not quite so intensive) to that of the U.S. market. In the late 1980s, large Japanese insurance companies, trust banks, and other institutions began to participate in the market for the first time. Because of the large amount of funds available for investment and the Japanese practice of acting more or less in the same way at the same time, Japanese institutions had a very large effect on the market over the past 10 years.

Investor Bias

On the whole, both institutional and individual investors have a heavy bias in favor of the better-quality names and for shorter maturities. They fear defaults, because they do not wish to expose themselves to seek recovery in bankruptcy proceedings. There have been times when a Baa-rated Eurobond issue has done well but, as compared to the United States this became a much less frequent occurrence. Still, there were some who predicted that with the right sales effort, a Euro junk bond market might emerge, which it eventually did.

New Issue Procedures

In the United States, securities issues must be filed with the SEC, which must declare issues "effective" before they can be sold to the public. To be declared effective, issues must meet disclosure and procedural requirements. In the past, the SEC would routinely take a few weeks to review filings placed with it. Today, as a consequence of SEC Rule 415, many companies can file "shelf" registration statements that, when effective, will provide an issuer with the means to come to market at any time on very short notice. Issuers must distribute securities through investment bankers acting as un-

derwriters who usually (but not always) will syndicate issues with others. The issue, when ready to be launched, will be priced at a "fixed" (i.e., nondiscountable by the other underwriters) gross underwriting spread that was established by negotiation between the issuer and the lead underwriter.

Thereafter, the issue will be allocated among underwriters by the lead underwriter. The underwriters will then commence to sell the issue to investors, virtually all of whom are experienced institutional investors who know the secondary market trading levels. By terms of the agreements between underwriters, all sales to investors must be at the fixed offering price until such time as the lead underwriter "releases" the issue for free trading at whatever price the market may then command.

Issues may be brought as "bought deals" in which one or a few underwriters purchase the entire issue (which may or may not subsequently be syndicated), or they may be done through the more traditional practice in which the issue is purchased from the company by the entire syndicate following pricing negotiations. Bought deals may be awarded to the lowest bidder after a competitive process, or they may be awarded without competition if the issuer likes the proposal made to it and wants to avoid taking any risk that the market may move against it before the issue is priced.

In the Eurobond market, there are a number of different practices. There are no requirements for filing an issue with any regulatory bodies except for the listing requirements of the London or Luxembourg stock exchange. In earlier years, most issues were "mandated" by a corporation to a particular lead manager who would form a syndicate, test the market for a week or two with "road show" visits to principal European cities with senior officers of the issuer, and then agree on price and gross spread with the issuer. Today, most issues are bought deals that are mandated to the underwriter offering the best net cost of funds in the currency that is ultimately desired by the issuer.

A Eurobond Pricing Example

For example, a company may inform those who ask that it is "thinking about" raising $500 million with a maturity of five to seven years. It may actually communicate this message to three or more underwriters to get their best ideas. Each underwriter will discuss the situation internally to come up with the most accurate assessment possible of the rate at which the issue could be completely sold within a day or two. For example, an issuance of ordinary five-year notes, noncallable with interest payments only until maturity (these terms are variables as far as the underwriter is concerned, to be adjusted as necessary to determine the optimal combination of attractiveness to the issuer and to investors), may be estimated to sell in the market to knowledgeable investors at, say, an annual yield of 7.25%. The issuer would expect to incur a "cost-of-funds" of a bit more than that—say, 7.30%—which would include the underwriters' commission, or "gross spread." The annual coupon is a traditional practice in the

Eurobond market, originally offered in place of semiannual coupons, common in the United States, as an accommodation to Swiss banks and their customers who did not like to be bothered with coupon clipping.

With an annual coupon of 7.00%, a bond would provide a cost of funds to the company of 7.31% at an all-in (including underwriter's compensation) issue price of 98.74%. If the underwriter can resell the bonds at a price of 98.98%, its customers will obtain a yield of 7.25%. The underwriter's profit is 0.24% (98.98% less 98.74%). This is the way bonds are priced in the United States; but there the underwriters agree (in writing) with each other that none will sell at a price other than 98.74% except to other dealers. Thus the price of 98.74% is "fixed" during the offering period, until the lead managers disbands the syndicate formed for the issue.

In the Euromarket, however, "traditional" (but now rapidly fading) practices required that a gross spread of 1⅞% would apply to a seven-year issue such as the example given above. However, this extremely high level of gross spread was largely fictional to all but the continental European bankers participating as underwriters in the deal. Only these banks can hope to retain the full spread, because they simply put the bonds into their clients' accounts at a price of 100%, with the 1⅞% difference between the price at which the banks were able to acquire the bonds being the bank's profit. But to maintain the spread of 1⅞% and still provide a competitive cost of funds to the issuer (7.31%), the bank must lower the coupon to 6.85% (which at a price of 98.125% yields 7.31% over five years).

Private clients or retail investors may be willing to accept a yield of 6.85% on the bonds, but institutions, focusing as they do on secondary market trading levels and required spreads over treasury securities, would not. In traditionally priced Eurobonds, underwriters are unable to sell bonds at 100% to institutions. Their clients will not pay more than 98.37% for the 6.85% bond (which will yield 7.25%), so they have to discount the bonds to them. This difference in pricing methods is called a "two-tiered" pricing structure (see table 3-5), though since 1989, and with rising levels of secondary market trading volume, most of the major Eurobond issues have been offered in the American fixed-price manner to effect better institutional distribution.

The fixed-price offer method essentially takes the pricing structure for the sale of Eurobonds to institutional investors and locks it into an agreement among underwriters not to sell at any other price so as to preserve the spread. However, it also eliminates the 0.125% "praecipium," or special portion of the management fee due to the lead manager, and the practice of charging all the after-market stabilization expenses to the other underwriters, both traditional practices of the Eurobond market that came to be much disliked. The far more transparent fixed-price method is virtually identical to the method used to price issues in the U.S. market.

But to win the mandate, the lead underwriter probably has to come

Table 3-5 Different Eurobond Pricing Methods (%)

	Traditional Pricing Method for Continental Banks	Fixed-Priced Offering Method for Institutional Investors
Annual Coupon	6.850%	7.250%
Gross Spread	1.875%	0.250%
Cost of Funds to Issuer	7.310%	7.310%
Price Bought by Investor	100.000%	100.000%
Yield to Retail Investor	6.850%	—
Gross Underwriter's Profit	1.875%	0.250%
Discount to Institutional Investors	(1.625%)	—
Yield to Institutional Investors	7.250%	7.250%
Net Underwriter's Profit	0.250%	0.250%

Note: Both methods produce the same cost of funds to the issuer (7.31%), and the same yield to the institutional investors (7.25%) at a net profit to the underwriter of 0.25%. The artificially large gross spread of 1.875% charged by the Continental bank is applied to a lesser bond coupon (6.85%) to provide the required cost of funds. Thus, the retail investor pays a much higher price for the bonds, as compensation to the Continental bank.

up with a rate to the issuer below 7.30% There are several ways this can be done.

First, an investor somewhere around the world, in Japan or the Middle East, for example, might be found who was prepared to purchase the bonds at a lower yield, thereby allowing the underwriter room to lower the cost of funds to the company. Sometimes before bidding, an underwriter would spend the preceding night scouring the investors in different time zones to see if demand can be found at the better price levels. Often, it can.

Second, the underwriter may find a way to create a synthetic dollar bond using swaps that would cost the company less than 7.30%. Again, the underwriter must scan the world. Is there an opportunity to issue bonds in, say, Australian dollars and simultaneously enter into a US$/Australian$ currency swap to obtain a lower cost of funds? There are many possibilities on any given day, and many must be checked out in detail. The underwriter could also decide to purchase the bond from the company at an aggressive rate, say at break-even, or 7.25% because he or she is convinced that interest rates will decline and will be "bailed out" by the rising market, an event that is certainly not assured. Finally, the underwriter may decide to offer to purchase the bonds at an even lower rate, say below 7.25%, because of an opportunity to use it in connection with a favorably priced swap transaction or simply as a means to buy market share.

Syndication and Underwriting Risk Management

Once an issuer selects one of the available offers, it will usually confirm and accept the terms proposed on the telephone. If so, the transaction becomes a "bought deal"—the underwriter has agreed to purchase the issue

outright. There are no outs for syndication, investigation into the issuer's business, documentation, or market changes. The underwriter owns the entire issue, period. In other cases, the issuer will only mandate an underwriter to proceed with the transaction, usually subject to a rather precise understanding as to when the issue will be priced and underwritten.

Either way, the underwriter's next step is to arrange for a syndicate of other underwriters to share the risk. It may be that the issuer has imposed on the transactions a group of "co-lead managers" of the issuer's own selection. Such co-lead managers are functionally the same as "co-managers" in U.S. transactions—they share in the management fee portion of the gross spread and appear prominently at the top of the list of underwriters alongside the "lead manager," or "book running manager," in U.S. terms. A lead manager will usually not propose or initiate the inclusions of co-lead managers for competitive reasons. It will, however, look for "co-managers" that are functionally about the same as U.S. "special bracket" underwriters, which rank just ahead of traditional "major bracket" underwriters. In Eurobond issues, large numbers of co-managers have become common, with 8 to 12 not unusual. The lead manager will try to lay off as much as 90% of the underwriting risk of the issue, keeping about 10%. Some issues are completely syndicated among the managers, but in most cases a general underwriting group, representing about 50% of the underwriting, is invited. If an issue is overpriced (too little yield), the lead manager may not be able to fully syndicate the issue, thus having to increase its own underwriting by the amount of any shortfall.

Once syndication has begun on an issue and its terms are known, the issue will appear in the "grey market." This is an informal, unauthorized, electronic quotation service that is provided to the market by certain bond brokers over the Reuters, Bloomberg, and other information networks. On one or more Reuters' pages there will appear a list of all of the latest issues that have been announced, together with a brief summary of their terms and any recent news concerning syndication. Individual bond brokers will have their own pages on which they post prices. All market participants and most institutional investors stay tuned into the grey market pages continuously to keep abreast of market developments. Before fixed-price issues became widely in use, the grey market data would include the bond brokers' indicative bid and offer quotations, expressed in terms of a percentage discount from the offering price, or in terms of a percent of par value (100%). These quotations would often show substantial discounts from the offering price, sometimes greater than the gross underwriting spread.

Co-managers (and other underwriters) finding themselves being allocated bonds in poorly priced issues may decide that they do not want to retain the market risk of holding the bonds in inventory and therefore elect to sell the bonds in the market. The easiest market to access is the grey market. If the issue is tightly priced and the co-manager has no demand from its customers, the co-manager may call a bond broker to arrange a sale of bonds on a confidential basis. This way the issuer and the lead

manager will not be able to know for sure that the co-manager was unable to sell the bonds allocated to it. The bond broker will then immediately call the lead manager of the issue and ask it to buy the bonds back at the grey market price quoted by the broker. If the lead manager wishes to stabilize the issue around the grey market level, it will purchase the bonds. Depending on the lead manager's response, the bond broker may adjust its quotes. This process can often have the effect of repricing an issue and causing a substantial portion of the entire issue to be reacquired (frequently at a loss) by the lead manager.

Such lead manager's stabilization purchases, in effect, are for its own account, not for the account of the whole syndicate, because stabilization losses can only be charged to the syndicate up to the amount of the underwriting commission. This is because in a traditional variable price underwriting, stabilization prices will vary, resulting in profits or losses, which may be substantial. It becomes difficult for the lead manager to separate transactions made for its own account—regarding its own bonds—and those of the syndicate. Accordingly, if more than a minimal amount of stabilization is to occur, it will be performed by the lead manager acting on its own and at its own risk.

It is often in the interest of the lead manager to stabilize issues: it prevents the grey market from collapsing to levels below the full amount of the gross spread, and it buys time for the marketwide sales effort to take effect. If the stabilization effort is persuasive, the issue will respond; if not, it may drop in price, which is most injurious to the manager holding the largest amount of bonds—usually the lead manager. If the issue is clearly mispriced, however, the lead manager may be better off to attempt to hedge the issue as early as possible—for example, by selling treasury bonds or, alternatively, by selling ("shorting") a similar Eurobond issued by another company—and then let the market manage on its own without accumulating additional bonds through stabilization. If the cost of financing the inventory of bonds is less than the income received on them, some participants are willing to carry the unsold bonds for as long as several months, until they can be sold off at higher prices when opportunities present themselves. Sometimes they can only liquidate such positions at a loss—often a large loss.

Clearly, the risk exposure of a lead manager was considerable under the grey market–dominated, variable-pricing system. Accordingly, lead managers experimented with several methods of imposing syndicate "discipline," usually without satisfactory results. However, syndicate practice permitted the lead manager to charge the expenses of the issue, including some stabilization charges, to underwriter accounts—that is, against the portion of the gross underwriting spread allocated to each syndicate member for agreeing to take on the underwriting risk. Before long, the lead managers had depleted the entire underwriting fee by stabilization charges, much to the annoyance of the other underwriters. By the early 1990s, the fixed-price underwriting method was introduced and became widely ac-

cepted, ending the wild activities of syndicate members and managers, although the grey market continues to exist and to act as a reality check for all participants.

Jumbos, Globals, and Private Placements

By the mid-1980s, issues exceeding $1 billion became common in the Eurobond market. These were usually floating-rate notes issued by sovereign governments or large banks, which, because of their size, were called "jumbos." By the late 1980s, some fixed-rate jumbos had appeared, after which the World Bank issued the first "global" bond issue, in which several separate markets (the Eurobond, the U.S. public debt market, the Japanese public market, etc.) were approached simultaneously at the same terms and rate. The World Bank issue had a "lead coordinator" for the issue and several different book runners for the respective tranches. The issue was successful and followed by others like it. One of these was a $5.5 billion two-part offering of 10-year notes and 30-year bonds by the Republic of Italy in September 1993. The issues were part of a $10 billion shelf registration filed with the U.S. SEC in July 1993 to be marketed over the following 10 years. The issues were structured to be acceptable as global bonds—that is, they were to be tradable around the world, registered in such countries as required it, and part of a paperless book-entry system that required the bonds to be registered. The filing of the U.S. registration statement was followed by a "road show" of Italian government officials to various U.S. and foreign cities to meet investors. Italy had a long-term debt rating of A-1 from Moody's and AA from Standard and Poor's. As the road show progressed, market conditions improved and the underwriters saw considerable demand for the issues building up. The 10-year issue was priced to yield 0.62% over 10-year U.S. Treasuries, and the 30-year issue was priced at 0.80% over 30-year Treasuries. These rates were approximately comparable to those of a high-grade U.S. corporate bond. U.S. investors accounted for about 40% of the total demand for the bonds. The rest were sold to Euromarket and Asian investors. This was the largest global bond issue undertaken to date; its success invited additional issuers, particularly sovereigns, to try the market.

Various European and Latin American governments also did global, jumbo issues that were principally targeted to the Eurobond market but also were offered in other markets. Often the Latin American bonds were rated below investment grade, but because of economic conditions at the time, the bonds were well received. Frequently, access to the U.S. market was provided through private placements (arranged by the lead manager of the Eurobonds) under SEC Rule 144a, which permitted the sale and resale of unregistered securities in the United States to certain qualified institutional buyers.

Because the various bond markets around the world had been subject

to extensive integration through arbitrage trading and institutional participation, the bonds could be sold at the same yield in all the markets, although demand would vary from place to place for a variety of reasons, including currency, rating, and maturity preferences.

Competition in Eurobond Markets

The many different participants bring many different strengths and other characteristics to the Eurobond market. Thus many banks, investment banks, and brokers have had the chance to operate in the market with certain important competitive advantages. Swiss and certain other European banks traditionally had the advantage of considerable in-house placing power. They could "encourage" their retail customers to purchase Eurobonds, which they brought to the market and for which they could charge full fees. This placing power naturally drew prospective issuers to them. U.S., Japanese, and British banks have the advantage of influential relations with their home-country issuers and with institutional investors. Other specialized participants appear from time to time—U.S. commercial banks, for example, have been key participants in floating-rate markets and in swaps, where they were able to use their large funding base and trading books to considerable advantage. Japanese banks and securities firms benefited not only by a steady flow of Japanese issuers in the market (many of which are guaranteed by a Japanese bank) but also by the large appetite for Eurobonds that occurs from time to time on the part of financial institutions in Japan.

In the United States, the 10 leading underwriters of corporate bonds together managed approximately 86% of the total market in 2000, a figure that has not changed much during the past 10 years. In the Eurobond market, on the other hand, the top 10 firms accounted for only 65% of the market in 2000, and the firms comprising the top 10 varied considerably from the rankings of 1999. By almost any method of comparison, the levels of competition in the Eurobond market are far greater than in the U.S. bond market (table 3-6).

As markets change to reflect investor preferences—for dollars over other currencies, for fixed over floating rate, or straight debt over equity-related-securities—the competitive picture changes, and different institutions emerge as having the greatest comparative advantage. Firms that have built a strong distribution and trading force and investment banking capabilities in various different markets will probably do best over the long run. Certainly, however, the Eurobond market is not one that can be dominated by any single firm, or small group of firms, over any length of time. The vigorous competitive action of the unregulated, innovation-oriented market will keep it that way.

All banks and investment banks seeking to compete in the international market must come to terms with three basic factors: (1) that the new issue

Table 3-6 Top U.S. Underwriters and Eurobond Lead Managers, 1999 and 2000

	2000			1999		
Manager	2000 Rank	Amount (U.S.$B)	Mkt. Share (%)	1999 Rank	Amount (U.S.$B)	Mkt. Share (%)
Top U.S. Underwriters of Debt and Equity						
Citigroup	1	181.7	13.9	1	167.5	13.1
Merrill Lynch	2	143.8	11.0	2	150.1	11.7
J.P. Morgan	3	141.1	10.8	6	118.1	9.2
Morgan Stanley	4	134.6	10.3	5	121.7	9.5
Goldman Sachs	5	134.4	10.3	4	131.6	10.3
Crédit Suisse First Boston	6	123.5	9.5	3	138.8	10.8
Lehman Brothers	7	102.7	7.9	7	111.3	8.7
Deutsche Bank	8	54.0	4.1	12	24.4	1.9
Bear Sterns	9	53.9	4.1	8	67.7	5.3
UBS Warburg	10	48.3	3.7	9	54.7	4.3
Total top 10		1,118.0	85.8		1,085.9	84.8
Total industry		1,303.0	100.0		1,280.6	100.0
4-Firm ratio (%)			46.1			43.5
10-firm ratio (%)			85.8			84.8
Top Eurobond Lead Managers						
Deutsche Bank	1	66.6	8.9	1	72.6	8.8
UBS Warburg	2	63.4	8.5	2	62.7	7.6
Citigroup	3	53.3	7.2	9	36.4	4.4
Morgan Stanley	4	53.2	7.1	3	60.7	1.3
Merrill Lynch	5	49.9	6.7	6	49.8	6.0
Crédit Suisse First Boston	6	47.2	6.3	4	51.0	6.2
Barclays	7	40.4	5.4	13	31.7	
J.P. Morgan	8	38.3	5.1	8	43.2	5.2
ABN AMRO	9	37.1	5.0	7	43.7	
BNP Paribas	10	33.1	4.4	5	50.7	6.1
Total top 10		482.5	64.7		513.3	62.2
Total industry		745.4	100.0		825.0	100.0
4-firm ratio (%)			31.7			22.1
10-firm ratio (%)			64.7			45.7

Source: Thomson Financial Securities Data.

business for investment grade bonds has become global; (2) that globalization has made the business extremely competitive and realized underwriting profits have declined accordingly; and (3) that firms must regard new issues, secondary market-making and trading, hedging, swaps, and arbitrage related to bonds all as one integrated business.

That the business has become global is no surprise today. Borrowers, when discussing possible financings with their bankers, want to know what is the cheapest way to raise funds from whatever source. A competitor, for example, who does not operate in the U.S. or Eurodollar bond market, the Swiss franc market, or Japan will be at a significant disadvantage over to a firm that is active in all of these markets. Becoming involved in these

markets entails a substantial threshold of cost, personnel, and supervision, without which a firm is, in effect, only an occasional participant in the global debt markets.

The Effect of the Euro on the Eurobond Market

Euro-denominated Eurobonds are now issued by international institutions such as agencies of the EU and the World Bank, and some major multinational corporations whose currency composition is European or global (e.g., Nestlé, Unilever, and Shell). These are issued free of withholding taxes and in bearer form, as previous Eurobonds were. They trade in the market on the basis of the creditworthiness of the issuer and liquidity alone. As there is no benchmark reference for direct EU obligations denominated in euros, comparable to Treasury securities in the United States, the market has had to establish a pricing regime for such issues—for example, by comparing the offering yields to currency-swapped U.S. Treasury bonds or German government bonds. On February 1, 1997 (before the euro itself officially came into existence), the European Investment Bank (EIB) issued €1 billion (equivalent to $1.18 billion) of bonds due in 2004. Payment for the bonds and payments of interest and principal until January were in ECU, after which time all payments were denominated in euros. The issue, known in the market as the first "euro-Eurobond" was three times oversubscribed.

Euromarket trading opportunities—as in other markets in fixed-income securities—often depend heavily on market volatility. Before the introduction of the euro, that volatility was affected not only by changing national market conditions but also by global market linkages and changing foreign exchange and interest rates in different parts of Europe and the rest of the world. Many observers (but not all) believe that increasing trading volume in cash markets and derivatives contributes to a dampening of volatility. Indeed, the volatility of long-term U.S. government bonds and the dollar-euro rate declined significantly during the period from the mid-1980s until the introduction of the euro in January 1999. Particularly in the run-up period to the euro, when countries were seeking to align their economic and monetary policies, volatility decreased, but trading volume was still high as investors made bets on which currencies would be selected to enter the EMU. The euro, of course, has eliminated all volatility between the participating countries and now contributes to the overall reduction of Euromarket volatility.

Trading volume also increases when markets are used more extensively by borrowers and investors of all types. The greater the volume, the more liquid and efficient the markets, and the tighter the pricing. In such markets, the easy arbitrage trades (in which the same securities are quoted at different prices in different locations) disappear entirely. Many market partici-

pants have discovered that trading in increasingly efficient markets is not an easy business. Indeed, much money was lost in Europe (and in the United States) during 1994, and 1998 bear market years for bonds, by traders who had open positions instead of fully hedged ones. The traders had discovered that the cost of hedging consumed all their expected profits, so they decided instead to bet on their "feel" for how the market would develop. Getting the feel wrong was certainly an expensive exercise for many trading firms and, indeed, probably cost the great firm of S. G. Warburg & Co., the Eurobond pioneer, its independence (Warburg was acquired by UBS).

Will the Eurobond Market Die with Further Financial Deregulation?

During the past two decades, there has been substantial deregulation of most of the national capital markets in the OECD countries. This is partly the result of involuntary "imported deregulation" and partly because of a desire by financial authorities to upgrade the quality and efficiency of national capital markets. A question often asked is, Will such deregulation, if continued, obviate the need for the Euromarket?

This subject has received much attention. Those who believe the Euromarket will wane with the rising importance of deregulated national markets consider that issuers prefer domestic markets when they are competitive, and that, because of greater secondary market liquidity, international investors prefer them as well. Those who are doubtful that the Euromarket is on its last legs believe, to the contrary, that there will always be enough regulation in most national markets to be able to reward those who attempt to escape them, and that, in a world of very diverse internationally minded investors, bargains will be offered from time to time to attract business into the great unregulated and untaxed arena of international bond and capital markets.

There is developing evidence, moreover, that the best prices are obtained in markets with the greatest amount of secondary market liquidity. Different currencies will offer different rates of course, but through currency swaps, these rates will be arbitraged into parity with the dollar, the euro, and other preferred currencies. Only the U.S. bond market can at present offer as much secondary market liquidity as the Eurobond market, and investors in the United States are increasingly accustomed to investing in Eurobonds as an adjunct market to (if not an integrated part of) the U.S. bond market. Thus if current trends continue, it appears likely, that rising liquidity in national bond markets will result in further integration with the Euromarket, in which case the borders between the markets may become very indistinct indeed. The Euromarket, therefore, should continue as an alternative even to less-regulated national markets.

Summary

The international bond market has experienced phenomenal growth for over a quarter of a century, primarily in the Eurobond sector. As an unregulated market bringing together from all parts of the world high-quality issuers with a widely diverse and changing body of investors, the market is historically unique. The Eurobond houses, based in London but coming from all corners of the world, compete to offer issuers rapid access to low-cost funds. Their success has furthered international financial integration and has contributed to the drive for deregulation. In the future, developments related to the creation of a common "internal" market by the European countries that adopt the euro has already caused capital market activity in Europe to expand greatly. Such increased activity may further diminish the differences between onshore and offshore debt financing as it increases the worldwide selection of debt instruments.

4

Swaps and Derivative Securities Markets

Few events have stimulated international capital market activity as much as the development, beginning in the early 1980s, of "derivative" securities. Derivatives, which include futures, options, and swaps, are contracts whose values reflect changes in the price of underlying assets (stocks, bonds, or commodities) traded on exchanges or in over-the-counter markets. Derivatives are used to manage the various risks associated with financial assets and liabilities, the market values of which can fluctuate widely. Globalization of financial markets has resulted in the spreading of derivatives to market centers all over the world, and in the extremely rapid growth in contracts outstanding, which were estimated by the Bank for International Settlements at the end of 2001 to exceed $86 *trillion* in "notional" value. Notional value means the principal amount that is hedged, not the actual value of the derivative instrument itself, which is far less than the notional amount.

Derivatives packaged together with cash market securities can create "synthetic" securities with substantially different characteristics than the original cash market instrument. Thus derivatives are used to alter the investment characteristics of a security without requiring the security to be sold and the proceeds reinvested. Derivatives traded on exchanges in the United States, Europe, and Asia are large-volume, commodity-like instruments that include interest rate and currency futures contracts, as well as interest rate and currency options (including options on futures contracts). Derivatives traded in over-the-counter markets include interest rate swaps (over $59 trillion of notional value outstanding at the end of 2001), currency swaps ($3.9 trillion notional value outstanding at December 31, 2001), other swap-related derivatives), and a variety of small-volume, customized instruments used to hedge interest rate, equity and foreign

Table 4-1 Financial Derivative Instruments Outstanding

	Notional Principal Outstanding (in billions of U.S. dollars)			
	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001
Exchange-traded instruments	***13,931.9***	***13,521.7***	***14,302.2***	***23,717.3***
Interest rate futures	8,020.0	7,913.9	7,891.9	9,234.0
Interest rate options	4,623.5	3,755.5	4,734.2	12,492.6
Currency futures	31.7	36.7	74.4	65.6
Currency options	49.2	22.4	21.4	27.4
Stock market index futures	290.7	334.3	393.2	334.0
Stock market index options	916.8	1,458.9	1,187.1	1,563.7
Over-the-counter instruments[1,2,3]	38,515.0	46,380.0	51,962.0	62,839.0
Interest rate swaps	36,262.0	43,936.0	48,768.0	58,897.0
Currency swaps	2,253.0	2,444.0	3,194.0	3,942.0

Source: *BIS Quarterly Review*, various issues.

[1]Data collected by the International Swaps and Derivatives Association (ISDA) only; the two sides of contracts between ISDA members are reported once only.

[2]Adjusted for reporting of both currencies; including cross-currency interest rate swaps.

[3]Caps, collars, floors, and swaptions.

exchange risks (see table 4-1). As a proportion of the international assets of BIS reporting banks, the notional volume of derivative contracts on interest rates and currencies rose from around 25% in 1986 to nearly 117% in 2001. Perhaps even more significant, trading in derivatives has in many instances exceeded that of the underlying cash markets.

This chapter addresses swaps and related derivative instruments, which can be tailored to reflect almost any interest rate or currency outlook and create an appropriate risk exposure. Table 4-2 provides definitions of the most common terms used in connection with derivative instruments.

Swaps

Swaps are over-the-counter instruments involving the exchange of one stream of payment liability for another. Before 1980, swaps scarcely existed. By 1985, they were seen to offer great advantage to issuers (and investors) of debt securities because, with them, a corporation could lower the cost of financing in bond markets, or an investor could raise the yield on bond investments, through arbitrage and by exploiting comparative advantages. Indeed, swaps had become so much a part of the international financial scene that Eurobond transactions involving swaps ("swap-driven transactions") were responsible at times for more than half of all new issues. Also, since about 1987, banks and other financial intermediaries have found swaps extremely beneficial in managing the special risks of interest rate and currency exposures from loan and investment portfolios. Swaps are enormously accommodating—they enable parties to change their finan-

Table 4-2 Common Terms in the Derivatives Market

Term	Definition
Derivative	A financial contract whose value is linked to the return on bonds, stock, currencies, or some other benchmark. Generally, derivatives fall into two broad categories—forward-type contracts and option-type contracts—and may be listed on exchanges or traded privately.
Options	A contract for which the buyer pays a fee in exchange for the right to buy or sell a fixed amount of a given financial instrument at a set price within a specified time. Options are "price-insurance" contracts because they protect buyers from adverse swings in the price of the underlying asset. The buyer can never lose more than the price paid for the option, but the seller's losses are potentially unlimited.
Cap	An option that protects the buyer from a rise in a particular interest rate above a certain level.
Floor	An option that protects the buyer from a decline in a particular interest rate below a certain level.
Exotic options	A wide variety of options with unusual underlying assets or peculiar terms or conditions. For example, a *lookback option* confers the retroactive right to buy a given financial instrument at its minimum price, or sell at its maximum price during a special "lookback period." A *compound option* is an option such as a put on a call, a call on a put, a put on a put, or a call on a call.
OTC derivatives	Derivative transactions take place "over-the-counter," or off organized exchanges, and usually by telephone.
Forward	An OTC contract obliging a buyer and a seller to trade at a set price on a future date are "price-fixing" contracts, because they saddle the buyer with the same returns as owning the underlying asset. Normally, no money changes hands until the delivery date; then, the contract is usually settled in cash rather than through exchange of the actual asset.
Swap	A forward-type contract in which two parties agree to exchange streams of payments over time according to a predetermined rule. In an *interest rate swap*, one party agrees to pay a fixed interest rate in return for receiving a floating interest rate from another party. An *equity-index swap* may involve swapping the returns on two different stock market indexes, or swapping the return on a stock index for a floating interest rate.
Future	Basically, an exchange-traded forward contract. Futures contracts are highly standardized, and the exchange acts as a counterparty to both buyer and seller, guaranteeing payment in case one of them defaults. In return, buyer and seller, are required to put up collateral, or margin, equal to a certain percentage of the underlying value of the contract which is marked to market daily.

cial assets and liabilities at will and at low cost, for example, to change a fixed-interest payment obligation into a variable one, or to change a dollar payment obligation into one denominated in euros.

Swaps constitute valid and binding agreements between participants to exchange one stream of future interest (and sometimes principal) payments for another. Swaps, however, represent contingent values and therefore do

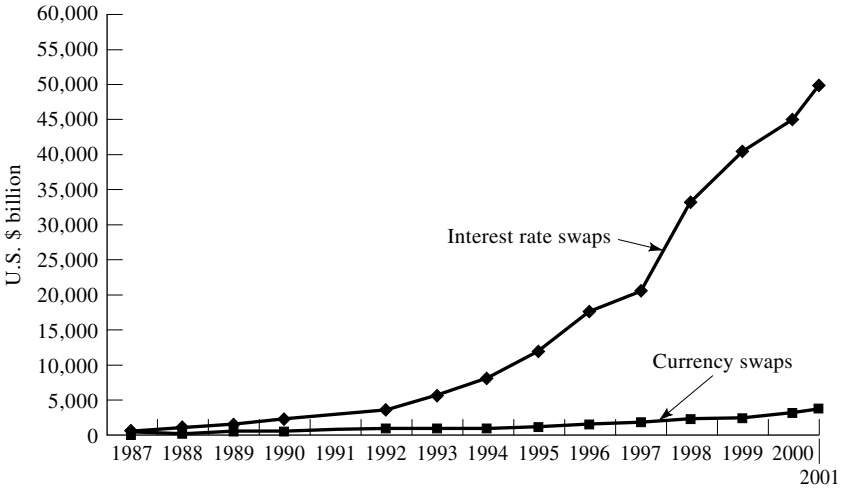


Figure 4-1. Swap market growth, 1987–2001.

not appear on balance sheets, except in footnotes. Since 1985 they have been transacted according to standardized documentation and almost always involve counterparties of high creditworthiness. The growth of interest rate and currency swaps has been exceptional since their origin, as indicated in figure 4-1.

The Origin of Swaps

In the early years of modern international capital markets, around the mid-1960s, foreign exchange controls that blocked or impeded the flow of funds across borders were abundant. In the days of fixed exchange rates, the conventional method of preventing funds from exiting or entering one's country was to surround it with a ring of exchange controls. For example, if a British pension fund manager wanted to invest in the U.S. equity market, he or she would either have to sell an existing overseas asset to pay for the new investment or purchase international "investment currency" to do so. Investment currency was rigged to be more expensive than domestic currency—in effect, it was the same as buying dollars for the U.S. investment at a premium or paying a higher rate for the dollars than otherwise prevailed. Similarly, if a U.S. company wanted to make a capital investment in its manufacturing facility in the U.K., it was under considerable pressure from U.S. authorities (under regulations issued by the Commerce Department's Office of Foreign Direct Investment, now extinct) to finance the investment with funds borrowed outside the United States, even if that meant—as it did until the late 1970s—that the cost of financing would be greater than what was available to the company at home. To accommodate the requirements of both such parties, the "back to back" or "parallel" loan

was devised. The U.S. firm would lend an agreed amount of dollars to a U.S. affiliate of the British pension fund, and, in a separate but "parallel" transaction, the U.K. pension fund would lend the same amount in sterling to a U.K. affiliate of the American company. Two loan agreements were required, both containing substantially the same terms and conditions, often including provisions for "topping up," or reducing the amount of one loan as an offset to the changed market value of the other. Such changes would occur because of changes in the dollars to pounds exchange rate. The loans did provide substantial value to each party, but the cost of arranging and executing them consumed a large portion of this value, especially when the principal amounts were small, which was often the case. Credit considerations were complex, even though the loans provided for a mutual offset in the case of default, and agreement on interest rates was often difficult to achieve when the maturities involved exceeded the one- to two-year periods for which forward foreign exchange rates could reliably be obtained. Banks were often asked to stand in the middle, to ease questions of counterparty credit exposure, even though such arrangements added further to the cost of the transactions. Accountants ruled that because of the offsetting provisions, the loans would not have to be included on the face of the companies' financial statements, which provided an advantage that direct borrowing from a foreign bank would not. After a time, much of the process was made easier by the familiarity of participants and the standardization of some of the procedures, but the overall volume of parallel loans was very modest by current standards.

After the collapse of the Bretton Woods fixed exchange-rate system, and the adoption of floating exchange rates, controls governing the international transfer of funds became obsolete and began to be removed. The U.S. regulations were rescinded in 1973, the British government abolished exchange controls in 1979, and other countries followed suit. Parallel loans were no longer necessary and immediately disappeared. Some of the financial principles underlying the parallel loan market, however, were deemed to have wider application and served as the basis for the swap markets that succeeded them.

Currency Swaps

A few years later, in August 1981, a significant transaction took place in which IBM and the World Bank agreed to exchange the future liabilities associated with borrowings in the Swiss franc and United States dollar bond markets, respectively. IBM was then perceived in Switzerland as one of the two or three best "names" from the United States and therefore was able to borrow Swiss francs in the Swiss market on extremely favorable terms, compared to all other foreign borrowers—that is, at about the same rate as the Swiss government. The World Bank, having used the Swiss market several times in the past and being involved with developing country loans, was not regarded quite so favorably by the Swiss and was therefore required to pay a higher rate than the best U.S. credits—about 20 basis points

above the Swiss government rate. In contrast, the World Bank, like IBM at the time, carried an AAA rating and was well respected as a credit in the U.S. dollar markets because of the backing of the U.S., German, Japanese, and other governments. The World Bank could borrow in the United States at rates only narrowly higher (e.g., 40 basis points) than U.S. Treasuries, but IBM would have had to pay a slightly higher rate than this.

So, if each borrowed in the market in which its comparative advantage was the greatest—that is, if IBM borrowed Swiss francs and the World Bank borrowed dollars—both borrowings would be at rates superior to the available alternatives. If they then swapped the liabilities each had incurred, the World Bank would create Swiss francs synthetically at a bargain rate, saving 10 basis points on the transaction, and IBM would save 15 basis points with its synthetic dollar financings. The parties had similar credit ratings, so counterparty risk was offset.

The way it worked was this. The World Bank borrowed at 5 basis points more advantageously than IBM could have done in dollars, and IBM borrowed at 20 basis points better in Swiss francs than the World Bank's best rate. IBM re-lent its Swiss francs to the World Bank at 10 basis points more than it paid for them, and (a) the World Bank gained, net, a 10 basis point advantage over its alternative Swiss franc borrowing cost, and (b) IBM gained a net 15 basis point advantage by combining the World Bank's 5 basis point advantage in dollars with the 10 basis points that it kept for itself on the Swiss franc financing (see figure 4-2). The value received by each party was the product of negotiation. Since then, market-makers quote prices for swaps that reflect the net demand of thousands of different market users. Each party swapped its fixed rate funding obligation for a different fixed rate obligation, which changed its liability into something quite different. (Today, currency swaps involving fixed-rate to floating-rate are also available.) The World Bank had created a synthetic Swiss franc security for itself that had all of the properties of the real thing, and IBM had done the same in dollars.

In the period preceding the IBM–World Bank currency swap, it was possible to arrange for foreign exchange purchases and sales in the forward markets, although, as indicated, these markets did not always operate beyond one- to two-year maturities. Swaps are now the preferred instrument for hedging foreign exchange exposure beyond a year. The growth of this market segment has put pressure on governments with restrictions on foreign exchange transactions to drop such restrictions, which the swap market can easily frustrate. Accordingly, considerable growth in nondollar currency swaps has occurred in recent years. Swaps in virtually all major currencies are now available, as shown in table 4-3.

Interest Rate Swaps

Having observed currency swaps develop, some bankers began to think of ways to apply the same idea to transactions involving short-and long-term dollar borrowings. They were encouraged by the existence of different

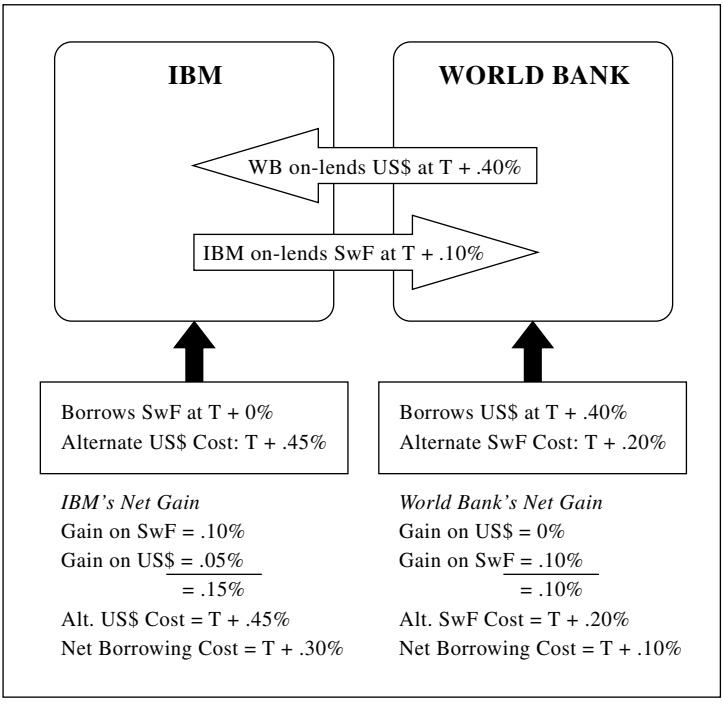


Figure 4-2. The first currency swap between IBM and the World Bank, April 1981: T = Treasury; SwF = Swiss franc.

credit risk premiums in the fixed-rate and floating-rate debt markets. For example, a weaker credit such as a BBB-rated industrial company would have to pay as much as 70 basis points more than an AA-rated bank for a five-year bond issue, but it would have to pay only 30 basis points more for a five-year bank loan based on LIBOR. So the BBB company could maximize its comparative advantage by borrowing from its bank and swapping the floating-rate interest payment obligation with an AA bank for a stream of fixed-rate interest payments that the bank had incurred through the issuance of Eurobonds. The bank would pass on its fixed-rate obligation to the BBB company at, say, its cost of funds plus a premium of 50 basis points. The BBB company would then be able to create a synthetic five-year fixed-rate borrowing at 20 basis points less than its alternative cost of funds. The AA bank assumes the BBB company's floating interest rate obligation to pay LIBOR plus 30 basis points, but it reduces this by the 50 basis point spread that it made in the fixed-rate bond swap, resulting in a net cost of funds of LIBOR minus 20 basis points (see figure 4-3). In this way an interest rate swap was created. Many more followed, with further modifications and improvements. A secondary market in swaps subsequently developed. New applications were introduced rapidly as volume

Table 4-3 Composition of OTC Foreign Exchange Derivatives by Currency

	Total Notional Amounts		
Currency	1998	1999	2000
Australian dollar	206	365	387
Canadian dollar	594	647	623
Danish krone	28	37	40
Euro	—	4,667	5,981
Hong Kong dollar	89	321	450
Japanese yen	5,319	4,236	4,254
New Zealand dollar	10	6	3
Nowegian krone	48	127	103
Pound sterling	2,612	2,242	2,391
Swedish krone	419	459	456
Swiss franc	937	880	848
Thai baht	28	24	18
U.S. dollar	15,810	12,834	14,073
Other	55	1,407	1,450
Minus double-counting	−8,144	−13,908	−15,411
Total	18,011	14,344	15,666

Source: *BIS Quarterly Review*, June 2001.

built up and the number of participants and intermediaries increased sharply.

Two basic types of interest rate swaps have become common since 1981: "coupon swaps" (of fixed-rate to floating-rate swaps such as the one just illustrated) and "basis swaps" in which floating-rate obligations indexed to different reference rates were exchanged. An example of the latter is a swap between a rate indexed to U.S. Treasuries and one indexed to LIBOR. Basis swaps include exchange of rate obligations indexed to the same reference, but for different maturities (e.g., 30-day LIBOR vs. 90-day LIBOR).

Through the end of 1982, the interest rate swap market operated in mainly an international context. During 1983, however, a large volume of swaps developed between exclusively domestic U.S. counterparties. Top-quality borrowers, such as the Student Loan Marketing Association (Sallie Mae), would issue fixed-rate securities to swap them into floating-rate obligations to fund its essentially floating-rate loan portfolio at a lower cost.

Then a major new use for interest rate swaps was found in the distressed U.S. savings and loan industry. These institutions had fallen into great difficulty as a result of financing fixed-rate home mortgages from the proceeds of floating-rate deposits. When interest rates soared in the late 1970s, many savings and loan (S&L) institutions suffered heavy losses. As rates began to decline again in the early 1980s, some S&Ls sold fixed-rate debt securities, collateralized by mortgages, to pay down variable-rate liabilities. Others simply swapped their existing floating-rate funding obliga-

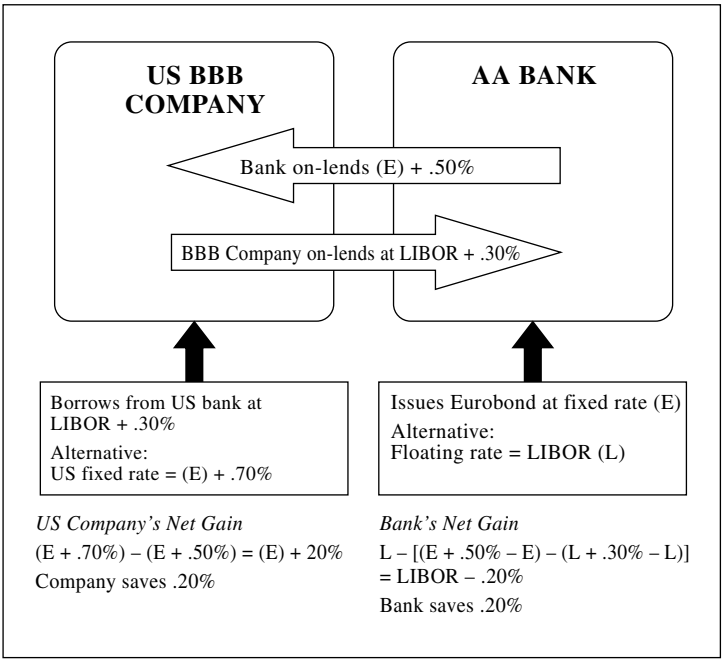


Figure 4-3. An early interest-rate swap between a U.S. company with a BBB rating and a bank with an AA rating: LIBOR = London Inter-bank Offered Rate.

tions into fixed-rate obligations, again offering existing mortgages as collateral.

Swaptions, Caps, and Floors

As the market for swap transactions developed, comparable developments were occurring in the field of financial futures and options. Financial futures became available in many different currencies and instruments and came to be traded on futures exchanges in London, Paris, Zurich, Frankfurt, Singapore, and Tokyo, in addition to the futures markets in the United States. Through sophisticated use of financial and foreign exchange futures contracts, new ways of hedging against interest rate and foreign exchange exposures were developed. Ultimately, these resulted in the ability of dealers to sell options on hedged positions, which they carried on their own books.

Soon, markets were being made in option contracts in which purchasers could, in effect, acquire insurance against future risk exposures. The ability of the dealer to price options that it was selling to others became crucial to the dealer's operation. Whereas the dealer collects the premium at the outset, the actual result of the contract would not be known for some time, often for several months. If the dealer had misjudged the value of the options that were sold at the beginning of the year, it might not

know it until nearly the end of the year—although after a time the development of an active secondary market in various types of options clearly revealed the value of the positions ("marking to market").

Gradually, the financial market environment became much more sensitive to and aware of sophisticated hedging devices and strategies, many of which were based on the improving understanding in the market of the many uses and values of swaps, futures, and options transactions used in various combinations, in which they are called *swaptions*. The swaption market includes any option that gives the buyer the right, but not the obligation, to enter into a swap on a future date. It also includes any options that allows an existing swap to be terminated or extended by one of the counterparties. Some of the more recent swaptions have included the following.

Forward Swaps

A forward swap is one in which the payment accruals commence at some specified time in the future. It can be used to fix funding costs in the future, as, for example, after the construction phase of a real estate project has been completed. There are many other uses as well, as illustrated by figure 4-4, which shows a forward swap used in conjunction with the issuance of a callable bond to provide the issuer with greater flexibility and a lower over all financing cost. In this case a French bank issued 7.5% yen bonds. The bonds, callable after five years, would mature in eight years. Upon issuance of the bonds, the French bank entered into a currency swap (Swap A) in which it would receive yen and pay euros.

After three years, the yen had strengthened substantially against the euro, and yen interest rates had declined. The value of the contract to pay euros and receive yen was worth more than when the contract was originally written. Because the yen/euro swap had appreciated, the French bank wanted to realize this value in some way. It could do so by, in effect, repaying the first swap (that is, selling it in the market at a capital gain reflecting its increased value) and replacing it with another one at current, more favorable rates. Or, it could gain more flexibility for itself by entering into a second swap ("forward" Swap B), a forward euro/yen swap which would come into effect in two years (at the call date) and then last for three years (until the bonds mature). The plan is to call the bonds in two years and replace them as a funding source for Swap A with Swap B, then coming into effect. Then the French bank locks in an income differential that is the equivalent of a three-year annuity instead of a capital gain. Alternatively, if rates had continued to improve, the bank could decide not to call the yen bonds and could sell Swap B at a profit instead.

Caps and Floors

Caps and floors involve the purchase of a series of options on short-term interest rate indexes, which enables the purchaser to fix the upper or lower

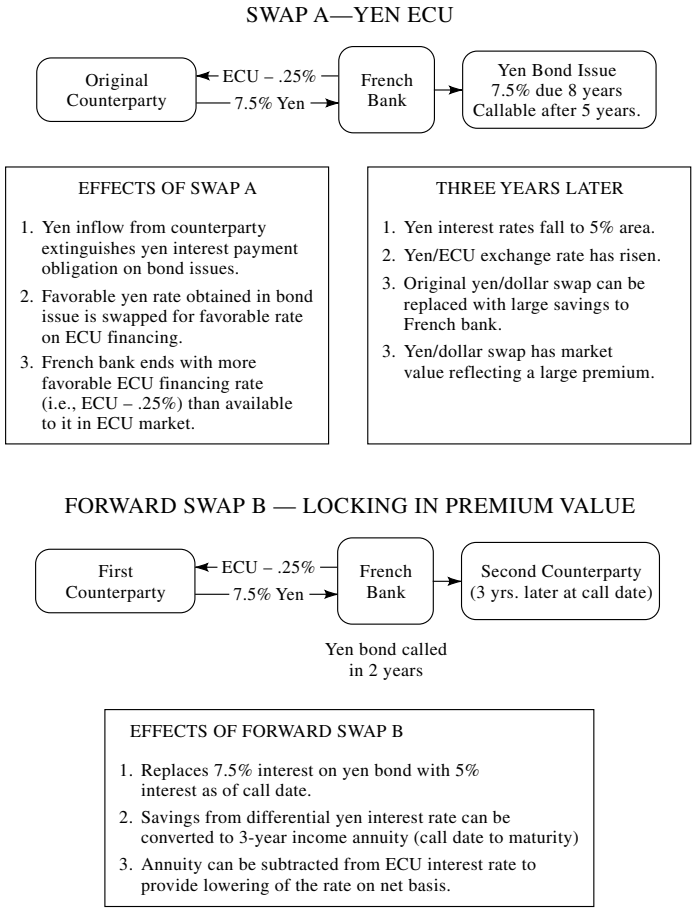


Figure 4-4. Forward swap–callable bond transaction: ECU = European currency unit.

rate to which it would be exposed. In combination with other instruments, a cap or floor for almost any kind of asset or liability exposure to interest or exchange rates can be created.

Collars

A collar combines a cap and a floor in a single transaction to limit both upside and downside risk.

Callable/Putable Swaptions

Customized swaps can be created by the addition of call or put features. In a callable swaption, which is made up by combining a regular interest rate swap and an option (at some additional cost for the options premium)

on the reverse of such a swap, a hedge can be established at the outset of a swap transaction involving, for example, a callable Eurobond issue where the call feature is deemed to have high value.

Contingent Swap

In essence a contingent swap is an option on a swap with particular characteristics that could be exercised if, for example, bond purchase warrants attached to a Eurobond issue to lower its cost should be exercised.

In these and similar cases involving combinations of swaps with other instruments, the desired customized package can be purchased from swap dealers who create them by taking counterpart, or "mirrored" positions, on their own books.

Credit Derivatives

Credit derivatives[1] allow a provider of funds to obtain protection against credit risk on an underlying financial instrument. Although loan guarantees exist for this purpose, credit derivatives offer more flexibility. There are three main instruments:

Total Return Swap

This is the exchange of actual returns from a credit instrument (e.g., a loan or a bond) for a guaranteed return. The protection seller pays a contractually determined return to the protection buyer in return for the actual returns from the asset. Since actual returns could be lower than expected returns, this protection offers a guaranteed minimum return to the protection buyer. Note that the protection buyer maintains ownership of the underlying asset.

Credit Default Swaps

These extend financial guarantees, which traditionally reimburse protection buyers only if the credit instrument defaults. A credit default swap reimburses the protection buyer if the credit rating of an instrument changes. That is, the protection buyer is covered not only in the event of default, but also in case of a credit downgrade or rumored downgrade. Protection suppliers receive a fee for this guarantee.

Credit Linked Note

This is a note issued by a protection buyer. The protection seller provides a principal payment, and the protection buyer makes regular coupon payments to the protection seller. At maturity, the protection seller returns to the protection buyer the principal as long as no predetermined credit events

occur. The note must be paid in full even if other events (not predetermined credit events) lower the value of the note.

According to the British Bankers' Association, the credit derivatives market has grown from $40 billion outstanding notional value in 1996 to nearly $900 billion in 2000. The BBA predicts the market could reach nearly $1.6 trillion by 2002. In 2000, the London market held an estimated $400 billion and U.S. commercial banks held approximately $200 billion.

Other Innovations

With increasing usage, the swap market has attracted a considerable array of new products and innovative applications.

Amortizing Swaps

Amortizing swaps have a variable notional balance, including balances that match the expected cash flow of a financing project or the prepayment schedule of a mortgage asset or liability.

Step-Up/Down Swaps

Step-up and step-down swaps have a varying fixed payment level—increasing or decreasing—for some portion of the swap term. For example, the fixed-rate portion may be set below the market for the first two years, with an above-market rate for the remainder of the term.

Mortgage Swaps

A mortgage swap is structured to replicate all or a portion of the yield or return characteristics of mortgage securities. In the most straightforward structure, a mortgage yield is exchanged for a floating-rate return, and the notional balance is amortized according to either a specific prepayment assumption or the actual prepayment experience of the underlying mortgage pool.

Commodity Swaps

A commodity swap exchanging payments based on the value of a particular commodity, like gold or oil. One party pays a fixed price for the commodity and receives the spot price of the commodity on the reset date.

Repackaged Securities

There have been occasions when a particular issue of floating-rate securities has gone awry in the secondary market, because of credit deterioration or regulatory concerns that have affected the market, and the issue has traded

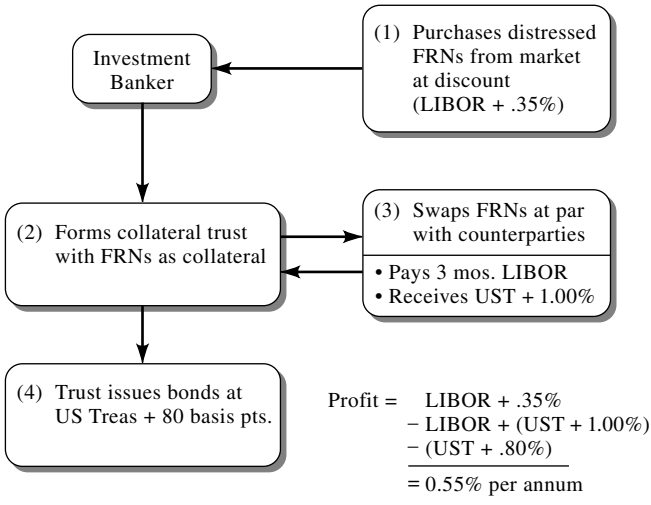


Figure 4-5. A repackaged securities transaction: FRN = fixed-rate notes; LIBOR = London Inter-bank Offered Rate; UST = Treasuries.

at unusually depressed prices. On such occasions, dealers have stepped forward with the intention to tender for the floating-rate securities (which pay, say, LIBOR) at a discount, so the effective yield becomes, say, LIBOR plus 0.35%. The securities are then transferred to a newly formed trust in which the notes are held as collateral. The trust, which may be owned by the investment banker/dealer, would then enter into an interest rate swap with a counterparty exchanging floating-rate payments for fixed-rate. The trust will then fund the fixed-rate part of the swap by offering fixed-rate bonds in the market as an asset-backed security, at, say, a rate of U.S. Treasuries plus 80 basis points. Thus the swap made possible the removal of the securities from the distressed floating-rate note market into the more healthy fixed-rate bond market, and the banker organizing the transaction profited from the difference in values. (see Figure 4-5).

Risks of Swaps

Several types of risks are associated with swaps. With their explosively increasing volume, these risks have become of concern to bank regulators around the world, as well as to investors in those financial intermediaries most involved with swaps and related products. Regulators, often slow to fully understand new technologies and market activities that develop quickly, feared that global exposures were so large that the entire financial system might be at risk to a sudden failure. The risks may have got out of hand, some regulators in the United States and Europe said, and would have to be reined in. Market practitioners, by contrast, claimed that far from increasing risk, derivatives improve market efficiency and provide es-

Table 4-4 The Different Flavors of Derivative Risk

Risk	Definition
Counterparty risk	Also known as credit risk, the risk that one party in a derivatives contract will fail to perform, causing the counterparty to suffer a loss.
Liquidity risk	The risk that a financial instrument, or a derivative based on that instrument, cannot be sold except at a sharp loss.
Market risk	The risk of an abrupt change in the price of an asset underlying a derivatives contract.
Operational risk	The risk of losses resulting from inadequate controls, human error, or management failure; includes the risk that the theoretical models used in pricing, tracking, hedging, and estimating the risk of derivatives will turn out to be flawed.
Settlement risk	The risk that an expected settlement payment on a derivative contract won't be made on time because of a default or a technical foul-up; this exposes the counterparties to market, liquidity, and credit risk.
Systemic risk	The risk that a disruption—at a firm, in a given financial market, or to a settlement system—will cause widespread difficulties at other firms in other markets or in the whole financial system.

Source: The *Wall Street Journal*, August 10, 1993.

sential tools for managing and even reducing total risk to the financial system. For brief definitions of the many types of risks related to derivatives, see table 4-4.

Counterparty (Credit) Risk

Interest rate swaps involve only a contractual exchange of interest payment obligations. No principal is exchanged in interest rate swaps. Currency swaps, however, do involve principal—they are mutual obligations to exchange all debt service payments (interest and principal) as each comes due. If one party defaults, the other can declare its swap payable and offset the defaulted obligation. Depending on interest and exchange rate movements between the date of swapping and the default, which would affect both interest and principal payments due, one party or the other would be owed a balance (a premium over the notional amount) after offsetting. Because of the offsetting feature, the amount of exposure to default risk is usually equal to only a small percentage (generally expected not to exceed 5%) of the notional values exchanged.

To preserve the hedge provided by the original swap, the nondefaulting party would most likely enter into a replacement swap with another counterparty, but in doing so would lose the premium due it. For example, if the BBB company (figure 4-3) defaults on its obligation to exchange payments with the AA bank—which has funded its commitment with a fixed-rate Eurobond—the bank finds itself with a sudden reversal of its funding: from LIBOR minus 20 basis points to a fixed rate. If the bank has used the swap to fund a floating-rate loan to a client, it no longer has a locked-in spread on the loan over its cost of funding. Instead, it has what might

be a substantially different interest rate differential on the loan, plus an unhedged exposure to the future movement of fixed-rates versus LIBOR.

The bank must call the Eurobond (if that is possible) and replace it with floating-rate funding at whatever rates the market then requires for the remaining period to maturity of the original Eurobond; or, it could replace the defaulted swap with another at whatever rates for swaps of the appropriate maturity then apply. Thus, the simplest measure of the risk to a party engaging in a currency or interest rate swap is the cost of replacing the swap in the market. If there has been no change in interest or currency rates since the original transaction, then the replacement cost, or the value to be obtained in selling the swap to another party, would be nil. Swaps only have positive or negative value to the extent that interest or exchange rates have changed since the original swap was transacted. Therefore, the replacement cost will be either higher or lower than the original cost, resulting in either a potential gain or loss.[2] The risk exposure is limited to the cost of replacing a swap at a loss. When marked-to-market, swaps are therefore either "in the money" or "out of the money" to the extent that they would gain or lose in the event of default and replacement. Net replacement value thus has become the market value of existing swaps, and reflects the value of the contingent asset or liability associated with the transaction.

The replacement cost of an interest rate swap, however, can never come close to its notional value (or principal equivalent amount) even when interest rate changes are considerable. The risk exposure of swaps, therefore, is small in relation to their notional values. To minimize counterparty risk, market-makers in swaps generally require that principals be themselves high-quality credits or that well-known banks act on behalf of their clients of lesser quality.

The replacement cost of a currency swap, even if it does not approach its full notional value, may be different from that of an interest rate swap, because the exchange of principal payments are also involved. Risk exposures of interest rate swaps of longer than one year, for which capital must be set aside, have been set at 0.5% of the principal amount by the BIS and the central banks of the OECD and some other countries. For currency swaps of more than one year, the ratio is 5% of the principal amount. As a contingent asset or liability, the swap is not recorded on the balance sheets of the participants. As the volume in swaps has grown so considerably in recent years, so has the value of the contingencies associated with them. These contingencies now represent substantial amounts and therefore pose important control issues to bank regulators. These issues are discussed in the rest of this section.

Basis and Market Risks

In the examples provided (figure 4-3) the parties involved were creating synthetic liabilities in fixed- or floating-rate dollars to fund asset purchases

in identical instruments, either fixed- or floating-rate dollars. Once they were matched up, only counterparty risk remained. A swapper, however, can choose to select swaps that provide exposures to other risks.

"Basis" risk involves swapping to have exposures to differently determined market indexes. An example would be the BBB-rated company not actually borrowing from the bank at LIBOR plus 30 basis points, which could be done, but instead arranging even cheaper funding for its side of the swap by using the U.S. commercial paper market. Although the company is still obligated to receive LIBOR plus 30 from the AA bank in exchange for paying 50 basis points over the bank's fixed-rate Eurobond cost, its own funding cost is now dependent on the U.S. commercial paper rates, not on LIBOR. This difference may be advantageous or not to the BBB company in the future; because the company believes that it will be, it proceeds, knowing that if the relationship between LIBOR and commercial paper changes, the company could experience a further gain or loss on its position.

Similarly, when the difference is not between instruments but between maturities; "market" risk develops. If the BBB company's own funding had been at 30-day LIBOR, instead of the more standard 90-day LIBOR, rate differences could also arise that would provide additional potential gains or losses. Frequently, these types of risk exposures are taken deliberately by principals to provide higher returns. In efficient markets, there is usually not much benefit in a totally risk-free position, so to create some benefit for modest risks, some players frequently expose themselves to basis and market risks.

Liquidity Risk

Theoretical replacement values depend on liquid markets to be realized. If markets should dry up, especially the over-the-counter markets—because of some kind of direct or indirect shock to the system—then all valuations could fall into question.

Operational Risk

Operational risk is the risk of things going wrong in the rapidly moving, high-tech trading environment of derivatives due to staff error (e.g., in pricing or valuing swaps) or sloppy accounting or control procedures. These risks extend to understanding the contractual legality for swap transactions, especially when dealing with state-owned counterparties and when exposed to the bankruptcy laws of different countries, and in ensuring complete documentation.

Aggregation (Interconnection) Risk

Derivative transactions involve different markets and instruments and can spread an individual bank's difficulties, as well as general liquidity risks,

throughout the entire global financial system. Therefore, individual banks must be able to monitor and regulate their aggregate exposures to other banks, markets, and instruments. This is an extremely complex task that not all banks are capable of managing.

Risk Management

Regulatory issues related to risk management of derivatives have continued to be both complex and controversial. Many such issues relate to equity and commodities derivatives, which are usually not connected directly to markets for interest rate and currency products offered by banks. In 1992, senior bank regulators from several countries began to issue warnings to the banking systems under their control to beware of excessive growth of derivatives. Too many banks, they said, were not prepared to monitor and supervise their own positions and could be subject to surprise discoveries or vulnerable to shocks generated elsewhere in the system of which they were a part. This expression of concern led to a special study by the Group of Thirty (a nonofficial think-tank comprised of former public and private sector senior banking officials) which published a report written for market practitioners. This report made several recommendations as to the management and control of derivative businesses, including suggesting that senior management assume responsibility for derivative positions, that dealers mark their positions to market daily, that stress simulations be run periodically to see how the portfolio would hold up, that credit functions be strengthened and made independent of dealing functions, and that netting provisions for credit and other exposure management practices be used. The report, in the view of many regulators and practitioners, seemed very much on target and possibly would be influential with bank examiners and supervisors, but it held no official standing.[3]

Despite best efforts of the regulators, derivatives-related exposures destroyed both the venerable U.K. merchant bank Barings Brothers in 1995 and the U.S. hedge fund Long Term Capital Management (LTCM) in 1998. In the later case, exposures were so enormous that the global financial system was considered to be at risk, so the Federal Reserve brokered a takeover of LTCM by private-sector banks that were active in the market.

The Users of Swaps

The widespread availability and simplicity of swaps have attracted a variety of users from around the world who enter into swap contracts for a wide range of reasons. The more active the market, the more innovative it has become. New applications involving swaps appear continuously. The result has been a substantial broadening of the range of opportunities available to both borrowers and investors.

The effect of such an enlarged financial menu has been to globalize the

palate of virtually all capital market users. Each borrower preparing a financing must check several different markets before it can be sure that it has selected the optimal course that best meets its requirements. Not only does the prospective borrower determine what the rates, terms, and conditions of a transaction in its own domestic market would be, it must also check the comparable opportunities in the Eurobond markets and all of the synthetic possibilities that can at the time offer competitive alternatives. Clearly, the ability to monitor, understand, and execute such a wide variety of different financings requires a substantial upgrading in the financial skills of the borrower's treasury department personnel.

Corporate Issuers

As an example, consider a frequent financer, such as GE Capital Services (GECS), which in the course of a single year will routinely borrow several billions of dollars. The financial staff of GECS will daily receive calls and e-mails from dozens of bankers suggesting different types of financings. All domestic markets will be covered, together with the Eurobond market, which will often contain a special "bargain," such as an offer to raise money in nondollar Eurobonds denominated in yen; Australian, Canadian, or New Zealand dollars; or Swiss francs, together with a swap back into U.S. dollars for the desired maturity at an especially attractive rate that would generate below-market financing opportunities. From this profusion of opportunities, GECS must select the choice that serves it best, knowing that during the course of the year it will be doing many additional financings and will want to balance its use of any single market appropriately. By spreading its total financing needs across all of the world's capital markets, GECS ensures that it is achieving the lowest cost of financing possible.

Other companies with high debt ratings but a small requirement for new financing might decide to use their "excess" debt capacity to benefit from arbitrage profits. Such a company might issue a fixed-rate dollar Eurobond at an attractive rate relative to its alternative in the United States and swap the issue into a floating-rate obligation carrying a net interest rate of, say, LIBOR minus 25 basis points. The proceeds from the original financing might then be used to purchase a floating-rate obligation from, say, a high-grade European bank, at LIBOR plus 10 basis points, resulting in a spread of 35 basis points. Naturally, companies do not participate in interest rate arbitrage to the point where it might interfere with their own borrowing requirements, but should an unexpected requirement arise, the swaps can always be reversed or the positions unwound.

Banks

Banks are very active users of swaps as a means to lower their cost of funds to improve lending profits and manage their funding gaps. They are also able to take advantage of natural swapping opportunities from their loan

book and the requirements of their clients. As a result, banks, especially U.S. banks, have become extremely large holders of swaps and related derivative products.

Alternatively to trading for their own books, some banks and other dealers in swaps retain portfolios of "matched swaps" as an off-balance-sheet revenue-producing asset. Such banks usually will manage the portfolio actively, buying and selling extant swaps at prices they consider attractive while also adding to the portfolio new swaps they have created. Many banks like to create swaps for their transaction value more than they like to retain them as a portfolio investment. Thus, originating banks are able to sell swaps to non-originators much as they sell bank loans. Beginning in 1992, several large investment banks created special off-balance-sheet subsidiaries in order to remain competitive with the large commercial banks in the swaps area. These subsidiaries were capitalized to receive AAA ratings (thus being highly acceptable as a counterparty) and used to house the firms' swap and other derivative positions.

Dealing in derivative instruments became an increasingly important source of revenues to banks and investment banks.

Investment Managers

Finally, managers of large investment portfolios are swap users. A bond portfolio manager may find it is more advantageous to swap the future payments from a German government Eurobond for the future payments from a U.S. Treasury bond than it is to buy the Treasury bond outright. Likewise, he or she may want to fix interest rates before a market change and therefore enters into an interest rate swap to do so. Asset managers are less advanced in their use of swaps than liability managers, but many believe they will catch up quickly once they become accustomed to handling the wide range of opportunities that swapping provides.

Substantial additional growth has occurred as more end-users from among both asset and liability managers discovered the benefits of swaps for interest rate and currency hedging, and new users from the real estate, mortgage finance, and international governmental, investment management, and corporate sectors became involved in the market.

Swap Pricing

The pricing of the swaps done during the early days of the market were based on the sharing of the comparative rate advantages realized through the swap process. However, as the users of swaps have multiplied, so have the influences on pricing. Counterparties use swaps for vastly different applications, and they compete with each other on a price basis for the same basic product—for example, a LIBOR versus a five-year Treasury swap. Also, the market now has a significant number of market-makers, or swap

traders, who are continually positioning in anticipation of market changes. This professional market trading has established a commodity-like price level for basic swap products. For less-liquid, noncommodity swaps, a premium can be expected to be paid.

The price of a swap is generally quoted as the all-in fixed rate for a particular maturity to be exchanged for, say, a 90-day LIBOR. This price will be affected by changes in the basic U.S. Treasury rate, by changes in the yield curve, and by hedging costs and the level of new issue spreads for domestic and Eurobond issues.

Accounting and Tax Issues

There are many types of swaps, and the accounting procedures used for them can differ. In general, however, the central accounting issue concerning swaps is that of their disclosure. Both interest rate and currency swaps do not have to be disclosed in financial statements in the United States and other countries unless individually or together they are considered to be material to the financial position of the company as a whole, in which case they must be described in the footnotes to the financial statements. So for financial reporting purposes, swaps are considered off-balance-sheet items in most cases. For income statement purposes, swap payments typically are reported as adjustments to interest expense, with gains, losses, or lump sum payments being amortized over the life of the original transaction. A swap ordinarily does not involve any exchange of principal, and, consequently, in most countries the cash flows on the swap are treated for tax purposes as ordinary income or expense, with gains, losses, or lump sum payments being taken as adjustments to income in the period incurred.

Regulatory Issues Involving Swaps

As discussed more fully in chapter 13, the BIS rules for improving bank capital adequacy that were adopted in 1988 by the 12 leading banking nations were aimed at "strengthening the stability of the international banking system and removing a source of competitive inequality for banks arising from differences in supervisory arrangements among countries."[4] Among the elements of the Basel proposals were a weighting system for relating capital to banking risks, including off-balance-sheet exposures.

The latter included procedures for calculating the "credit equivalent amounts" of interest rate and currency swaps, as well as certain forward market transactions. The credit equivalent amounts, as finally adopted by the committee and against which capital must be reserved, are to be calculated by adding together the "current exposure" of a contract and the "potential future exposure." The Basel proposals did not reach a final consensus on valuing the current exposure of swaps, but the participants

agreed that bank regulators could use discretion and should rely on either the mark-to-market or replacement cost method in doing so. In calculating the mark-to-market exposure of a swap contract, only negative exposure counts: that is, if the swap is "in the money," or has positive market value, it cannot be used to offset current negative exposures of "out of the money" swaps. The net effect of the BIS capital standards is to increase the amount of capital that banks must have to maintain their swap portfolios.

Swaps as Bridges between Markets

Swaps are a means of integrating markets that would otherwise remain substantially independent of one another. In the early days of the Eurodollar bond market, substantial differentials existed between its rates and other terms of borrowings and those of the domestic dollar bond market. The European investor base was quite different and greatly influenced by such factors as exchange rates, tax factors, and the need for anonymity. In recent years the Eurodollar and U.S. dollar bond markets have become substantially integrated. The original distinguishing factors remain important, but investors have less leverage over borrowers now than they had previously because borrowers enjoy greater flexibility. Among these alternatives are interest rate and currency swaps, which permit the creation of synthetic securities in which the interest rate is set in the most favorable market.

Interest rate swaps link short-term and long-term rates, or capital market rates and bank lending rates. When the spreads between the rates available become great enough, they attract enough business to reduce them. In any case, however, the market for "plain vanilla" interest rate swaps is sufficiently liquid that dealers now quote very narrow (e.g., 5 to 6 basis points) bid/asked spreads. In the cap market, spreads range from about 6 basis points for two years to about 35 basis points for 10 years. Thus, large volumes of market activity can compress the rate differentials between fixed- and floating-rate dollar instruments.

In the same way, currency swaps link long- and short-term dollar and non-dollar rates. More accurately, perhaps, it could be said that currency swaps link dollar bond market borrowing rates and conditions with those of various non-dollar bond markets. Both links are summarized in figure 4-6.

The swap market has become very efficient in scouring the world's capital markets on a 24-hour a day basis to locate swapping possibilities that provide added value to participants, and in quickly communicating these possibilities to clients. Once a transaction is completed, the market is aware of it immediately and any "new" aspects of the deal are quickly assimilated. A few more transactions of the same type occur bearing the higher fees or other costs, reflective of the innovation. Then, usually after a relatively short period, the spreads close, the advantages disappear, and

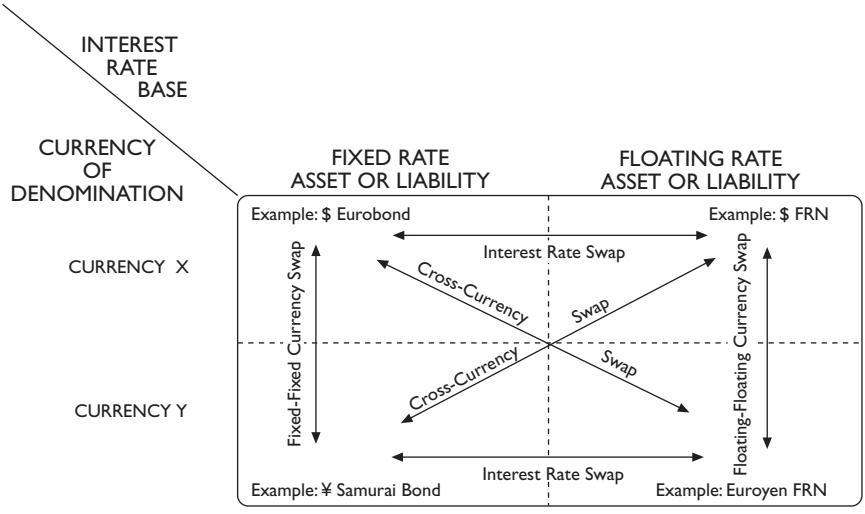


Figure 4-6. How swaps link the international capital markets: FRN = fixed-rate note.

the market goes looking for the next opportunity. Such speed and efficiency is made possible by competitive forces, by excellent telecommunications facilities, and by a major increase in the market sensitivities and technical competence of both the bankers and their clients. The more rapidly and efficiently markets work, the more efficient the linkages.

Competing in Swaps and Derivatives

There are many different competitors in the market for swaps and other derivative securities. These include banks and investment banks, finance companies, insurance companies, and dealers from the United States, the United Kingdom, continental Europe, Japan, and other parts of Asia. Their roles are essentially that of end users and swap arrangers and providers. Many large banks and other financial houses act as both users and providers. Competition is driven by innovation in application of swap technology to new uses, improved terms and pricing, and the ability to cover market opportunities all over the world.

In the early days of the market, investment bankers tended to act as agents, and commercial banks as principals. Competitive pressure, however, quickly drove a number of investment banks to position swaps that they were trying to arrange in order to complete a particular, fast-moving deal in which they were competing with other firms. Back then, if First Boston was trying to arrange for a seven-year interest rate swap for Alcoa, it might decide to wrap up the business by taking the Alcoa exposure on its own books with the intention of selling it or matching it with another swap later

on. In time, First Boston might sell the package of Alcoa's obligation to it, and its obligation to Alcoa (together called a "matched swap"), to another bank or repackage the swap by selling one obligation, with or without a match, and keeping the other for its own portfolio to be matched with another swap priced more advantageously.

By skillful management of its matched book of swaps, First Boston could earn revenues, stay on top of the market in swaps so as to compete more vigorously, and offer its clients swaps as principal to minimize the risk of the business being done with another party. Disadvantages include (1) substantial administrative costs associated with keeping track of all the swaps passing through the firm's hands, (2) risks associated with swap counterparty failure, and (3) the possibility of swaps requiring an allocation of regulatory capital in the future. Many of the major U.S. investment banks operate in the swaps business as principal, and, of course, virtually all of the international commercial banks do so as well.

Competitors recognize that to be successful today, firms must enlarge on the linkages that exist between the swaps desk and other financing departments of the firm. Swaps have become commodities applicable to transactions involving corporate finance, mortgage and real estate finance, project finance, asset management, foreign exchange, and virtually all other areas of a firm's business that involve the putting together of sophisticated financial packages. The global capital market departments of all the major securities houses are in daily contact with a large number of potential bond issuers. The fixed-income department is in daily contact with a large number of asset managers. The type of transaction to be selected by such issuers or investors may involve one or more swaps. To quote a deal to the client requires hands-on attention of the swaps desk, along with a very short response time.

Summary

Unknown before 1980, swaps and their family of related transactions have become a large and important part of the global financial landscape today. They are useful to issuers of securities and to investors as a means to manage financial market risk exposures and to either lower costs of funds or increase return on investment. They enable participants to bridge (and thus aid in integrating) financial markets across maturities, currencies, and forms of payment. Swaps have a multitude of applications and therefore have proliferated widely since their introduction. Swaps are comparatively cheap and quick to arrange; they involve standardized and simple documentation and expose their participants only to modest risk levels in relation to the notional amounts involved, which nonetheless must now be accounted for by banks under the current capital adequacy rules. The market will continue to welcome new ideas and further applications for swaps. As in virtually all financial services today, competition is extensive and favors those

who are able to create value for their clients, to manage their own exposures efficiently, and to keep abreast of—and contribute to—the fast-moving technology of the market.

Notes

1. Information found on "Credit Derivatives Website" by Vinod Kothari (www.credit-deriv.com).

2. As the value of the swap depends on the *change* in interest or exchange rates, it is a first derivative (in calculus terms) of the rates; hence, it is a "derivative security."

3. Group of Thirty, *Derivative Practices and Principals* (Washington, D.C., 1993).

4. Basel Committee on Banking Supervision. *International Convergence of Capital Measurement and Capital Standards* (Basel, Switzerland, 1988).

5

International Bank Lending

The previous chapters explained how banks can assist clients in obtaining long-term funds by issuing bonds and equities. This chapter introduces bank lending to companies and other types of borrowers, along with the mechanisms of global commercial lending.

International lending has changed dramatically over the years. Major, highly rated corporations, public-sector enterprises, and governments have all largely migrated to the equity markets, where their own securities command terms that are competitive (and often superior) to those banks can provide. This has largely supplanted straight bank-to-client lending, and even smaller and less highly rated borrowers have found it possible to tap the capital markets using various kinds of credit and liquidity backstops and asset-backed structures. As a result of the LDC (less-developed country) debt crisis of the 1980s, a major class of sovereign borrowers disappeared by the 1990s—borrowers for whom the capital markets had also traditionally been closed. Some countries continued to borrow as a result of forced loan rescheduling and new-money packages in the 1980s as the debt crisis wore on, and there was some renewed interest in banking lending to LDCs (as emerging market borrowers) until the next major crisis in 1997–1998.

Nevertheless, international bank lending continues as an important part of global financial markets. In times of financial instability, the capital markets tend to shrink and in some cases even disappear as viable sources of finance, and borrowers flock back to the banks. Many creditworthy corporate borrowers maintain sizeable bank lines even in the best of times, partly to make sure the banks are there when and if they are needed. And there are certain kinds of financings, such as short-term lending to finance merger, acquisition, and leveraged buyout transactions, as well as longer-term lending on project financings, where there are no good substitutes for traditional bank loans. This may be because the bor-

rower cannot be sure precisely when the funds will be required or when they can be repaid out of the proceeds of stock or bond issues or asset sales, or because the transaction is likely to encounter significant and unanticipated developments over its life that requires a form of financing where the added flexibility is worth more than the added cost. Bank lending provides one of the few alternatives for close borrower-lender contact and monitoring, and therefore maintains significant advantages in contracting and information costs.

Commercial Lending Facilities

There are various ways to classify international bank lending to corporate, government, and other types of borrowers.

First, a bank may lend to local clients out of branches or affiliates in foreign countries in which it operates, funded by local-currency deposits or local money-market borrowings. This is purely local business, competing mainly with local banks. Foreign-based banks normally have to compete purely on price and quality or by focusing on a specific market niche involving special industry expertise, for example. Foreign banks lending in local markets also may focus on affiliates of multinational companies based in their own home countries, or on financing international trade transactions. It nevertheless remains essentially "domestic lending abroad," and the only thing international about it is the transfer of product or credit know-how, or client relationships, from the parent organization or from affiliates in third countries.

Second, a bank may undertake direct cross-border lending to clients located in another country. They focus mainly on special kinds of transactions as part of close bank relationships to particular clients, including foreign affiliates of multinationals; as part of workouts of earlier troubled loans; or as part of international private banking relationships. In many cases, such loans take the form of syndicated credit facilities, as discussed later in this chapter.

Lending facilities, whether direct or syndicated, can take a number of forms. There are "revolving credit agreements" (called revolvers), which permit clients to borrow, on demand, up to a certain maximum amount over an agreed period of time under an agreed interest formula. In return, the bank earns a commitment fee for standing ready to lend, whether or not such lending actually occurs. These are usually "committed facilities," and the commitment is legally enforceable and covered by appropriate legal documentation. Committed facilities require the same kind of careful credit analysis as actual loans, especially since, for some clients, committed facilities will be taken down only when capital market financing is unavailable or more expensive. Such facilities often take the form of "backstop lines," which rating agencies like Moody's and Standard and Poor's require issuers of commercial paper to have in place in order to assure investors that the

liquidity will be there when the paper matures. Borrowers may also arrange for "uncommitted facilities," which are not legally enforceable and, hence, involve lower fees. Clients may find these attractive because of the lower cost if they believe there is little likelihood of difficulty in accessing financial markets in the foreseeable future.

In the course of ordinary credit relationships with clients, banks will have in place limits on the amount of lending exposure they are willing to incur, sometimes called "undisclosed, unadvised guidance lines," which may be increased or decreased at the bank's own discretion based on changing circumstances.

Whether committed or uncommitted, international commercial lending facilities may be associated with a range of other banking products, especially those involving interest-rate or exchange-rate protection. Examples include "forward-rate agreements" (FRAs), which permit a client to lock in an interest rate today for a loan to be taken at some future date; interest rate caps or collars; and currency swaps, as discussed in chapter 2. In turn, the bank will hedge these transactions in the market and keep whatever spreads or fees it is able to earn on these collateral services.

Bank Financing of Foreign Governments and Government Entities

Lending to units of foreign governments took on major importance in the 1970s and again in the 1990s. The reasons included:

- The rapid growth of balance of payments financing needs on the part of national governments
- The use of government agencies as intermediaries to secure external financing for a wide variety of ultimate borrowers domestically
- Major borrowing needs on the part of government and quasi-government entities like power authorities, sewage systems, trading companies, airlines and shipping companies, and the like, at both the national and state-local levels
- Active participation of governments as owners of manufacturing and trading companies, as well as financial houses and banks
- The growing use of government guarantees to facilitate foreign borrowing on behalf of private ventures

Sovereign lending collapsed after the debt crisis in the early 1980s and the migration of OECD (Organization for Economic Cooperation and Development) government entities to the global bond markets, but it revived gradually in the 1990s until another crisis in 1997–1998.

Government borrowing abroad may be undertaken by a national entity charged with managing the country's external finance—for example, its

central bank, monetary authority, ministry of finance, or similar institution. It may also be undertaken by other government-owned authorities or corporations, often called *parastatals*, although such external borrowing usually must have the approval of a coordinating agency such as the central bank.

Balance of payments borrowing is undertaken by countries with current-account payments deficits that are not offset by private capital inflows, resulting in a balance of payments deficit. The proceeds of external borrowing by the country's monetary agency are often used to intervene in foreign exchange markets to support the external value of the national currency, the exchange rate. Balance of payments borrowings may be seasonal or cyclical, in response to periodic underlying variations in export receipts and import disbursements or capital flows, or they may be structural due to an essentially permanent shock (e.g., a major drop in export prices) to which it will take time to adjust. Such borrowings may also be chronic as a result of a more or less permanent excess of domestic absorption over production, capital flight due to lack of confidence in the country's future, and similar factors.

Seasonal and cyclical balance of payments borrowing is essentially self-correcting and finds its everyday parallels in corporate working capital borrowing and personal finance. To the extent that such needs cannot be handled from a country's own reserves, short-term borrowings under bank credit lines, reviewed periodically, may be an alternative method of handling. Structural balance of payments borrowing is designed to ease the pain of adjustment to new economic realities and can also be fully justified, provided the necessary adjustment actually does come about within an acceptable time frame. This is not the case with a country essentially living beyond its means and engaging in chronic external borrowing, its government unable or unwilling to take the steps needed to restore balance via domestic macroeconomic or exchange-rate policies, ultimately heading for a rough landing for debtors and creditors alike.

Fiscal borrowing concerns external financing to cover budgetary deficits; it is linked directly to the balance of payments and its financing. In many cases, fiscal borrowing involves short-term loans made in anticipation of government receipts and, therefore, tends to be self-liquidating.

Development borrowing involves the financing of intrastructure projects—schools, hospitals, roads, railways, airports, port facilities, communication networks, power grids, sewer systems, public housing, and a variety of others. Some such projects are direct producers of foreign exchange (generating exports or saving on imports), while others are not. As distinct from development project lending, program lending may involve literacy training or vocational education, for example, with potentially far-reaching domestic and international consequences that are usually extremely difficult to forecast.

Loan Syndication

As noted, most major international lending facilities are syndicated. In simple form, a syndicated credit facility involves the combined activities of a number of banks in the assembly of a relatively large loan to a single borrower under the direction of one or several banks serving as lead managers.

The borrower has the advantage, under such arrangements, of being able to raise a larger sum than any single bank would be willing to lend, at substantially lower cost and more efficiently than the same amount of borrowing from multiple sources on its own. Moreover, the borrower enters the market fewer times and thus may improve future access to financing. Borrower "visibility" is enhanced by major syndications involving a large group of banks, possibly making future financings easier. Syndicated loans may also be traded, thus becoming liquid rather than illiquid assets for the ultimate lenders or investors, with favorable effects on borrowing rates.

The lenders have the advantage of:

- Better diversification of their asset portfolios
- Participation in lending they might not otherwise have access to
- Cooperation with multiple banks (often home based in a number of different countries) having greater collective expertise and information than any single bank
- Reduced risk of borrower default against a syndicate of banks as compared to any single bank, due to the enhanced penalties of default for the borrower in terms of limited future access to financial markets
- Certain legal protections inherent in syndicated loan agreements
- The potential for loan trading and derivatives sales

Banks also find participation in a variety of syndicated loans an efficient way to obtain the necessary expertise, market exposure, and visibility without incurring unacceptable financial exposure.

Essentially, international syndicated loan facilities represent a cross between debt underwriting and traditional commercial bank lending. They open medium-term financing opportunities to many borrowers who might not otherwise be able to obtain credit on comparable terms through the international or domestic securities markets, private placements, and other financial vehicles.

Historically, international syndications of medium-term credit facilities began in the late 1960s, when changes in interest rate levels and volatility increased the attractiveness of major financings on floating-rate terms, as opposed to fixed-rate bond issues, and borrowers' needs outstripped the lending capabilities of individual banks. Their antecedents include the long-standing practice of multibank term lending to corporate customers in the United States, priced at or above the domestic prime lending rate. During the 1970s and 1980s, somewhat over half of all medium- and long-term borrowings in international capital markets, well over 80% of such bor-

rowings by developing countries, and almost all such borrowings by centrally planned economies were in the form of syndicated loans. While lending and project financings in the LDCs took up the bulk of syndications in the 1970s, mergers and acquisitions (M&A) and leveraged buyout (LBO) syndications took their place in the latter part of the 1980s. Lending in connection with mergers and acquisitions assumed major importance in the 1990s, especially in sectors like telecommunications, as did project finance.

The geographic center for syndicated lending has always been the city of London, plus New York and Hong Kong. The actual booking of syndicated loan participations is done as well in the various offshore banking centers. Figure 5-1 shows that 58.4% of syndicated loans were booked by European banks in 2000 and 2001, compared to 11.8% and 7.4% by Japanese and North American banks, respectively. By contrast, North American banks lead-managed almost 70% of global syndicated loans in those years.

The Syndication Process

Borrower contact with a national government agency, an electric power authority seeking to finance a significant capacity expansion, a corporation seeking a standby facility for a major acquisition, or, perhaps, with a national development bank intending to borrow a large sum internationally which it will then on-lend in smaller amounts to domestic enterprises—all are maintained routinely by lending officers of major international banks. The better the "relationship" between a bank and the potential borrower, the better the bank's information about the client's evolving financing needs and the greater its chances of playing a significant role in meeting those needs.

In seeking syndication business, banks rely on:

- Their own branches, representative offices or other affiliates maintaining contact with the prospective borrower
- Referrals from other units of the bank, or referrals through established corporate and other client relationships
- Referrals from other banks anxious to render a service to their own clients, yet not in a position to take a leadership role themselves, with whom good relations have been maintained
- Direct solicitations from potential borrowers or, in the event of joint lead-managed syndications, other banks
- Approaches by investment banks acting as advisers to borrowers, one of whose functions is to facilitate capital-market access through introductions to competent banks active in loan syndication

Knowing the borrower and conditions in international lending markets, a prospective lead bank will carefully draw up a proposal to arrange the loan, thereby seeking a syndication mandate. The proposal will specify pricing,

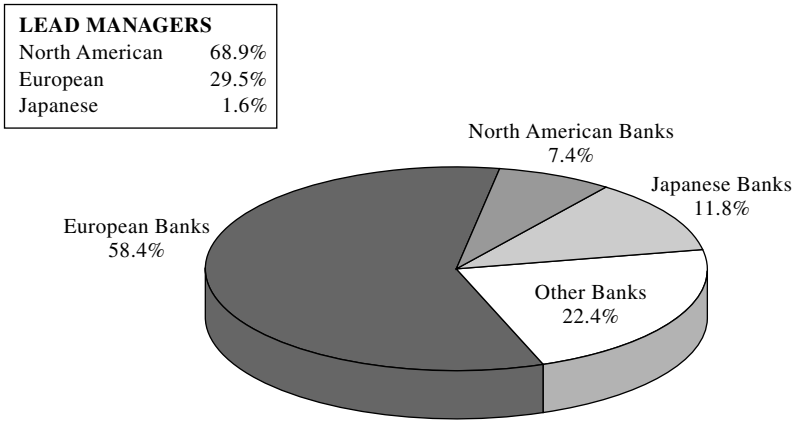


Figure 5-1. Distribution of International Bank Lending by Nationality of Banks, 2000–2001 (*Data*: Bank of International Settlements, "Consolidated Banking Statistics," Basel, January 2001–2002).

terms, fees, and other pertinent aspects of the loan, and it will indicate whether or not the syndication will be fully committed. If it is fully committed, the bank will undertake to provide the full amount of the loan to the borrower according to the terms of the mandate, whether or not it is successful in its efforts to interest other banks in participating in the loan. If the syndication is partially committed, the bank will guarantee to deliver part of the loan, with the remainder contingent on market reaction to the loan. In a "best-efforts syndication" the borrower will only obtain the funds needed if sufficient interest and participation can be generated among potential participating lenders by the good-faith efforts of the bank seeking the mandate. These, however, are rare since the commitment represents a major part of the value of a syndicated loan.

By this time, or shortly thereafter, the bank may have brought in one or more co-lead managers to help with the syndication and to share in the underwriting commitment, especially if the amount to be raised is very large or if the deal is rather complex. Generally, the larger the loan, the larger tends to be the management group involved, including several lead managers, managers, and co-managers, each group accepting a different share of the underwriting responsibility, and several "brackets" of participants, whose role is usually confined to supplying funds.

The terms of the formal letter seeking the mandate will follow extensive discussions with the borrower and will be carefully tailored to its needs and to market conditions. The terms will have to be fully competitive with other banks going after the same mandate. The mandate letter will also specify exclusivity of the mandate and will repeatedly note the leading roles the mandated bank is to perform in the syndication.

There are a variety of negotiable trade-offs, such as those between the

tenor and size of the loan, drawdown schedule, grace period, amortization schedule, spread, fees, tax issues, borrower information, and legal covenants. In seeking a mandate, the prospective lead bank must strike a balance between what the borrower wants and what the market can live with—that is, what will result in a successful syndication—always keeping a watchful eye on what competitors may propose. Sophisticated borrowers will often accept "second-best" proposals from highly responsible and prestigious lead banks over more "imaginative" or lower-cost bids from aggressive competitors if they feel that this will better serve their long-term standing in the market. Still, the tolerance for less than fully competitive bids is generally very low.

If the borrower decides to go ahead with the syndication, the mandate will be awarded to one of the competing banks or to joint bidders, who then become lead manager(s) of the syndicate. Suppose a single bank has won a mandate on a $500 million fully committed syndication and that the lead bank wishes to keep $75 million of this in its own portfolio—its "target take." It will thus have to find a way to sell down the remaining $425 million to other banks and, to do so, will have to develop a syndication strategy that will successfully raise the required sum yet necessitate minimum sharing of the management fee that will be paid or the visibility it attracts for putting the loan together. Several other banks may have to be asked to jointly manage or co-manage the loan, however, and thus be allocated a portion of the total funds to be raised—part of which they will take into their own portfolios and the rest they, in turn, will sell down to other syndicate participants—in return for a share of the management fee.

The lead bank is generally expected to take a share in the loan that is at least as large as that of any other lender. The management group—lead manager(s), managers, and co-managers—may initially retain as much as 50% to 70% of the total loan for their own portfolios, much of which may be sold later in loan-trading programs.

The syndicate will be put together by the lead manager and the management group on the basis of offering e-mails to banks around the world, followed up quickly with elaborate written documentation and personal discussions.

Deciding which banks to invite into the syndicate is a major part of a lead bank's task and will help determine its strategy. It must be able to judge the invitees' country and industry exposures, past client relationships, degree of sophistication in syndicated lending (especially in complex deals), its own relationships with invitees, and similar factors that will determine individual banks' receptivity to the deal. In some cases, the borrower will also express a preference as to which banks should (and should not) be invited to participate. Contacting a large number of banks to obtain perhaps 20 or 30 ultimate participants is not unusual. Banks invited to participate will usually decline, accept, or request further information on the basis of the offering communication, and careful track will be kept of the responses by the lead manager or management group.

If there are several lead managers, one of them is assigned to keep track of responses from each of the banks that have been approached. This can be rather complex when a large number of banks in a variety of countries are involved, with responsibility for contacting them divided among members of the management team.

Meanwhile, the lead manager will work on preparation of an information memorandum, in which the borrower will disclose financial and economic—and sometimes historical and political—facts pertinent to current and projected creditworthiness. This, together with a term sheet restating the conditions of the loan, will be sent to interested banks, carefully prefaced by an emphatic disclaimer of all responsibility for its content on the part of the lead manager(s). This disclaimer is necessary to avoid possible legal liability in case of default or other problems with the loan that may arise later. The information memorandum, although prepared by the borrower, will be carefully checked for accuracy and completeness by the lead bank(s).

If things go well, the loan will be fully subscribed. If it is oversubscribed, either participations will be prorated among the interested banks or, occasionally, the total amount of the loan will be increased at the option of the borrower. In the latter case, however, prospective syndicate members may wish to reconsider their participation if they are less comfortable with a larger loan to the borrower concerned. An oversubscribed syndication may well result in an unhappy borrower (who thinks the interest rate or fees are too high) or unhappy banks (who are unable to get as much of the loan as they were initially offered). The competence of the lead manager is called into question by both sides.

If insufficient funds are raised, then the borrower will have to make do with less if the syndication is on a best-efforts basis, or the banks in the management group will have to book the balance themselves and thereby exceed their target take if the syndication is fully committed. In such a case the syndication is considered "unsuccessful," with potentially serious adverse consequences for the future prospects of the borrower, as well as the lead manager(s) in the syndicated loan market. Again, the competence of the lead manager will be called into question.

Both under- and oversubscribed deals must be avoided, and this is why tailoring the terms of the loan to perceive market receptivity—accuracy in pricing—is such an important determinant of competence in loan syndication leadership. Particularly desirable participations are those which present a favorable risk-return profile, in comparison with both other loans available in the market and those offered in the months immediately ahead. Lead banks with a track record of completing such deals are rewarded by further leadership roles and, obviously, adding attractive paper to their own portfolios.

Along the way, a loan agreement will be drawn up, which spells out the rights and obligations of all parties to the deal, governing law and related matters. Drafting of the loan agreement, especially in complex deals,

may be initiated during the syndication process, and various possible points of contention will be discussed with the borrower. Even after the successful completion of syndication, work on the loan agreement may well continue until all points are agreeable to both sides. No bank is finally committed in a loan syndication until it has accepted the terms of the loan agreement, and, if no consensus can be reached on a point it has identified as being vital, it can gracefully withdraw from the syndicate. However, most of the time the loan documentation seems to be sufficiently standard that preparation time and acceptability questions are relatively minor problems. Selection of competent legal counsel in syndicated loans is of great importance in this regard.

Definition of the purpose of a loan in the loan agreement may or may not be helpful. On the one hand, it is the creditworthiness of the borrower as a whole that matters, not what the borrower intends to do with a specific block of funding. Excessive specificity in a loan agreement may unintentionally throw the loan into default, to the chagrin of borrower and lender alike. On the other hand, the purpose of a loan may be a good tip-off as to how the borrower is likely to conduct its affairs in the future, or to its current financial condition, and could therefore figure prominently in an overall creditworthiness assessment.

Publicity will eventually have to be arranged and a signing ceremony will be held, usually including formal lunches and dinners. Finally, an agent bank will be appointed early in the game; their job will be to run the books on the loan—a critical and influential role that the lead managing bank will usually want to keep for itself.

Where multiple banks form the lead management group, they will split the main jobs between them: (1) preparation and distribution of the information memorandum, (2) keeping track of syndication responses from potential participants, (3) negotiation of the loan agreement, (4) arranging the signing, (5) handling publicity, and (6) taking on the agency function. Those tasks providing the closest contact with the borrower or the greatest visibility in the market are most sought after and will generally go to the dominant members of the syndication group.

There are a number of variants of this general full syndication pattern. If market conditions are not receptive to a full syndication, or if a borrower is regularly in the market for funds, a club loan may be arranged, wherein a separate information memorandum is not necessary and the lead bank, together with the rest of the management group, provides the entire amount of the loan themselves. In a semisyndication, an unusually large share of the funds is provided by the managers themselves, and the balance is provided by a relatively small number of participants who generally know the borrower or its industry well and hence get involved on a more exclusive basis.

In participation loans, one or more banks will underwrite the entire financing and execute the loan agreement, later individually selling down participations to a number of other banks without the formal structure of

a full syndication. Also called a "pre-advanced syndicate," the borrower actually gets its money from the lead bank(s) before part of the loan is sold down on the basis of a participation certificate only and no borrower contact whatsoever. The same is true of loan notes, which are sold freely among any banks interested in booking participations in a particular transaction. In this way a great deal of liquidity has been added to the global lending market in recent years.

The entire syndication process normally takes anywhere from two weeks to three months, depending on the borrower, the complexity of the deal, market conditions, competence of the managers, size of the loan, and similar factors. All out-of-pocket costs involved in the syndication—including legal fees, advertising, travel, and communications charges—are for the account of the borrower.

Maturities and Structure

Syndicated lending is often medium term in nature, and the banks involved may have to take a relatively long view of the borrower's ability and willingness to service the loan. This has been one reason for the importance of government and government-guaranteed borrowing in this market from time to time. Many private-sector syndications (such as acquisitions financings) are much shorter in maturity and are designed to be refinanced by lower-cost bond or stock issues later.

Given borrower needs, loan maturities tend to follow market conditions and borrower creditworthiness. Syndicated loans usually involve a drawdown schedule, according to which the borrower will actually acquire the principal of the loan, generally related to the date on which the loan is signed. Repayment of principal may be over a 5- to 10-year period, and there may be a grace period of several years during which no repayment of principal is due. Principal repayment may then be made on an amortization basis over the rest of the life of the loan, all at once at the end (called a "bullet loan"), or on some other mutually agreed schedule.

Clearly, maturity and loan structure considerations must meet both borrower and market requirements. In devising an appropriate structure, the lead bank must use its expertise, market positioning, influence with the borrower, and creativity in bringing the two sides together. And, unlike ordinary loans between a borrower and a lender, the terms of syndicated loans generally become publicly known. It is difficult to keep pricing, fees, maturity information, legal covenants, and borrower information confidential if it has to be fully disseminated among 20, 50, or more banks in a major syndicated loan.

Borrowers and lenders constantly compare terms of syndications, both over time for individual borrowers and among borrowers, so that precedent plays an important role in the market. Various research services also disseminate deal information. A borrower will compare the terms offered with those it faced the last time it entered the market and those apparently being

offered to others. If the borrower shows up too frequently, if its creditworthiness is perceived to have deteriorated, if the purpose of the loan is questioned either in its own right or as an indication of its overall competence, or if others enter the market who are deemed to have better standing—whatever the reason, the borrower may have to live with higher costs or shorter maturities, or both. And what happens today will help set the stage for the borrower's next foray into the market.

Pricing

Syndicated loans in international banking are generally priced on an agreed-upon floating base rate of interest, in most cases the London Interbank Offered Rate (LIBOR), as a proxy for the banks' own cost of funds. To this floating base is added a contractual spread, which may be fixed for the entire life of the loan or may be split—that is, fixed at one spread for the first several years and another spread for part or all of the rest. For example, the rate on a typical eight-year syndicated credit to a major borrower may be set at LIBOR + ¾% for the first five years and LIBOR + ⅞% for the rest of the period.

Interest payable by the borrower is adjusted on a rollover date, usually every three or six months, at the borrower's option, with the new period's base rate being specified in the typical loan agreement as the average LIBOR quoted two days earlier by selected reference banks that are members of the syndicate. The strongest of these banks can usually attract three- or six-month deposits at a cost below LIBOR or may fund the loan in other maturities, depending on relative interest rates, to secure funding profits in addition to the contractual spread.

This may be combined with a cap, floor, or collar option defining maximum allowable deviations from the interest rate benchmark to protect borrowers and lenders from interest rate risk. Note that floating-rate pricing in syndications place the basic interest rate risk, except that between rollover dates, on the borrower. Banks nevertheless retain credit risk and country risk, as well as funding risk—that is, the risk that funds in the needed currency may not be available when funding for the loan has to be rolled over. The possibility of widening or narrowing future spreads does leave banks with some residual interest rate risk even on floating-rate loans; for example, a bank may participate in a very finely priced syndication today, but market conditions may cause substantially wider spreads for the same borrower a year or two later.

All payments of principal and interest in syndicated loans are specified *net to the lender*—that is, free and clear of all taxes levied by the borrower's country or fully creditable against the taxes levied in the bank's home country. Liability for taxes levied where the loan is booked is often a point to be negotiated. Participants in syndicated loans tend to be comparatively detached in evaluating loan pricing since they, unlike the banks in the management group, have little or nothing to gain in terms of a relationship

with the borrower. What's good for the lead managers is not necessarily good for the participants.

In the past, however, banks have participated in syndications on the thinnest of spreads in order to compensate for slack loan demand elsewhere, to secure access to the market or client, or to generate opportunities for funding profit or because of sloppy risk assessment and loan portfolio management. Such banks became known in the trade as "stuffees."

Fees

Of particular interest in evaluating the returns to banks from loan syndication are the fees paid by the borrower to the participants. These take several forms.

First, managers will have to be compensated for arranging and underwriting the loan, including assumption of the risks involved. This usually takes the form of a front-end *management fee* as a flat percentage of the total loan (e.g., 1%) payable at or shortly after the signing. The size and complexity of the loan, the nature of the borrower, competition among banks for the borrower's business, and similar factors figure into the negotiated size of the front-end fee. Second, a part of the management fee will usually have to be shared by the syndicate manager(s) with other participants in order to successfully sell down a loan, especially a very large one. This *participation fee* takes the form of a flat percentage of each bank's final amount lent. It is often divided into size categories based on the level of participation by groups of banks.

Third, since a particular loan may not be drawn down immediately, but has to be made available to the borrower over time as specified in the loan agreement, a separate *commitment fee* is often provided, generally a flat percentage (e.g., ½%) on the undrawn portion of the loan, starting on the day of the signing and prorated among the participating banks.

Finally, the bank acting as agent in a syndication will normally negotiate an *agent's fee*, usually a fixed sum (e.g., $150,000 per year for the life of the loan) payable by the borrower up front or annually in recognition of that bank's responsibilities in running the books on the loan.

While the agent's fee and the commitment fee are clearly set in the deal terms, the division of the management fee among syndicate participants is a matter for negotiation and may in the end be quite complex. On a $100 million fully committed loan lead-managed by a single bank that has negotiated a 1% management fee, or $1 million, the bank may decide that it has to distribute $750,000 to all banks in the "co-lead" category to ensure a successful syndication but to withhold ¼% ($250,000) for itself as compensation for serving as "manager of the managers." This ¼% portion is called a *praecipuum* and represents the unique return to lead manager(s) for arranging the deal.

It may now decide to offer a participation fee of ¾% of final participation to banks (including itself) that lend at least $10 million each (co-

lead managers), ½% to banks participating at a level of $5 million or more, and ¼% to banks that take under $5 million. Suppose, of the $100 million total loan, the lead manager takes $15 million into its own portfolio, four co-managers are in at $10 million each, plus six banks at $5 million each and 15 banks at $1 million each. Of the available $750,000 in participation fees, the lead manager thus gets $112,500 (¾% on its $15 million participation, or *final take*), co-managers get $300,000 (¾% on $10 million × 4 banks), first-level participants get $150,000 (½% on $5 million × 6 banks), and second-level participants get $37,5000 (¼% on $1 million × 15 banks). Under these conditions, a total of $600,000 in participation fees have been allocated, leaving $150,000 unallocated, called the "pool." This pool is normally distributed to the management group in proportion to their individual underwriting commitments.

In this example, the fee earned by the lead manager out of the $1 million management fee is as follows:

Praecipium	$250,000	
Participation	112,500	
Pool share	40,909	
	$403,409	(1 bank)

Each of the co-managers gets:

Participation	$ 75,000	
Pool share	27,273	
Total	$102,273	(4 banks)

Each of the first-level participants gets:

Participation	$25,000	(6 banks)

Each of the second-level participants gets:

Participation	$2,500	(15 banks)

All of this adds to $1 million: $403,409 + $102,373(4) + $25,000(6) + $2,500(15) = $1 million (rounded off).

For the lead manager, this means an immediate return of 2.69% of its final take ($15 million); for co-managers it is 1.02%, for first-level participants 0.5%, and for second-level participants 0.25%. But because these fees are *immediate*, the interest equivalents based on the average life of the loan are proportionately higher. This illustrates the importance that credit-related fees tend to assume in evaluating a bank's overall return on syndication activity and why U.S. banks have sought the lion's share of lead-management roles. The objective for lead banks is to maximize fee income per dollar actually lent, and this obviously means commanding a position in the upper

tiers of syndications where the bulk of the fee income (as well as the risks and the required skills) are lodged. It also means, for the lead managers, trying to maintain confidentiality about the overall size of the fee—and sharing it only to the extent necessary to ensure a successful syndication.

As components of returns to the participating banks (and costs to the borrower), spreads and fees are obviously related. Because higher contractual spreads may carry negative connotations about the borrower's creditworthiness, the borrower may agree to fatter fees to compensate the lenders for finer spreads in order to improve its market positioning in future borrowings. Similarly, borrowers will sometimes undertake benchmark financings—syndicated loans with extremely fine pricing even if there is no real need for funds (with the borrower viewed by the market as particularly creditworthy) to "show the flag" and try to improve future borrowing conditions. A borrower's "name" in the market evolves over a period of time, as does a bank's competitive performance, and both have a great deal to do with the structure of pricing and fees.

The Agency Function

The task of servicing a syndicated loan falls on the agent bank, usually the lead bank or one of the lead managers assigned the job. In one respect, the agency function is purely a mechanical one, involving running the books on the loan. There are at least seven functions:

- Seeing that the terms of the loan agreement are complied with regarding drawdown, rollover, interest payments, grace period, and repayment of principal
- Collecting of funds from participants as per the drawdown provisions and disbursement to the borrower
- Periodic fixing of the interest rate against the floating-rate base (such as LIBOR) as per the contractual spread
- Computing of interest and principal due, collecting from the borrower and distributing to the lenders—not such a simple task when funds are due in one place and time and payable in another
- Monitoring loan supports, such as collateral valuation, guarantees, and insurance
- Evaluating and ensuring compliance with covenants in the loan agreement and informing participants, as necessary
- Collecting periodic reports from the borrower, independent auditors, or other information and distribution to participants

Such tasks have to be done reliably, efficiently, and promptly, yet they are little more than clerical in nature.

It is when trouble brews that the agency function takes on a far more complex and fundamentally different character. The loan documentation will obviously specify under what conditions there is an event of default,

but this may involve zero-, partial-, or full-agent discretion. A capable agent bank that has attained this role by virtue of a superior track record in this function, participation in syndicate leadership and a sizeable loan commitment for its own book is likely to have sufficient familiarity with the borrower and large enough stakes in the outcome to be trusted with some measure of discretion and forbearance in problem situations, unless such decisions can only be made by a stipulated voting procedure among syndicate participants.

If a borrower does encounter difficulties, the syndicate leadership and/or the agent bank performs a critical role in explaining the problem to loan participants and creating a climate within which a workout can be accomplished—one that is obviously in the fundamental interest of both sides. The role of agent took on enormous importance during the sovereign debt renegotiations throughout the 1980s.

Defining the agent's proper role is not easy. What is the agent's legal responsibility to the borrower and to lenders? If the agent bank is also lead manager, it may well have long-standing ties to the borrower—and potentially divided loyalties. What information obtained by the agent about the borrower's financial condition should be kept in confidence, and what should be passed on to participants? Discretion also carries with it potential liability, which an agent bank may wish to avoid. Yet a continuing and digestible flow of information to syndicate participants may form the basis for smoothing adjustments to problem situations, sound advice to the borrower, avoidance of crises where everyone loses, and preparing the way for possible infusions of additional funds by syndicate members where workout situations are encountered. Day-to-day borrower contact is critical, and this cannot possibly be provided by the whole syndicate. And a certain degree of agent discretion—perhaps backed up by a small committee of syndicate members—and flexible interpretation of the terms of the legal documentation may lead to a far better outcome than applying no flexibility at all. There must be mutual trust and commonality of interest, coupled with adequate flow of information, for which no amount of legal language can effectively substitute.

The agency function is enhanced by the fact that full borrower due diligence can be inadequate in the case of some syndicate participants. They may be too small and have inadequate staff capabilities, or the cost may be excessive, or the time available before a decision has to be made may be too short. Yet the lead banks' own assessments cannot be made available because of the implied liability involved. Apart from the lead banks' efforts to ensure an accurate and complete information memorandum, there is no good solution to this problem.

Competitive Performance

Relatively few banks dominate international loan syndication activities. Table 5-1 gives the 2001 rankings for lead banks on publicized Euro-

Table 5-1 Global Syndicated Lending, 2001
(full credit to lead manager)

Firm Rank 2001	Syndicated Bank Loans
Citigroup—SSB	278,375
J.P. Morgan Chase	514,476
Merrill Lynch	37,987
Goldman Sachs	43,953
Morgan Stanley	20,060
Crédit Suisse Group	42,485
UBS Warburg	33,870
Deutsche Bank	83,423
Lehman Brothers	32,760
Bank of America	238,057
Dresdner Kleinwort Wasserstein	48,339
Barclays	58,742
ABN AMRO	30,869
BNP Paribas	28,938
Bear Steams	4,492
HSBC	30,059
Nomura	1,744
RBS Group	67,279
Societé Generale	58,666
Mizuho	53,674
Banc One	59,368
West LB	46,252
Commerzbank AG	37,335
Mitsubishi Tokyo	29,291
CIBC	33,231
RBC Dominion Securities	19,037
HVB	18,098
Wachovia	25,258
Toronto Dominion	24,246
ING Barings	29,047
Credit Agricole Indosuez	10,427
Fleet Boston Corp.	31,901
First Union Corp.	35,572
DZ Bank	1,653
Total	2,108,964

Data: Thomson Financial Securities Data, 2002.

loan syndications. The name of the game is obviously syndicate leadership, and in a market where news travels fast and that is rife with scuttlebutt, a strong position may be difficult to attain and to hold.

Lead managers in syndications carry heavy responsibilities to both borrowers and lenders. They must be absolutely forthright and reliable in their dealings with participants. They must stay away from substandard deals and develop a pattern of offering participations that have attractive risk-return profiles. They must avoid the "hard sell" (a difficult thing to do

when things are not going well) and retain participant respect even in the heat of the syndication process. They must be thoroughly familiar with market conditions and individual banks' attitudes toward particular borrowers, and they must develop a good overall working relationship with a broad array of banks, including participations and possible management roles in syndications led by others. Finally they must have a major presence in loan syndication centers staffed by specialized groups who can effectively back up the coverage teams at the customer end to win mandates and at the same time be capable of structuring a syndicate and successfully getting the deal. Such individuals are generally bright, tactful, resourceful, and tough bargainers.

At the other end of the deal, successful lead banks must have established sound working relationships with (and reputation among) potential borrowers, often covering the gamut of banking services (possibly a local presence), and a track record of commitment in good times and bad. They must be a steady source of sound advice, even if this runs counter to the current desires of the borrower. They must be able to convince the borrower of their strong position in the syndications market and of their ability to bring off a syndication on the most competitive terms possible. Their image of competence must be unquestioned, and they must be seen as important players in the market. Above all, lead managers must avoid errors. Misestimating market conditions or borrower acceptability may produce a "failed" syndication or an embarrassing return to the borrower for sweeter terms. Syndications can fail outright, leading to red faces all around, a loss of fees, or a humiliating return to the market with sweetened terms. Even renegotiated syndications can have such consequences. Both can strain relationships between the syndicate leadership, the borrower, and participating banks—and, if repeated too often, this strain can severely erode the ability of those responsible to compete for syndications in the future. Likewise, mishandling the job of agent, which is always possible in problem situations, can cause serious difficulties to borrower and syndicate participants alike. They can produce "black marks," which, when cumulated and amplified by market gossip, can seriously erode a bank's competitive position for the most lucrative aspects of the business.

Since loan syndication is rather similar to the underwriting function for debt securities, one might expect investment banks to play a much stronger competitive role in loan syndication than appears in table 5-1. However, borrowers like banks awarded syndication mandates are expected to take a substantial share of the loan themselves, and in a fully committed deal they *must* be in a position to do so if necessary. This investment banks are generally unable or unwilling to do. Similarly, syndicate participants like to see lead managers and agents with sizeable stakes in the game, whereas investment banks may be viewed as working primarily for the borrower's interests. Still, in order to fully serve their clients, most major investment banking firms have created a senior debt and syndicated

lending capability. Borrowers have sometimes put great pressure on investment banks to arrange loans in order to obtain more profitable investment banking mandates. Indeed, few wholesale banks that purport to provide a full range of services to their global client base are not actively involved in syndicated lending today. This has advantages for borrowers and lenders alike. It also can lead a bank into unproductive lending or excessive credit exposure in an effort to capture lucrative advisory or underwriting fees proffered by clients.

6

Asset-Related and Project Financing

Chapter 5 discussed international commercial lending and related activities in terms of general obligations of borrowers. There are, in addition, several specialized forms of lending that have limited recourse to ultimate borrowers and their balance sheets, or sometimes none at all. These can provide attractive lending opportunities but also can expose banks to significant risks. Some such transactions, in which the asset is a major basis for the financing, also lend themselves to securitization, selling loan exposures to other financial institutions, and repackaging. This chapter discusses the various types of lending that are based on the value of assets underlying trade financing, international leasing, and project financing. Each has its own unique characteristics and poses unique challenges to banks hoping to compete effectively.

Financing International Trade

Banks have been involved in the financing of international trade and effecting payments for international trade transactions since at least medieval times. The basic *transactions services* involve cutting information and transactions costs for importers and exporters, making payments for international transactions as expeditiously and cheaply as possible, and providing associated foreign exchange and risk-shifting services. The basic *credit services* involve the direct extension of credit from the time internationally traded merchandise leaves the factory door (and sometimes before that) to the time the buyer completes payment, or, alternatively, making possible credit extension for this purpose by the financial market by providing credit

backstops for some of the risks involved, again in the most cost-effective way available.

Forms of International Payment

Probably the easiest and cheapest forms of payments for international trade transactions in which sales from an exporter to an importer are made are on an open-account or consignment basis, or against payment in advance. Both are possible only if the two parties know each other well and trust each other.

If a transaction is done on a consignment basis, the exporter ships the merchandise and sends the shipping documents to the importer, who is then able to claim the goods when they arrive. When the importer sells the merchandise, it sends the proceeds minus its markup to the exporter. The same thing happens when the transaction is done on an open-account basis, except that the importer remits payment to the exporter on arrival of the goods or within an agreed period of time thereafter. Selling on consignment loads the entire risk (that the merchandise will actually be sold and that the importer will actually pay)—as well as the financing of the goods while in shipment and in the importer's inventory—onto the exporter. Selling on open account loads the credit risk onto the exporter as well, together with part or all of the financing. Nevertheless, the exporting firm may be willing to accept the risks involved in selling on consignment based on its underlying competitive position. Selling on open account is normally done when there is a close connection between importer and exporter, as when the importer is an affiliate of the exporting company. Serious collection problems arise in the event of default, in part because all claims must be filed under the laws of the importer's country.

Payment in advance may be specified in certain cases where the exporter is able to impose on the importer all of the risks and credit costs—the risk that the goods will actually be shipped and will arrive as specified and the cost of credit during the time the goods are in transit and sometimes even as the goods go through the production process. This form of payment is sometimes specified for certain types of custom-made products, which cannot be sold to anyone else, and when the exporter has very substantial bargaining leverage.

In all three cases (payment in advance, consignment, and open account), banks get involved only in the payment function itself and will receive customary fees for this service, as well as for the spot or forward exchange transactions involved.

International Collections. Perhaps the most straightforward, direct involvement of banks in international trade is collection of amounts due on arms' length transactions between importers and exporters. Suppose the two parties do not know each other well. The exporter would not want to ship merchandise on a straightforward basis, because he could not be sure of

getting paid. The importer could take care of this problem by simply paying in advance, but then could not be sure the merchandise actually got shipped. This calls for an intermediary who takes care of the risk exposure on both sides.

The exporter prepares a "trade bill," or draft, which the importer is supposed to pay either when he takes possession of the merchandise ("documents against payment," or D/P draft) or when he accepts the draft (D/A draft) for payment at some specified future date, such as 30 or 90 days down the road. The exporter prepares the merchandise for shipment and obtains a "bill of lading" (B/L) from a common carrier such as an airline or shipping company, attesting to the fact that the goods are as specified and that they were shipped on a given date and along a specified route. The B/L and the D/P or D/A draft are sent to the exporter's bank, which, in turn, sends the draft and documents to its correspondent bank in the importer's country with instructions to hand over the documents (permitting the importer to claim the merchandise), either against payment or against acceptance of the draft.

If it is a D/P draft, sometimes called a "sight draft," the payment is collected by the bank in the importer's country, transferred to the bank in the exporter's country, and credited to the exporter's account. No credit is extended, and the collection process is compensated by fees—plus a spread and fees on any foreign exchange transactions in the middle. The same thing happens if it is a D/A draft, a "time draft," except that the payment is collected for the account of the exporter on the specified date 30, 60, or more days in the future, after it has been accepted by the importer. In the meantime, the time draft may be held to maturity by the exporter, or it may be accepted by the importer's bank and either held to maturity by that bank or sold in the local banker's acceptances market, with the discounted proceeds collected for the exporter immediately. In this case, credit is extended by the holder of the time draft, who collects interest in the form of the discount.

Letters of Credit. Documentary time drafts for collection provide one vehicle for access to credit to finance international trade transactions, other than straightforward bank loans to the exporter or the importer. An alternative is the "letter of credit" (L/C), which efficiently takes care of properly allocating the credit risks to those best able to bear them and at the same time greatly facilitates access to financing at the best-available terms.

Assume the exporter and importer do not wish to extend credit to each other or to take payment risk. The exporter asks the importer to request its bank (the "opening bank") to issue an irrevocable letter of credit for the transaction amount in the exporter's favor. By doing so, the bank commits itself to paying the specified amount if the importer is unwilling or unable to pay, assuming the merchandise has been shipped precisely as specified in the terms of the L/C. The opening bank will then send the

L/C to its correspondent bank in the exporter's country (the "advising bank"), which will forward it to the exporter. The transaction will subsequently take place using a sight or time draft, as discussed, with the credit risk covered by the opening bank. An L/C of this type will cover only a single transaction, with tight specification of what will be shipped and how it will be shipped.

It may also be that the exporter is unfamiliar or uncomfortable with the importer's bank. In that case, the exporter may request that the opening bank's L/C be confirmed by the advising bank in his own country—a "confirmed, irrevocable letter of credit." Should the importer default, the importer's bank will pay. Should both be unwilling or unable to pay, the exporter's advising bank will pay. Of course, the advising bank must be comfortable with the credit standing of the opening bank and with the country risk involved (e.g., the risk that exchange controls may be imposed that prevent the necessary foreign exchange from being made available). Again, the transaction will take place as specified earlier, and in the case of a time draft the acceptance can take place in the exporter's country and be discounted in the local banker's acceptance market at money market rates. Figure 6-1 shows how the process works.

In addition to unconfirmed and confirmed irrevocable letters of credit, there are other variants as well. Revocable L/Cs may be amended or canceled by the opening bank at any point and therefore will offer the exporter less protection and a lower price. Revolving L/Cs will cover multiple or continuous shipments of merchandise. If a revolving L/C is cumulative, any amounts used become reavailable once the transaction has been consummated, which is not the case in a noncumulative revolving L/C unless it is specifically amended to be so. A "transferable L/C" permits the exporter to assign the proceeds to one or more secondary beneficiaries (e.g., subcontractors), while in a "back-to-back L/C" the exporter uses the first L/C (opened by the importer in his favor) as the basis for requesting his bank to open a second L/C in favor of his own supplier(s). This would tend to be used by exporters who are middlemen between domestic manufacturers and foreign buyers and who do not have acceptable credit standing of their own.

In the case of international trade transactions covered by L/Cs, banks have a number of opportunities to earn fee and interest income. Fees go to banks for issuing (opening) L/Cs and for advising and confirming them, for collections, for foreign exchange transactions, for accepting time drafts, and (when the draft is held on the bank's own books) for extending credit—with the rate of interest reflected in the associated discount. Obviously, this is a highly competitive, transactions-intensive business. Banks that are best at it have strong client bases involved in international trade and have designed procedures that are convenient to use, efficient, and error-free (often using e-based platforms), as well as substantial networks of correspondent banks.

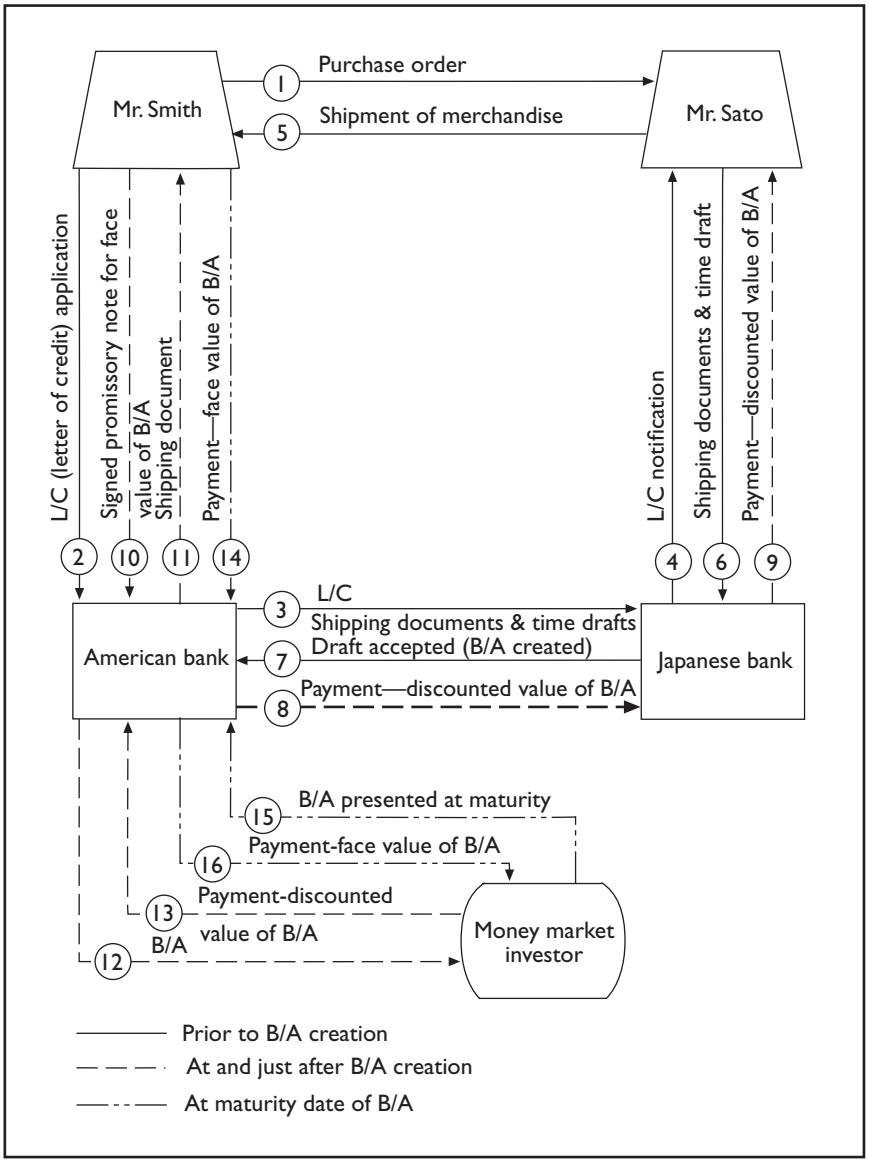


Figure 6-1. Trade financing via letter of credit (L/C) and banker's acceptance (B/A).

International Factoring

Another form of international trade financing, particularly common in Europe, is called "forfait" financing. Under this structure, a bank (acting as a so-called forfaiting house) will buy from the exporter the obligations due on the part of importers in various countries without recourse to the ex-

porting firm itself. The exporter will receive the discounted proceeds immediately—based on evidence covering the quality, quantity, and shipment of the merchandise—with the discount reflecting both the interest charge and the credit risk (commercial as well as country) the forfaiter is assuming. The promissory notes involved are usually endorsed by the importer's bank. The notes, now endorsed by both the importer's bank and by the forfaiting house, can then be held to maturity or resold in the market.

To some extent, forfait transactions are similar to "factoring," which is familiar in the United States and certain other domestic markets. Factoring involves a bank that believes it is sufficiently familiar with the customers of a particular client to buy its accounts receivable on a nonrecourse basis at a discount. The goods have already been shipped and the bills sent out, and it is up to the bank to collect. Factoring is common in the garment industry. It is a specialized business in which risk must be carefully managed through intimate knowledge of the industry and the creditworthiness of the customers, as well as loan diversification. It can be highly profitable for banks that know how to manage the risks involved. Internationally, factoring is more difficult because risk management is problematic: a domestic bank having the basis to understand the risks associated with a client's foreign customers is difficult to imagine, unless two or more banks (or branches of a single bank) work together, swapping factored receivables involving customers in each bank's home country.

Government Export Financing, Backstops, and Countertrade

Governments in most industrial economies and many developing countries provide export assistance of various kinds in order to stimulate foreign sales of domestic companies—so-called export credit agencies, or ECAs. These involve guarantees covering commercial risks, as well as political and economic risks associated with the importing country, along with concessionary financing of various types. For example, in the United States, the Export-Import Bank (Eximbank) provides direct loans to exporters and importers, export credit insurance, guarantees, and backstops for banks involved in international trade financing. Short-term credit support, up to 180 days, is provided through the Foreign Credit Insurance Association (FICA) run by Eximbank and private insurance companies. Export financing of commodity transactions is handled by the Commodity Credit Corporation (CCC). There are similar agencies in other countries, such as Hermes in Germany and COFACE in France. All permit lodging certain risks with the government at concessionary rates, thereby taking them out of the commercial market. Often these can result in very attractive profits for the banks involved, in light of the limited foreign risks they have to assume.

Banks in certain countries have become very active in arranging and facilitating "countertrade," "barter," "buybacks," "switchtrade," "offset," and other transactions with countries that are experiencing foreign exchange problems. For example, a company may ship a piece of capital

equipment to a particular country in return for which it is obligated to take back (or buy for cash) certain other commodities or to arrange their sale to third parties. Or it may build a plant on a turnkey basis, for which it gets paid in a stream of production from that plant. This business is highly specialized and risky. Normally the companies involved are in the best position to price countertrade services and to manage the risks. Banks in some countries get involved in facilitating such transactions, and in a few cases in taking on the role of principal as well, but in general they are in a poor position to carry the risks. Naturally, as exchange controls wane and external convertibility rules in most of the important trading countries, barter and countertrade becomes largely relegated to a substratum of the most problematic countries.

International Lease Financing

An important form of asset-based commercial financing involves leasing of mobile capital goods. These can include aircraft, barges, containers, drilling rigs, pallets, power generation equipment, computers, production machinery, medical equipment, materials handling equipment, and the like.

In leasing, the lessor owns the equipment and leases it to an operator, recovering the lease payments and the residual value, which together cover the equipment's acquisition cost plus profit. Lessors may or may not have the option to acquire the equipment during or at the end of its useful life. Such "financial leasing" is distinguished from "operating leasing," where the lessor is responsible for maintaining and insuring the equipment and covering any applicable taxes. Financial leases are noncancelable, whereas operating leases are often used by customers to cover their short-term equipment needs and can be canceled at any time. Operating leases tend to be the province of specialized leasing firms, which finance themselves with bank loans or in the capital markets, with full recourse to the lessor, on the basis of their own credit standing.

There are two types of financial leases. Straight bank leasing involves 100% bank financing on equipment procured according to the customer's specifications, with the asset acquired by the bank and delivered to the customer against assignment of the leasing documentation. Lessor and lessee may get together on the basis of an existing banking relationship, or they may be brought together by a broker. Alternatively, the lease may be structured through a leasing company, which pledges the equipment as well as lease revenues, with full recourse. Leveraged leasing is generally done through a separate leasing affiliate of a bank or its holding company and an ownership trust, which owns the equipment. The bank contributes a part of the required funds in the form of equity (generally at least 20%), and the leasing affiliate borrows the rest on a long-term basis from banks or institutional lenders such as insurance companies, which have recourse to lease payments and to the equipment.

Leasing tends to be heavily tax driven. Lessees are able to deduct lease payments as part of the cost of doing business, while the lessor deducts both interest costs and depreciation on the asset. Internationally there are instances where "double-dip" tax-driven leases may be possible due to the possibility of deducting interest and depreciation expenses in two tax jurisdictions because of the structure of the lessor arrangements for the lease.

International leasing is a specialized business, and it is often dominated by specialized firms such as the major aircraft leasing companies of General Electric and International Lease Finance Company (ILFC) of the United States (controlled by American International Group), both of which provide operating and financial leases to airlines that cannot afford or prefer not to purchase their aircraft outright, have temporary capacity needs, or want to lease for tax reasons. By careful diversification across customers, these lessors attempt to limit their exposure to risk, although the fact remains that they are often heavily exposed to the risk embedded in the industry of the lessees (such as airlines), and the opportunities for hedging their assets or equipment orders are relatively narrow. Other companies, such as General Electric, engage in a broader array of leasing activities. In turn, they finance themselves with bank debt, commercial paper, and capital market instruments.

Project Financing

The financing of large-scale projects such as pipelines, oil and gas production, tunnels and bridges, energy plants, sports stadiums, major office buildings, and similar long-gestation, highly capital-intensive ventures has evolved into an important major competitive arena for international financial services firms. The sheer size of the financing needs that are frequently encountered, and the complex financial-structuring and specialized risk-evaluation requirements involved, have concentrated leadership in this business among the relatively few banks that have developed and maintained the financial resources and technical skills needed.

Driven by increased competition and growing pressure on the profitability of conventional international lending, a number of commercial and investment banks have succeeded in developing capabilities in a broad range of banking functions, thus enabling them to offer comprehensive financial support and advice through the life of a major project.

Background

Modern project financing appears to have been largely an American invention, dating back at least to the 1930s. However, by the late 1990s, project financing had become a global activity. The business can be traced to bank financing of independent oil companies during, particularly in Oklahoma

and Texas. Few of the "wildcatters" who dominated the oil business at the time had either the financial resources to bring new discoveries into production or strong-enough balance sheets for ordinary unsecured bank borrowing on anything but a very limited scale. Secured borrowing was likewise precluded, since the principal "assets" to be financed were usually a hole in the ground and some associated equipment and supplies with questionable resale value. Yet it was clear that the resources in the ground themselves represented a prospective value as a future revenue stream that—if it was produced economically—could become the basis for attractive bank lending opportunities. Loans could be serviced from the proceeds of the future sale of the resource without necessarily looking exclusively to either the operating company's balance sheet or to capital equipment for credit support.

Called "production payment financing," this early approach in effect mortgaged the resource in the ground, with financial institutions betting that it was actually present in sufficient quantity, that it could be lifted economically, and that it could be sold at a price that lived up to a set of initial expectations, all within reasonable margins for error. Given the nature of large-scale energy projects such as offshore oil and natural gas ventures—as well as terminals, pipelines, and other facilities relying on throughput charges for cash flows—the development of "project financing" eventually grew in volume and international scope. The concepts underlying project financing were later extended from energy to other ventures such as power plants and cogeneration facilities, tunnels, bridges, pipelines, office buildings, and telecommunications facilities where the future cash receipts from the project are regarded as the primary means for the underlying loans.

Structural Aspects of Project Financing

A fairly standard approach to structuring a project financing, for example in the petroleum industry, is for the sponsors (e.g., BP-Amoco, Shell, Exxon-Mobil) to establish a vehicle company in which they are the principal shareholders. The vehicle company tends to have relatively thin capitalization in relation to the financial needs of the project. Each sponsor holds a sufficiently small share of the equity in the joint venture that the vehicle company cannot be construed for legal and accounting purposes as a subsidiary. Funding of the project is then routed through the vehicle company. Ideally, a record of such financing does not appear on the sponsors' balance sheets at all. If it does, it is only as a footnoted contingent liability. Similarly, the assets acquired in the course of undertaking the project appear on the financial statements of the vehicle company alone. One purpose of project financing is thus to preserve the sponsors' own credit standing and future access to financial markets. A typical alternative cash-flow profile is depicted in figure 6-2.

Vehicle companies may take a variety of forms, particularly if the project involves multiple sponsors whose presence might be appropriate if:

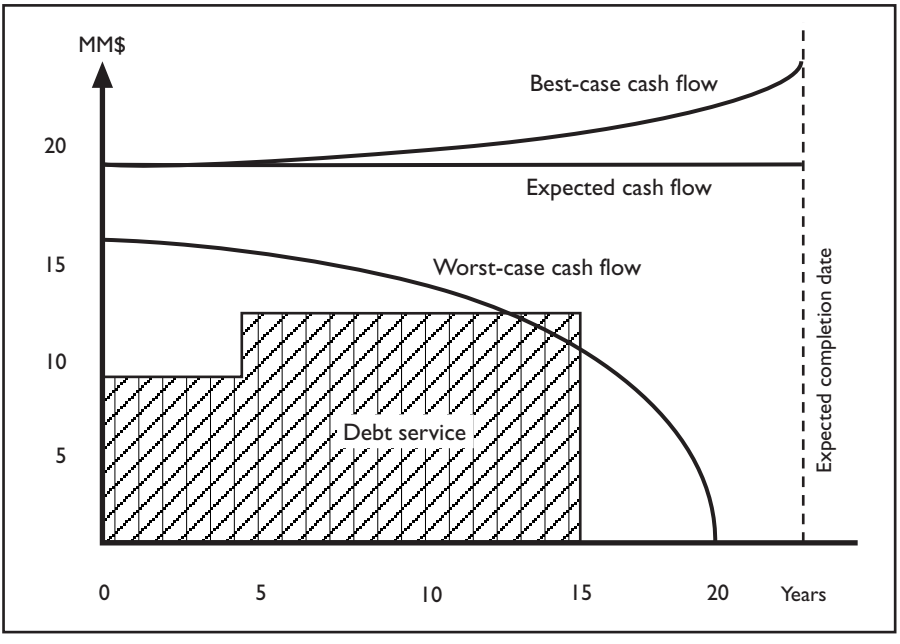


Figure 6-2. Projected project cash-flow profile: comparison of expected and best-case/worst-case cash flows.

- The project exceeds the financial, technical, or human resources of a single company
- The need for risk-sharing clearly exists
- A large project yields significantly greater economies of scale than several smaller ones
- The resource itself is jointly owned
- The sponsors are complementary in terms of their capabilities
- The country where the project is located mandates a joint venture with local interests

In the case of multiple sponsors, a separate corporate entity, partnership construction trust, or contractual joint venture may be created. Each entity may have a number of subforms and different managerial, legal, tax, and credit implications. Each may exist through the life of the project or for specific shorter time periods.

Financial Design

Once the vehicle company has been established, the financing of a project must be "engineered." The financial design process must take into account the risks involved; the various prospective sources of financing, accounting, and tax regulations; and the possibility of recourse to the various parties,

the different entities having an interest in the project, and similar factors. Financial design may be assigned to a financial adviser—possibly an investment or merchant bank. The adviser must have the necessary technical expertise, contacts, track record, and innovative thinking necessary to help stitch together the highly complex financial undertakings required, each of which might have one or more unique characteristics.

Working closely with sponsors' financial staffs, the adviser must pay careful attention to potential sources of finance worldwide, understand opportunities for laying off risks and achieving leverage targets, and be able to aid in identifying project risks and support arrangements, contingencies, foreign exchange aspects, and related facets of the deal. The objective is to minimize the cost and exposure to risk of the sponsor, while making the loan attractive to prospective lenders and investors. Individual lenders, including local banks in host countries and smaller banks in third countries, may be receptive to particular deals at various times. Attractive "windows" for parts of a financing package are often open only for brief periods of time. Supplementary financial advisers may be brought in for their special expertise and contacts to help arrange official export credits, determine the legal and tax issues involved in accessing national capital markets, and provide coordination with multilateral development agencies.

Financing Components

The principal components of project financing differ considerably from one project to the next, but each project generally uses multiple sources of funds. These include short-term and long-term debt, with medium-term lenders often replacing short-term lenders on completion of the project. Repayment schedules may be quite flexible, including some automatic resetting of debt service under various conditions (such as delays and cost overruns). This permits sponsors to develop financial strategy in other parts of their business with less concern for possible unanticipated project cash needs. To obtain the most favorable financial arrangements for projects, all conceivable sources of funds must be tapped.

Sponsor loans are advances made by the sponsor-owners of the vehicle company. Such loans would appear on the sponsors' balance sheets, compromising the off-balance-sheet intent of project financing. Sponsor-owned captive finance companies can be used to achieve the same objective. The captive finance company, with limited equity investment by the sponsor, can borrow and lend on its own account without altering the financial profile of the parent corporation and thus permit greater financial leveraging.

Supplier credits are granted by manufacturers who can provide the needed equipment on competitive terms and whose governments may vigorously promote such exports. Energy projects in particular are highly capital intensive, and much of the total capital outlay involves machinery and equipment—drilling platforms, steel pipe, draglines, pumps, engines and

compressors, communications equipment, and so on. Concessionary terms provided by or through ECAs include long maturities, fixed interest rates well below market levels, and attractive insurance cover for lenders. It is advantageous to shop for the most attractive (subsidized) supplier credit arrangements—financing provided either directly by governmental export credit agencies or by banks benefiting from government credit subsidies and guarantees.

Such loans can be quite lucrative for commercial banks, and banks may provide related loans to the same project at preferential rates if they are guaranteed a piece of the export credit package. In addition to the benefits of below-market fixed interest rates and longer maturities, such credits sometimes are linked to government grants, soft loans, and similar forms of foreign aid to the country where the project is situated. This component of project financing thus takes advantage of the intense export competition among supplier countries. A number of potential sources of supplier credits may be approached by project sponsors and their advisors to secure the best possible financing terms for equipment of engineering services.

Large-scale projects will vary widely in terms of the percentage of total cost accounted for by capital equipment and services eligible for supplier credits. If capital equipment and construction services are to be provided domestically by vendors in the country where the project is located, the prospects for financing through supplier credits will naturally be correspondingly less.

Customer credits can also be an attractive source of financing, especially when a project is specifically designed to provide raw materials or energy to a particular buyer (for example, an electric utility or a steel company, trading house, or government procurement agency). U.S. utilities have sometimes subsidized exploration and development of energy resources through advance payments, for example, and private German and Japanese buyers of metals either have been willing to provide direct financing or have helped secure support from government sources. Individual firms, trading companies, and minerals consortia have made sizable loans against future resource deliveries to ensure themselves of reliable supplies.

Advance payments by sponsors may also be used for this purpose—in effect, loans to the vehicle company to be repaid in the form of shipments after the facility comes on-stream. The absence of customer credits—perhaps due to financial limitations or lack of agreement on price concessions—may sometimes be partially offset by loans from local sources in the country where the project is located, giving other prospective lenders an indication of the project's importance.

Insurance companies, pension funds, and bond debt, traditional sources of long-term financing in many countries, would appear to be ideal participants in project financing packages, because the gestation periods on large-scale ventures are often very long. The relatively stable and predictable cash flows of such nonbank institutions would seem to allow them to finance at much longer maturities than, for example, commercial banks.

However, insurance companies and pension funds generally demand commensurately higher interest rates, as well as strict security arrangements or guarantees. This could require a supplementary guarantee from their home government, or it may negate their participation altogether. Lack of investor interest in anything but conventional government and corporate debt limits the international bond markets as a source of financing for projects until they are up and running with a proven track record.

Lease financing represents another potentially useful source of project financing, which may have important legal, tax, and accounting advantages. As discussed, a leasing company (perhaps bank owned) typically holds title to mobile equipment used on a project, claims depreciation for tax purposes, and leases it to the project operator, who, in turn, may be able to claim lease payments as an expense for tax purposes. The leasing company may also pass some of its tax benefits on to the operator in the form of lower equipment rentals. In turn, the lessor may finance the equipment through long-term borrowing secured by the equipment itself, often at relatively favorable rates of interest.

Commercial bank loans usually form a major part of the typical project-financing package, generally in the short- and medium-term maturities priced on a floating-rate basis. Bank loans normally cover the critical earlier years of a project and traditionally involve full recourse to sponsors or third-party guarantors. They may also be serviced by production payments on a nonrecourse basis if appropriate guarantees can be provided and if the issue of legal claim to the source of the underlying cash flows can be satisfactorily resolved. Bank loans are often arranged on a syndicated basis, which means that multiple banks have to be convinced of the soundness of the loan and the project. Successful bank financing depends in part on the "fit" between the term over which loans are needed and the repayment requirements specified by lenders. For many projects, financial needs may extend well beyond conventional bank lending terms, sometimes limiting this form of financing to shorter periods in the construction or initial operating stages.

Equity capital can nevertheless cover a significant part of total project cost. Sponsors may inject cash into the project, particularly in the very early planning and start-up stages, or they may contribute to engineering staff, know-how, or administration. In addition, third parties, particularly potential customers, may be prepared to provide equity capital to a project on a minority participation basis. In a few cases like Eurotunnel, major public equity offerings may be undertaken to form the basis for large-scale debt financing.

Other potential sources of project funds may include wealthy individuals (domestic and foreign), central banks or monetary authorities, and investment management firms via common or preferred stock in the vehicle company, notes and debentures, convertible debentures, trade credit, and commercial paper. Straight (unsecured) loans are often enhanced by warrants, conversion rights, or rights to other securities. Local-currency fi-

nancing may be secured from indigenous banks, particularly for working capital purposes, or possibly on a longer-term basis from local insurance companies or other sources of medium-term financing. Often one form of financing, such as subordinated loans, will make participation more attractive to one or more other sources of funding.

Standby Letters of Credit and Guarantee Facilities

Project financings often involve guarantee instruments that cover the performance of contractors involved in construction and related services. These can provide an important source of security for project participants, since sizeable progress payments are sometimes made to contractors. Contractor default could place a project's vehicle company and its sponsors in financial jeopardy.

Under a standby letter of credit, a contractor asks a bank to open a letter of credit on behalf of the entity that has awarded the contract, which may be "called" by the beneficiary under certain, specified conditions of nonperformance contained in the guarantee instrument. If a "call" occurs, the bank will make payment and, in turn, the contractor is obligated to make prompt reimbursement to the bank. The bank's obligation is limited to paying the amounts specified to the beneficiary and does not include direct intervention to assure completion of the work involved. Standby L/Cs include:

- Advance payment guarantees, posted against up to 100% of advance or progress payments to a contractor;
- Bid guarantees, to ensure that a bidder will actually accept the award if made or that he will subsequently post required performance guarantees, usually 1% to 2% but sometimes 5% to 10% of the bid price;
- Performance guarantees, valued at perhaps 5% to 10% of the contract price, stating that the contractor will actually perform in accordance with the agreement;
- Maintenance or retention guarantees, used to cover contractor warranties after full payment has been made, perhaps 10% of the contract price.

Under a standby L/C, the contractor signs an indemnity agreement outlining his obligation to the bank, which is triggered by an incurrence of liability on the part of the bank to the beneficiary under terms and conditions carefully specified by the contractor and agreed to by the beneficiary. The two represent separate sets of legal obligations. If the beneficiary calls the standby L/C for whatever reason, the bank must pay, although it will not incur a loss unless indemnification by the contractor is refused. For this reason, and because contractor losses in the event of a call may vastly exceed the value of the standby L/C, careful credit assessment of the contractor on the part of the issuing bank is essential. Calls may occur because a contractor's financial difficulties prevent completion, because of

technical or operating problems, or even because of arbitrary or fraudulent action on the part of the beneficiary. This reinforces the need to specify conditions of default, possibly including independent certification, since the bank's obligation is unconditional.

To backstop its position, a bank issuing a standby L/C or other type of guarantee may require a lien on the contractor's assets, other security interest, cash margins, or certain covenants related to debt and coverage tests. The guarantee instrument may also be structured to diminish over time, while the project draws to completion and the risks involved decrease commensurately. Fees for standby L/Cs or other guarantee instruments can be substantial and are paid by the contractor, presumably to be passed recouped to the extent possible in the contract price.

Foreign Exchange Considerations

Foreign exchange aspects can assume a major dimension of project financings since cash needs, financial obligations, and resource sales will often be denominated in different currencies. The risks involved may be addressed in the short term by means of currency swaps or borrowings in the currencies needed and in the long term by financing in the appropriate currencies, swaps, long-dated forward contracts, and local-currency financings. Because of the extended duration of project financing, the foreign exchange aspects can be exceedingly complex and may test the ingenuity of the financial advisors and banks involved.

Co-financing

The World Bank and the International Finance Corporation (IFC); regional development banks in Asia, Latin America, and Africa; and other intergovernmental institutions—all have traditionally been in the business of project financing. They are often able to provide attractive terms because of direct agency financing by participating national governments or because the agency is able to fund itself long-term on domestic or international markets on a favorable basis. Particularly large projects in developing countries that exceed conventional financing capabilities may be able to proceed under a co-financing arrangement with international institutions, based on agreements with the host-country government.

Co-financing can take the form of joint financing, where all lenders share in responsibility for the entire project, or parallel financing, where each lender finances a separate part of the project. The World Bank and IFC have a long history of bringing other lenders and investors in on large-scale natural resources ventures where they have taken a leadership role.

Co-financing is clearly desirable for projects where the resources of the borrower, the World Bank, and other sources of finance are insufficient to cover necessary outlays. It "stretches" World Bank or IFC resources over

a broader portfolio of projects without significantly diluting the borrower's degree of responsibility or the care taken in project appraisal; at the same time, it gives co-lenders additional assurances of the quality of projects and the prospect of reduced sovereign risk attributable to the World Bank Group's presence.

In evaluating the financial requirements of a project likely to require co-financing, the World Bank or IFC looks first to prospective sources of long-term, fixed-rate financing, most often found among official bilateral or multilateral institutions or official export credit agencies and generally tied to purchases in a particular country. Funding is then sought from commercial sources to fill any remaining gaps. In the case of a typical electric power project, for example, the World Bank reviews a specific portion of the borrower's investment program and may agree to finance certain subprojects within it. Funds from private lenders are then sought to help finance other subprojects closely related to those financed by the bank.

Generally, the World Bank's resources can only be used to finance the foreign exchange costs of goods and services identified in advance, and only those expenditures that are made after approval of the loan by the bank's executive directors. Hence, borrowers often find that commercial financing is required to cover expenditures that may not qualify for World Bank assistance, such as start-up costs, other imported goods and services, local procurement, and working capital needs. In addition to the use of private co-financing to complete the financing plan of a project as defined by the World Bank, there have cases in which co-financing was sought to help fund investment programs that are complementary to, but not included in, bank-assisted projects.

Under the World Bank's co-financing program, borrowers are ultimately responsible for selecting the private lenders brought into a deal. However, the bank does provide assistance by making co-financing opportunities widely known to potential lenders, and it often provides borrowers with names of banks in the major capital markets that in the past have shown an interest in co-financing. At the request of borrowers, the bank also takes the initiative in establishing contacts with prospective private lenders to ensure that borrowers make a reasonable effort to explore the prospects for commercial financing with a representative sample of banks before reaching a decision. The bank encourages private lenders and borrowers to establish early and direct contact whenever a co-financing opportunity has been identified.

The terms and conditions of the commercial loans under co-financing are negotiated directly between the private lender and the borrower, just as the World Bank negotiates (independently of co-lenders) the terms and conditions of its own commitments directly with the borrower. Once drafts of the loan documentation pertaining to each lender become available, the World Bank and the private lenders agree on any cross-reference clauses to be included, as well as provisions to be incorporated in the text of the

memorandum of agreement. The bank reserves the right to approve clauses in the loan agreement between the private bank and the borrower that affect its own rights, such as cross-default clauses.

World Bank borrowers securing co-financing from private sources generally choose syndicated lending. The lead banks, acting on the borrower's mandate, assume full responsibility for arranging and managing the loans. However, at the request of the borrower, the World Bank's co-financing staff has occasionally helped identify potential syndicate participants. The applicable loan agreements have followed established syndicated loan precedents with respect to terms and conditions, again negotiated directly between the private lenders and the borrower. Since the disbursement procedures of private banks differ substantially from those of the World Bank, they are handled separately and independently. Although it is common practice to agree on periodic staged disbursements over a fixed period, loans are frequently drawn down in a lump sum soon after signing. Similarly, payment of interest and principal to co-lenders are set independently of the World Bank loan.

A longer-term benefit related to World Bank co-financing activities involves introducing borrowers in developing countries to new commercial bank lenders and assisting them in securing continued access to international capital markets. At the same time, commercial banks emphasizing the financing of specific projects, as opposed to country lending, have found new clients in developing countries. World Bank projects for which private co-financing has been arranged have historically been concentrated in the industrial and utility sectors. Figure 6-3 depicts a project financing involving the International Finance Corporation in a Brazilian highway project.

Figure 6-4 provides a summary overview of a complex project structure. Linked to the project is the sponsor, working with the agent bank on the financial structure, injecting equity and receiving profits. Also identified are the contractors undertaking the construction work, who may also be involved as equity investors and possibly take product in partial or full payment for their services. Then there are suppliers (possibly working under a supply-or-pay agreement); the project operator working under an operating and management (O&M) agreement; and the customers, possibly involving a take-or-pay agreement. Also identified in figure 6-4 are the project lenders, the international institutions, and the possibility of their co-financing, and the government of the host country possibly providing guarantees or allowing the project to proceed under a BOT (build-operate-transfer) agreement.

Risk Assessment and Risk Management in Project Finance

Project financing is intended to design financial structures to be serviced from future cash flows, often with limited recourse to the project's sponsors.

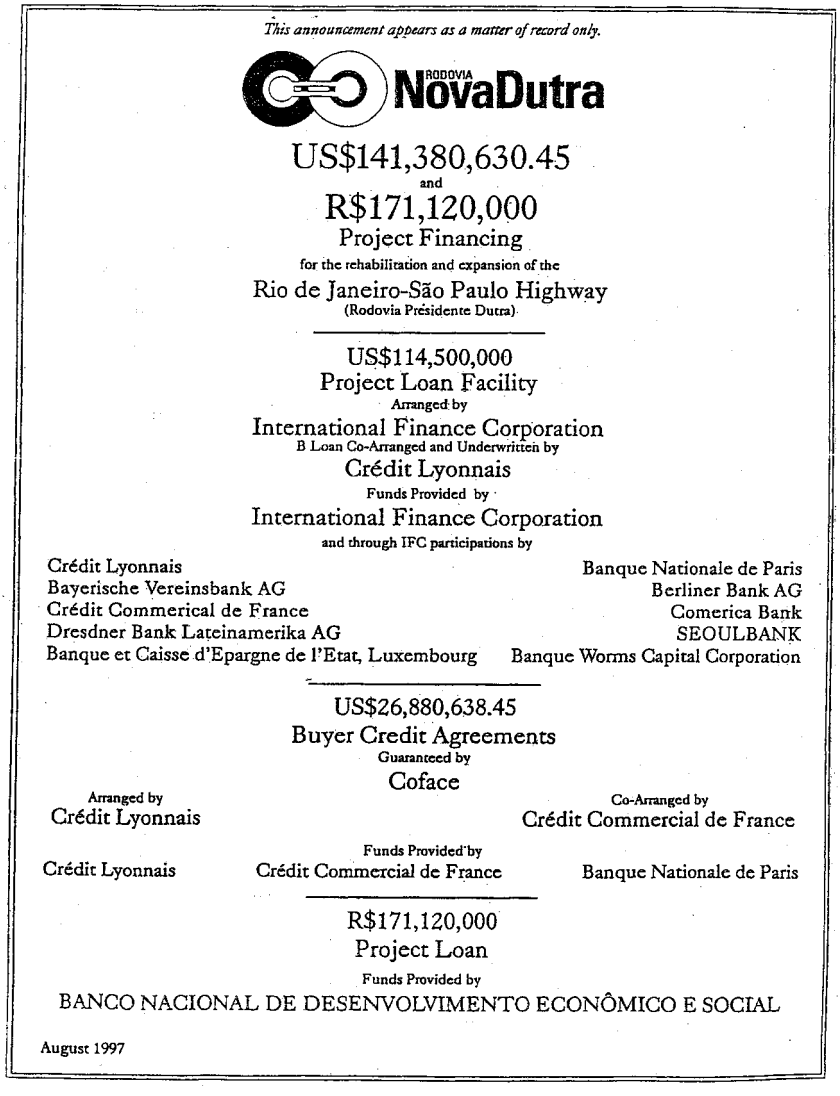


Figure 6-3. Example of a project financing involving international agencies.

Financing that is structured in this way limits the burden placed on sponsors' balance sheets and diminishes future borrowing capacity and creditworthiness less than other modes of financing. Lenders and investors rely on the project's expected revenue stream and often carry a share of the technical, commercial, and political risks. Evaluation of risk and the application of risk-limiting techniques thus are critical in project financing because of the heavy reliance on the project itself to provide effective debt

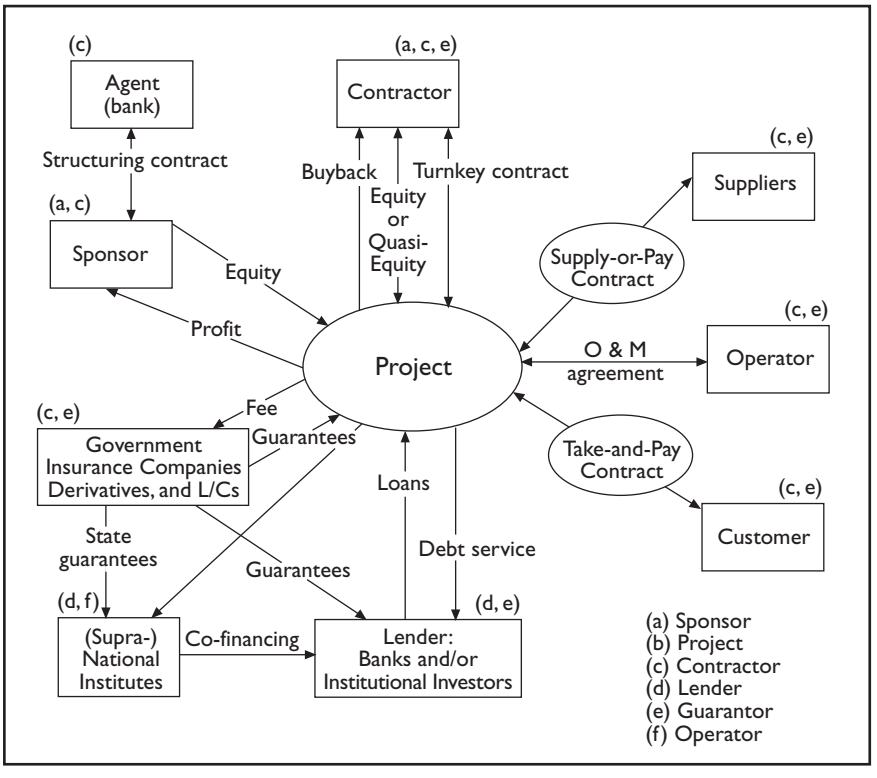


Figure 6-4. Project finance relationships.

service. There are at least nine distinct types of risks lenders face in project financing:

1. *Resource risk* involves the possibility that the oil, gas, or minerals in the ground, which represent the basis for debt service in natural resource and energy projects, are not, in fact, there in the required quality or quantity.

2. *Input* or *throughput risk* concerns nonextractive projects such as power plants, transportation infrastructure ventures, or pipelines where the basic viability of the project depends on the availability and price of energy, raw materials, or other resources under the original terms. In the case of tunnels, bridges, and similar projects, the risk is that supply or demand factors may result in a traffic shortfall, leading to a revenue deficiency.

3. *Technical risk* relates to the engineering characteristics of the project itself. A project may turn into an outright failure for technical reasons or may result in substantial cost overruns, requiring significant additional capital infusions.

4. *Timing risk* focuses on the possibility that delays, from whatever source, will stretch out the period of construction before the cash flows

that support the financing actually begin. Such delays (especially in an inflationary period) can be the source of substantial cost overruns and raise interest charges considerably. Even relatively short delays may lead to extensive escalation of construction costs.

5. *Completion risk* combines technical and timing risks. Completion problems include errors in engineering and design; construction delays due to strikes, weather, or late delivery of equipment and supplies; unanticipated topological problems; new and untested construction techniques under prevailing conditions; cost escalation due to a serious lack of skilled labor; and similar factors. In practice, the lenders have traditionally been willing to rely on cash flows from projects only after they have become operational, requiring the sponsors to provide financial supports and guarantees before loans become strictly nonrecourse. More recently, there has been a greater willingness on the part of lenders to accept, under appropriate circumstances, a range of precompletion risks that previously the sponsors alone had to carry.

6. *Market risk* concerns future demand for the product or service supplied by a given project. Prices for many raw materials are naturally volatile, and they also may be subject to significant long-term (secular) shifts over the extensive period of time that faces the financing. What happens, for example, when demand for the customer's own output undergoes a severe and prolonged decline? In addition, some products and services such as natural gas, transportation, and electric power are highly dependent on local or regional market developments and may easily encounter a demand shortfall. This problem may be complicated by difficulties in storing or finding alternative uses for certain resources (e.g., natural gas). In assessing market risk, demand forecasts clearly hinge on such factors as price and income elasticities, competition, exchange rates, availability of substitutes, government policies, political developments, and environmental concerns.

7. *Operating risk* focuses on the long period of time that projects and their financing generally involves, over which costs may change or during which labor, transportation, or other critical elements may be disrupted by external sources or management incompetence. Operating problems also include inability to meet output targets or quality specifications, poor engineering or design work, unexpectedly high maintenance costs due to corrosion or wear, price increases on energy equipment and materials, exchange-rate movements, and other factors.

An important source of operating risk is the quality and stability of the local labor pool, particularly in developing countries. This risk often can be reduced by training programs, astute labor relations, and tapping external labor sources. Prospective operating expenses and their variability, project location, complexity of environmental problems and similar factors may also influence perceived operating risks. The best assurance to lenders is a proven track record under similar circumstances on the part of the project operator. Management-related sources of operating risk are of direct concern to sponsors and operators if the project is to be completed and

operated as planned. Project logistics and their links to subcontractors, to labor relations, and to environmental conflicts are often of major concern here.

8. *Force majeure risk* involves acts of God, such as earthquakes, hurricanes, or other weather-related calamities; warfare; and other uncontrollable events that may lead to failure, escalate costs, delay completion, or disrupt operations. Provisions to accept force majeure risk are usually agreed by lenders in project financings—generally for a limited duration only.

9. *Political risk* involves the political conditions that surround a project during the period covered by a financing. Terrorist acts, labor disruptions, tax changes, expropriation, newly imposed environmental controls, invasions from abroad, and similar events arising from the political environment fall under this general heading. So do expropriation or nationalization, imposition of exchange controls, changes in royalties or depletion allowances, and pressures for indigenization of equity or human resources—some of which may be imposed retroactively.

Issues related to country problems are supposed to be covered in standard country-risk assessments carried out independently by project lenders and investors (see chapter 12). However, a given project may have a risk profile that is quite different from that of the country as a whole. A project may be politically sensitive in a country that is otherwise characterized by a very low degree of assessed risk. The specific kind of natural resource involved, project location, employment of nationals, nature of the target markets and downstream uses, and shifting government and interest-group priorities may dictate project risk that may be a cause for lender concern. This deviation of "project-specific risk" from conventional country risk often requires complex analysis.

As with other types of business risks, those related to project financing involve the variance in the expected returns to lenders and investors. Some of these risks are related to short-term exposures and will be liquidated early in the life of the project, or they are incurred and eliminated during comparatively brief periods as the project moves ahead. Others involve relatively long-term exposures, where the expected returns are characterized by a rather high degree of variance. Moreover, for some lenders, variance in expected returns is not symmetrical (they can only lose, never gain), while for investors, variance in expected returns describes the chance of gain as well as loss that may be attributed to some of the sources of project risk. Finally, it is important to note that, within the framework of a given project, exposure to risk does not lend itself to diversification—unlike cross-border lending to countries, where some local borrowers may fare quite differently than others in response to changed country circumstances.

In essence, lenders have to decide which of these risks are "bankable" and which must be covered by any of the available contractual arrangements involving either project sponsors or third parties such as customers, governments, or international organizations. This decision depends on

prior experience, technical expertise, and the perceived degree of control over a wide range of variables. Such perspectives, of course, differ among participants in project financings: a complex deal can yield several different views on who is really carrying the risks involved. Banks' willingness to assume project risks remains very much project- or sponsor-specific. For example, lenders might be fairly comfortable evaluating the risks associated with a new production platform in the South China Sea or offshore Nigeria if they have done a number of similar deals in the past.

Evaluation and Mitigation of Project-Related Risks

Sources of risk to lenders and investors in project financing sometimes relate only to completion of a project, or they may be longer term and concern the project's operation over many years. Evaluating and reducing both completion and operating risk requires expertise and ingenuity. Financial management of these risks generally relies on various guarantees. These may be direct (full and unqualified commitment on the part of the guarantor); limited in terms of amount or duration; or contingent, involving relatively unlikely events that lenders may feel the need to be mitigated in order to secure their participation. Guarantees may be either implied as an obligation of the guarantor or indirect via performance of some related activities, which will, in effect, make the lender whole in the event of problems.

Resource Risks. Resource risk facing lenders is often evaluated by independent technical studies. The sponsoring firm or consortium will have made its own evaluation of the available quantity and quality of the resource to be recovered, such as natural gas. This information will be carefully assessed by the major lenders' in-house technical experts and confirmed by outside consultants, with the cost of any further independent evaluation of natural resource reserves borne by the vehicle company or its sponsors. Project financings will almost always involve multiple financial institutions. The technical assessment of available resources must be convincing to the lead institutions and to the other participants. This procedure has the added advantage of independent verification of the viability of the project.

Completion Risks. Similarly, the sponsor's own evaluation of the technical problems involved in completing a project needs to be assessed in-house and possibly by engineering consultants or other outside experts. The track record of the sponsors in successfully undertaking comparable projects elsewhere is of great importance. Projects involving new technologies or particularly adverse conditions (climatic, topological) tend to multiply the risks incurred.

Lenders often require completion guarantees from project sponsors, who unconditionally warrant that performance will be as specified (quan-

tity, quality, timing, and minimum period of operation) and that they will cover any and all cost overruns. Sponsors are typically asked, in advance, to agree to specific tests of physical and economic completion, with lender recourse lapsing only after these tests have been satisfactorily met. Cost-sharing arrangements may oblige sponsors to carry a specific pro rata share of all project outlays, including debt service payments.

Other ways of reducing completion risk include penalty clauses, performance bonds, and guarantees such as standby L/Cs covering contractors on the project and completion guarantees issued by the sponsors themselves or other banks. These warrant that construction will be finished on schedule and that there will be no cost overruns. Technical criteria relating to performance of the facility upon completion are often employed to ensure that things work as they should. In turn the guarantor may syndicate the guarantee or protect himself by means of bonds or insurance covering individual contractors and others involved in the construction phase of a project.

Sponsors may also provide "comfort letters," sometimes called "letters of moral intent" or "keepwells," promising to supervise and maintain an active interest in the vehicle company throughout the precompletion and operating phases of the project without issuing a formal guarantee. Such documents, even when tightly worded, cannot be viewed as de facto guarantees by project lenders.

Supply Risks. Where applicable, supply or throughput risk on major resource-related projects such as pipelines can, be handled by obtaining guarantees from the suppliers of raw materials or energy sources, specifying the required throughput amounts and prices to be charged. In payments for the use of such facilities, there often is a "hell-or-high-water" clause, which anchors the absolute, unconditional nature of the obligation irrespective of nonperformance by the other party.

Market Risks. Market risk in project financings is often met by "take-or-pay" contracts, whereby the ultimate buyers of the output unconditionally commit themselves to make specific payments for a given period of time, whether or not they actually take delivery. One problem with take-or-pay contracts is that in effect, the sponsor sacrifices a certain degree of control over the facility. Since the guarantor may be a third party, this can involve somewhat higher borrowing costs. Such issues have to be weighed against the drawbacks of an explicit sponsor guarantee for the life of the loans involved. A "take-*and*-pay" obligation is a somewhat softer version, that depends on actual delivery of the resource. Naturally, the credit standing of the purchasers must be carefully reviewed, as must a variety of market-related elements. Market risk can sometimes be reduced by direct customer equity participation in projects, debt participation, floor prices, and price-escalation arrangements.

It may also be possible in project financings to obtain "deficiency guar-

antees" covering an entire venture, either from the sponsors or from the government of the country where the project is located—or perhaps the home-country governments of the sponsors. Some guarantees cover losses of principal and interest suffered by lenders after any collateral has been liquidated in the event of default. In the case of a government's sovereign guarantee, country risk assessment will determine its true value. Collateral in offshore project financings can take many forms:

- A lender's mortgage over the borrower's interest in the license or project facilities
- Assignment of the lender's interests in the various agreements and contracts
- Assignment of insurance proceeds
- Assignment of revenues received, such as liens on accounts receivable or liens on petroleum inventories
- Contingent claims on related bank accounts
- A pledge of shares of the borrower

In addition, sponsors may be required not to reduce their financial interest in a venture below a specified level. Sellers of equipment to the project may also be willing to provide certain guarantees, or this function may be taken up by exporting-country government agencies. The existence of a complex of guarantees, of course, provides support for project financing only to the extent that the guarantors are able and willing to meet their obligations and, hence, each guarantor has to be subject to careful credit analysis. Even after all guarantees are taken into account, the underlying soundness of the project itself still tends to be the determining factor.

Political Risks. Political risks in project financing can be dealt with in a variety of ways, including purchase of political risk insurance, participation of influential banks from a number of different countries (particularly from major trading partners or creditors of the host country), or regional development banks or the World Bank. Sometimes the country's needs for continued balance of payments loans, including rollovers of maturing debt, may give banks sufficient implied leverage to constrain adverse political moves.

A central function in project financing is thus to identify and try to quantify the various risks, and to structure the deal to allocate these risks acceptably among the various participants. As financial institutions develop a better understanding of the risks in particular types of projects, they seem increasingly prepared to accept a larger share of total project risks, which means less onerous covenants and guarantees for project sponsors. A reputable sponsor with a good record should be able to negotiate over a range of risks that bankers would not have accepted early in the history of project finance. The fundamental challenge facing financial advisors on major pro-

jects is to put together a financing package that will align the interests of all parties, given the financing sources available, the risks, and the options available for reducing those risks.

Build, Operate, and Transfer

Given the scarcity of public financings for infrastructure projects in many countries, the build, operate, and transfer (BOT) model has made its appearance. Essentially, BOT takes what is conventionally defined as a public-sector infrastructure project under a concession granted by the government and applies private capital to develop the project and to operate it for a period of time at a profit in order to give the investors an acceptable return, after which the facility is transferred to the government. The technique actually originated with the development and financing of rail systems in various parts of the British Empire in the nineteenth century.

BOT equity is raised from private sources or through a public share offering by a sponsorship consortium for a special-purpose vehicle company. The sponsors may be contractors seeking engineering and construction work, operating companies, equipment manufacturers, or suppliers or customers, usually with the active support (but not direct participation) of the public sector. The equity serves as an incentive for the contractor and operator to perform on time and within budget, since each has a significant stake in the venture, and it provides cushioning and comfort to lenders in terms of the project's economic viability. A pure BOT project would raise debt financing purely on its own merits, although in many cases government guarantees are in fact involved. Eurotunnel between Britain and France is an exception in that there are no government guarantees. Designing BOT structures is not cheap, and the higher quality the risk assessment, the higher the costs incurred by the sponsors who have no guarantee that the project will in fact go ahead.

Advantages and Costs of Project Financing

The growth of project financing is obviously linked to material advantages over other, more traditional, forms of lending to accomplish the same objectives. First, to be economically viable, projects often are so large that they outstrip the financial capabilities of the firms involved, even in the joint ventures. North Sea oil development, the Alaska pipeline, and Eurotunnel are perhaps the most well known examples of mega-project financings. With all possible supports for the loan captured in the financing package, the project itself must in the end be capable of justifying a significant share of the debt incurred.

Second, we have noted that project financings are largely off-balance sheet as far as the sponsoring companies are concerned, except perhaps as footnotes related to long-term debt. Full guarantees, nevertheless, have to

be captured in financial statements as contingent liabilities, although completion guarantees might be omitted on the grounds that they are merely normal parts of doing business. Project financing enhances sponsors' borrowing capacity in the view of prospective lenders. This permits a far higher degree of de facto leveraging of their capital than would otherwise be possible without incurring commensurate risks. If they are successful, ventures structured along project-financing lines can have very positive effects on sponsors' profitability.

Third, project financing may permit a greater degree of bank risk reduction through loan-portfolio diversification than alternative forms of financing. In some ways, project financing may indeed be superior to sovereign lending. The project itself may generate independent export revenues or reduce import expenditures, or it may have broad-gauge favorable effects on the external debt-servicing capacity of the host economy. Projects may also provide a good indication of a country's long-range economic outlook and the quality of its economic management.

Project financing costs can be expected to exceed the costs of comparable financings undertaken directly by project sponsors. Involvement of multiple lenders and other parties tied together by a complex structure of undertakings absorbs a substantial amount of time and effort that can translate into equally substantial legal, management, and financing fees, and interest spreads on substantially nonrecourse financings will tend to reflect the incremental risks accepted by lenders—with borrowing costs potentially well above the sponsors' corporate borrowing rates. Where such risks are shifted through insurance, the associated premiums will add to overall financing costs, while other forms of risk-transfer such as offtake contracts or consumer financing may involve substantial price concessions. It is also to be expected that state-owned energy and resources companies will sometimes shun project financing, as government-guaranteed or imputed government-backed financing is less costly for them.

Competition Among Financial Institutions

Tables 6-1 and 6-2 indicate how project financings compare in volume with total syndicated loans and identify the principal countries of project lending.

From a profitability point of view, project financing offers potentially attractive opportunities to financial institutions. The global presence of large international banks provides an important information advantage in obtaining leadership positions in project financings, in evaluating risks, and in assembling the financial resources necessary to carry them out.

Financial "packaging" is the essence of project financing, and economic returns to advisers and others that can be attributed to this function—actually returns on proprietary information and financial innovation—can be very substantial. However, project sponsors and their advisers sometimes

Table 6-1 Distribution of Syndicated and Project Loans over Time

	All Loan Types		Project Finance Loans, All Tranches	
Signing Date (1)	Value ($B) (2)	Number (3)	Value ($B) (4)	Number (5)
1980	$91.6	1,096	$10.1	105
1981	181.6	1,535	14.1	146
1982	163.5	1,638	9.7	113
1983	101.9	1,189	10.7	122
1984	201.3	1,704	11.8	148
1985	233.7	1,485	6.6	61
1986	228.7	1,447	9.8	97
1987	363.7	2,041	21.7	143
1988	578.0	2,836	19.1	215
1989	676.5	3,218	28.5	215
1990	574.6	3,626	45.4	232
1991	554.2	3,765	49.9	331
1992	625.9	4,880	48.9	381
1993	788.6	5,031	53.0	398
1994	1,073.3	5,732	60.8	386
1995	1,396.9	7,019	72.5	493
1996	1,609.3	8,317	58.5	455
1997	2,056.8	10,016	99.7	513
1998	1,698.7	8,703	75.5	459
1999	1,947.3	8,028	85.1	544
2000	542.2	1,760	31.2	89
Total	$15,688.4	85,066	$822.5	5,646
% of Total			5.2%	6.6%

Data: Capital DATA Loanware.

Note: This table shows the distribution of syndicated loans from the Loanware database over time (excluding bilateral loans). The columns include all tranches, all project finance tranches, project finance tranches greater than $75 million, and project finance tranches greater than $75 million with syndicate data (our sample).

find it possible to "unbundle" the project financing package to secure different services (loans, foreign exchange contracts, standby L/Cs, lease-financing) from a variety of different suppliers.

An institution serving as financial advisor on a project can work closely with sponsors, governments, international agencies, suppliers, customers, and other advisers and guarantors to establish contracts that may prove useful in generating future business. This is a high-profile activity, in which the adviser is called on to use a great deal of ingenuity. Advisers must be able both to satisfy borrower needs for suitably structured financing at lowest possible cost and at the same time to satisfy respective lenders (who often have quite distinct interests and objectives) of the inherent soundness of the project. Usually advisers must design a financial plan that can be presented to lenders as a unified, consistent whole to minimize disagreements, negotiations, and delays.

Table 6-2 Distribution of Syndicated and Project Loans by Location

No.	Country (1)	All Loan Types Value ($B) (2)	All Loan Types Number (3)	Project Finance Loans, All Tranches Value ($B) (4)	Project Finance Loans, All Tranches Number (5)
1	United States	9,483.8	43,879	124,64	489
2	United Kingdom	1,390.2	5,914	101.05	207
3	Australia	370.9	1,833	40.34	140
4	Indonesia	108.4	1,492	40.09	120
5	China	96.1	1,528	24.55	116
6	Taiwan	67.7	548	23.58	48
7	Malaysia	78.6	938	22.40	83
8	Canada	533.8	2,312	22.27	78
9	Hong Kong	176.2	577	22.00	77
10	Thailand	74.3	1,197	20.92	77
11	Italy	258.4	1,897	13.72	31
12	Saudi-Arabia	65.6	302	13.56	39
13	Turkey	65.4	891	12.61	79
14	Mexico	138.1	742	11.64	40
15	Qatar	15.3	50	11.58	28
Top 15 Countries		$12,922.7	65,166	$505.0	1,652
Full Database		$15,688.4	85,066	$822.5	5,646
Top 15/Full Database		82.37%	76.61%	61.39%	29.26%

Data: Capital DATA Loanware.

Note: This table shows the geographic distribution of syndicated loans from the Loanware database. The columns include all tranches, all project finance tranches, project finance tranches greater than $75 million, and project finance tranches greater than $75 million with syndicate data.

Success in project financing gets around quickly, but so does failure. The most lucrative part of project financing clearly is fee income, which on a complex financing arrangement can be sizeable. Since to some extent it is unrelated to lending, fee income can have a very positive effect on overall returns on assets. A lead institution in a project financing will generally participate directly in a financial package. It may also be called on to lead-manage one or more syndicated loans or bond or equity issues, thereby tapping into profits from that source as well. Additional returns may come from funding profits, foreign exchange business, interest rate swaps, and other sources.

The profitability of project financing to international commercial or investment banks, and to the limited number of other banks able to participate effectively, is tied to its complexity and its risks and returns. Relatively few financial institutions seem to have the necessary legal, accounting, tax, financial, and technical skills, either at their head offices or at strategically located regional offices, to become major players. When this constraint is combined with the need for large-scale financing in various maturities, the capability of effective syndicate leadership, and close spon-

sor contact, it is not surprising that the number of major participants is limited. As a result of the high barriers to entry, project financing has emerged as something of an oligopolistic market in that it is dominated by those few major banks with financial and technical resources and the experience and expertise to evaluate the risks and devise suitable financing packages. Because of their reputation and power in the market, the leadership in most project financings is likely to involve at least one of the major players. Other banks may rely on the 10 to 12 international banks that constitute the top tier in project financing, in the same way that smaller banks may look first to the lead manager and then to the borrower in making a decision to participate in a loan syndication or in lending to a sovereign borrower. Such reliance, without adequate recourse, is clearly unhealthy and may well lead to a suboptimal allocation of financial resources in project financings worldwide.

Project financing techniques and large-scale capital-intensive ventures are clearly inseparable. The latter could not be carried out with the same degree of effectiveness and efficiency without access to global financial markets and the economic discipline imposed on such ventures by the funding approaches developed in project financing. Lending techniques are brought to bear which ensure that all risks and returns are carefully weighed by a large number of parties and that the risks are borne by participants best able to cope with them in the light of expected returns.

7

Global Equity Markets

International transactions in equity securities have expanded enormously since the mid-1980s. The increase is the result of greatly increase volume of cross-exchange transactions in secondary markets, cross-border mergers and acquisitions, and of new issues offered to investors under one of several different "globalized" distribution techniques. The United States has been prominently involved in these developments. Worldwide gross purchases by foreigners of U.S. securities were $17 trillion in 2000, a fourfold increase from 1990. Similarly, U.S. gross purchases of foreign securities were $5.5 trillion in 2000, a more than fivefold increase from 1990. Global equity market capitalization has also grown during recent years, from $9.5 trillion in 1990 to more than $26.6 trillion in 2000 (see table 7-1). However, in 2001 and 2002 when equity markets in the United States were in decline, so were equity markets in other parts of the world, and global equity market capitalization declined significantly.

Behind the Growth

This extraordinary growth in the appetite for investment in international stocks has been widespread. Not only are investments in the United States, Japan, and the major European countries in demand, so are investments in shares from other European countries—and from a variety of "emerging" markets, from Mexico to the People's Republic of China. These developments reflect the many factors that have led toward the integration of capital markets around the world—powerful forces such as the opening up of national markets through various deregulatory processes; substantial improvements in financial reporting, information gathering, and dissemina-

Table 7-1 Global Equity Markets Capitalization

	1990	1995	1997	1998	1999	2000	2001
Market Value in $ Billions							
United States	3,105	6,918	10,731	12,648	16,733	15,214	13,827
Japan	2,928	3,545	2,161	2,440	4,463	3,157	2,505
United Kingdom	850	1,347	1,996	2,373	2,855	2,612	2,125
France	312	500	676	985	1,497	1,447	1,844
Germany	355	577	825	1,087	1,432	1,270	1,029
Canada	242	366	568	544	789	770	840
Switzerland	158	398	575	702	693	792	492
Hong Kong	83	304	413	344	609	623	506
Netherlands	120	287	469	600	695	640	—
South Africa	137	277	216	151	180	131	127
Australia	108	243	296	329	428	373	376
Italy	148	210	345	566	728	768	506
Spain	111	151	290	400	432	504	449
Sweden	92	173	265	278	373	328	234
Other developed	223	404	596	851	1,137	990	1,347
All emerging markets	509	1,728	1,717	1,472	2,539	2,015	1,243
World	9,481	17,428	22,139	25,770	35,583	31,634	27,450
Percentage of Total							
United States	32.7	39.7	48.5	49.1	47.0	48.1	52.0
Japan	30.9	20.3	9.8	9.5	12.5	10.0	9.4
United Kingdom	9.0	7.7	9.0	9.2	8.0	8.3	8.0
France	3.3	2.9	3.1	3.8	4.2	4.6	6.9
Germany	3.7	3.3	3.7	4.2	4.0	4.0	3.9
Canada	2.6	2.1	2.6	2.1	2.2	2.4	3.1
Switzerland	1.7	2.3	2.6	2.7	1.9	2.5	1.8
Hong Kong	0.9	1.7	1.9	1.3	1.7	2.0	1.9
Netherlands	1.3	1.6	2.1	2.3	2.0	2.0	
South Africa	1.4	1.6	1.0	0.6	0.5	0.4	0.5
Australia	1.1	1.4	1.3	1.3	1.2	1.2	1.4
Italy	1.6	1.2	1.6	2.2	2.0	2.4	1.9
Spain	1.2	0.9	1.3	1.6	1.2	1.6	1.7
Sweden	1.0	1.0	1.2	1.1	1.0	1.0	0.9
Other developed	2.4	2.3	2.7	3.3	3.2	3.1	5.1
All emerging markets	5.4	9.9	7.8	5.7	7.1	6.4	4.7

Source: International Federation of Stock Exchanges (FIBV).

tion technology; and greatly improved trading environments. The growing involvement of major financial institutions, in the United States, Europe, and Japan—as investors and as providers of services to the markets—reflects a substantial change in their behavior from the more conservative practices of the past (before about 1980), during which investment horizons were mainly limited to domestic markets.

Market Liberalization and Deregulation

The much-resisted abolition of fixed commission rates by the New York Stock Exchange (NYSE) in May of 1975—an event then called "May-

day"—generated a number of fundamental changes in the way equity markets operate all over the world. The basic principle involved was that a stock exchange could not operate as a private club with rules that prevented market access by nonmembers and required fixed minimum, nonnegotiable per-share commission rates, irrespective of trading volume.

As institutional trading grew during the 1960s, many large investors began to complain about the high cost of commissions and their inability to recover these by becoming members of the exchange. The SEC and the Antitrust Division of the U.S. Department of Justice took an interest in the issue and ultimately forced the NYSE to rescind its minimum commission rules, to allow foreign brokerage firms to become members, and to include nonmembers on its board of directors. Immediately after these rule changes, institutional commission rates plummeted (today they are down to less than 5% of pre-Mayday levels on large institutional transactions), and many firms were required to reorganize and to improve their competitive capabilities. In response to such pressures, the NYSE member firms introduced many innovations and provided much more extensive and more valuable services to customers, thereby improving the quality and efficiency of the markets considerably. In 1975, the daily trading volume on the NYSE, which accounted for 85% of all shares traded in the United States, was 18.6 million shares, annual market turnover was valued at $127 billion, and the market capitalization of listed companies was $134 billion. By 2001, daily trading volume averaged 1.2 billion shares, annual market turnover was $10.5 trillion, and market capitalization was $16 trillion. But by 2000 the development of electronic, screen-based markets like the National Association of Securities Dealers Automated Quotation Service (NASDAQ), increased regional exchange trading, and off-market trading arrangements had reduced the NYSE share of total U.S. equity trading to about 50%.

The Mayday effect was not lost on other countries. In the late 1970s, the Labour government in Britain instituted a lawsuit against the London Stock Exchange (LSE), alleging that its clublike operations were in restraint of trade. The Conservative government of Margaret Thatcher inherited this lawsuit and settled it with the LSE in 1983. Under the terms of the settlement, the LSE agreed by October 27, 1986, to abolish membership restrictions and the requirement that members act only in a "single capacity"—either as dealers or brokers, but not as both. This settlement fundamentally changed the economics of the U.K. securities business and led to what the British press called the "Big Bang" in London, a total transformation of the equity market in the United Kingdom. Under the new system that replaced the old rules, any qualified firm (including commercial and merchant banks and foreign securities firms) could join the LSE. Firms could act as both brokers and dealers (as in New York). And commission rates were fully negotiable.

The Bank of England, wishing to take advantage of the coming changes to improve the efficiency of capital markets in the United Kingdom (especially for government securities, and in anticipation of large privatization

issues to come), and to firm up London's position as Europe's most active financial center, also contributed to the "reregulation" of London financial markets by revising the capital requirements for market-making in government and corporate debt securities, as well as equities. And the British Parliament passed a landmark, omnibus securities regulation bill, the Financial Services Act of 1986, to set up an institutional framework for securities market regulation. This law has since been updated and amended.

In consequence, trading volume in the United Kingdom more than doubled, commissions were slashed; many of the British brokers and dealers merged into other, stronger groups; competition increased greatly; and large integrated securities firms such as S. G. Warburg, Merrill Lynch, and Goldman Sachs, expanded their market shares. The benefits of the reforms, as in the early days after Mayday in New York, were seen to flow mainly to the users of securities market services at the expense of the providers of such services. The competitive difficulties caused by Big Bang were heightened after the worldwide stock market crash of October 17, 1987.

The rest of Europe was very mindful of the market changes in London. By this time, preparations were under way for the implementation by the European Union (EU) of the Single Market Act in 1992, and the EU Commission was in the process of promulgating directives for the future conduct of banking and other financial services. Liberalization to accommodate greater competition was the key to the EU reforms, and in all countries some form of financial market deregulation occurred. Extensive, though far less comprehensive changes than occurred in Britain were made in France, Germany, Italy, and Switzerland. Similar changes were also adopted in Canada, Australia, and New Zealand, and ultimately in Japan, where regulatory changes were more difficult to make because of a competitive impasse between banks and securities firms that had been separated by Article 65 of the Securities and Exchange Law of 1947.

In general, a decade after the Big Bang settlement was reached in London, the principles of open access and negotiated commissions were adopted (at least in significant measure) by almost all countries in which important stock exchanges existed. In Japan, fixed commissions still existed, but a system of progressively increasing discounts for large stock trades in effect did away with minimum rates by 1992. This wide acceptance of competitive and regulatory practices reflects a degree of global convergence that had not occurred before, one which has become increasingly difficult for individual countries to oppose. This is because market forces could now create trading alternatives to those blocked by local regulation. If Britain were to impose a stamp tax on stock trading, then much of the LSE's trading business would migrate somewhere else—for example, to New York—where over-the-counter market-makers can quote tax-free prices to U.K. investors. Rather than lose its stock market business to New York, the British would be more likely to drop the stamp tax. Also, governments intensively lobbied other governments to offer reciprocal access to financial service markets or otherwise suffer denial of such access to local markets by nationals of their countries. For example, if the Japanese

should deny access to the Tokyo Stock Exchange (TSE) to brokers from the United Kingdom, then they would run the risk of having access to the various London markets denied to Japanese banks and brokers. Between market forces and political pressures, it has become extremely difficult for any developed country to drag its feet indefinitely in opposition to the emerging global standard of stock market reforms.

Improved Information Flows

Advances in information and communications technology have been essential to the growth in the international equities markets. Market information of all types is now available internationally, through newspapers, computer screens, and contact with brokers. Securities can also be traded internationally in most OECD countries with a high degree of reliance on trouble-free payment and delivery, which was rarely the case before 1980 outside the United States, the United Kingdom, and Canada. It is now possible to receive a reliable quote on virtually any stock whose home market is one of the major financial centers, from just about anywhere, on the telephone or via the Internet. Quotes are also available for securities from many other countries on very short notice.

The computerization of various national markets, such as in Britain, France, Switzerland, and Germany, has introduced a variety of new technological capabilities for screen trading, futures and options transactions, and paperless trading that did not exist before Big Bang. These developments have had the effect of linking international marketplaces, making possible a level of expansion that probably could not otherwise have occurred. So have major advances in transactions processing, clearance and settlements, and custody.

With these developments has come a large increase in the number of trained professionals who provide the many services needed to sustain a growing market. These services include such front-office activities as providing investment research (covering an increasing number of different companies and securities from an increasing number of countries), block and program trading and portfolio insurance services offered to institutional clients, indexing and other services offered to investment companies and mutual funds, and an increasing use of derivative securities for customer risk-management programs. Internal and back-office capabilities include various firmwide exposure risk-management and hedging functions, optimal financing of trading positions, improved payment and settlement activities, and more efficient record keeping, management control, and information services.

Better Trading Markets

Trading markets in international equity securities have improved steadily since the early 1980s. Before that, secondary trading in international stocks was limited. The level of trading activity in the home markets, especially

in continental Europe, was often low and liquidity was limited. The market for American Depositary Receipts (ADRs)—quoted in dollars and traded in New York—was useful for some stocks, mainly British, Japanese, and Canadian.[1] But prices were still set in the home market, and gradually U.S. investors shifted their business there. A few multinational companies were listed on the NYSE and the TSE, more on the LSE, but trading volumes in the foreign markets were rarely significant, compared with those in the home market. Accordingly, some foreign companies chose not to list on the NYSE because of the expense and the awkward disclosure requirements associated with becoming an SEC "reporting company." Many such companies instead allowed their shares to be traded in the over-the-counter markets by firms specializing in international stocks.

For years, the principal international stock trading activity was foreign stock arbitrage, in which one would buy an ADR of, say, a Dutch stock and simultaneously sell the number of underlying shares represented by the ADR in Amsterdam. To do this profitably, one must be a master of the details involved. The purchase in dollars after commissions must cost less than the proceeds of the sale of the shares, after commissions and transfer expenses, and after the foreign exchange costs of converting back into dollars. Such arbitrage activities kept prices of international shares around the world in line with their home market values.

The next development was to provide improved market-making services to customers interested in buying foreign securities that were not available on exchanges. For example, a U.S. pension fund might want to buy shares in Fujitsu Ltd., which was not listed on any U.S. exchange or in NASDAQ but for which ADRs were available. The pension fund might call a Japanese broker based in New York who could say, "We will take your order and purchase Fujitsu shares in Japan overnight. We will confirm tomorrow and tell you at what dollar price the order was executed. We will then deposit the shares with the agent bank in Japan and have ADRs put into your account in New York." Alternatively, the pension fund might call a U.S. market-maker in Fujitsu and be told, "We will sell you Fujitsu dollar ADRs right now for $20." If he does not have Fujitsu ADRs in inventory, the U.S. broker will try to buy them in the New York market or will trade with a Japanese broker overnight to get the shares needed to deliver to the pension fund. The market-maker's price will reflect the various uncertainties with which he must contend. Such international block trading services soon became popular with major U.S. and European institutional investors. Certain stocks became international favorites, and the U.S. and British firms quickly offered research coverage of them. Soon these services were offered to investors all over Europe and in Japan. Over time, the trading volume in international equities expanded considerably, and pricing tightened accordingly.

With foreign membership now available on exchanges in Europe and the Far East, as well as in North America, it is possible for participating firms to be active market-makers in U.S., European, and Asian stocks

around the clock. Such firms are able to balance orders from around the world, not just from their home market. They are also able to limit their market-making activities to stocks for which they see international demand and not find themselves in the position of being a market-maker for all comers, as some national dealers feel they must do. The commitment to dealing in international equities by major firms is now very substantial and is reflected in the number of personnel that have been added in research, trading, sales coverage, systems and back office, and foreign exchange by major U.S., British, Japanese, and other country securities firms. A very large increase in market infrastructure has occurred, which not only makes improved services possible but also provides competitive energy in the market as all of these new employees seek to advance their careers.

The result of these developments has been a substantial increase in the value of worldwide equity trading activities, which increased from $5.8 trillion in 1990 to $42 trillion in 2001. This increase reflected a large increase in trading volume in Japan, which exceeded the total volume of U.S. equity trading in 1988 and 1989. After 1989, however, because of the precipitous drop in Japanese share prices, trading substantially dried up, declining nearly 80% to $635 billion in 1992 (24% of 1992 U.S. trading volume), but trading elsewhere in the world (outside of the United States and Japan) held its own by 2000 (see table 7-2).

Europe. The improvement in access to market-making for international shares is also very important in Europe. In London, increasing interest in continental European stocks on the part of British, American, and Japanese institutional investors has caused many London-based market-makers to offer French, German, Dutch, Italian, and Swiss shares through the LSE's Stock Exchange. Many European shares are listed in London, where reportedly a large percentage of all European cross-exchange share trading now occurs. London's exchange was the first in Europe to become well adapted to institutional trading, and as London remains the financial capital of Europe, a great deal of the professional trading in European and other equity securities takes place in that city. In 2001, about two-thirds of the LSE's market capitalization and value of shares traded was contributed by non-U.K. companies.

It can be expected that some trading in European stocks will migrate back to their more competitive marketplaces at home. For the moment, however, the massive English-speaking trading infrastructure, the supportive regulatory environment, and the large relative size of the London market compared to other European markets indicate a continuing advantage for market-makers to remain in London.

This situation has encouraged continental European markets to accelerate internal reforms to consolidate local and regional exchanges into a single, modernized national market. The task has been completed in Germany and Switzerland, two countries with a legacy of several exchanges located in principal cities. The effort has been to concentrate on the mar-

Table 7-2 Global Value of Shares Traded

	1990	1995	1997	1998	1999	2000	2001
Market Value in $ Billions							
United States	1,887	5,660	10,601	13,424	20,471	32,994	22,965
Japan	1,532	1,146	1,118	933	1,892	2,641	1,660
United Kingdom	543	1,153	1,989	2,888	3,399	4,559	4,551
France	121	213	414	588	770	1,065	3,180
Germany	509	594	1,068	1,492	1,551	2,120	1,442
Canada	68	180	350	369	386	648	462
Switzerland	N/A	340	569	689	562	639	595
Hong Kong	35	96	454	206	230	377	241
Netherlands	41	124	280	410	471	679	635
South Africa	10	17	45	62	87	77	70
Australia	40	98	169	161	198	226	244
Italy	42	87	203	487	539	1,020	2,269
Spain	43	299	903	1,118	1,184	1,577	1,503
Sweden	16	94	176	230	314	485	387
Other developed	52	113	208	533	596	695	397
All emerging markets	873	1,011	2,243	1,629	2,493	2,532	1,997
WORLD	5,811	11,227	20,789	25,218	35,144	52,334	41,963
Percentage of Total							
United States	32.5	50.4	51.0	53.2	58.3	63.0	54.7
Japan	26.4	10.2	5.4	3.7	5.4	5.0	4.0
United Kingdom	9.4	10.3	9.6	11.5	9.7	8.7	10.8
France	2.1	1.9	2.0	2.3	2.2	2.0	7.6
Germany	8.8	5.3	5.1	5.9	4.4	4.1	3.4
Canada	1.2	1.6	1.7	1.5	1.1	1.2	1.1
Switzerland		3.0	2.7	2.7	1.6	1.2	1.4
Hong Kong	0.6	0.9	2.2	0.8	0.7	0.7	0.6
Netherlands	0.7	1.1	1.3	1.6	1.3	1.3	1.1
South Africa	0.2	0.2	0.2	0.2	0.2	0.1	0.2
Australia	0.7	0.9	0.8	0.6	0.6	0.4	0.6
Italy	0.7	0.8	1.0	1.9	1.5	1.9	5.4
Spain	0.7	2.7	4.3	4.4	3.4	3.0	3.6
Sweden	0.3	0.8	0.8	0.9	0.9	0.9	0.9
Other developed	0.9	1.0	1.0	2.1	1.7	1.3	0.9
All emerging markets	15.0	9.0	10.8	6.5	7.1	4.8	4.8

Source: International Federation of Stock Exchanges (FIBV).

ket's technical architecture to optimize efficiencies and to encourage innovations and increased competitive activity to recapture market share of equity trading in Europe. Futures and options exchanges have also been opened in Paris, Frankfurt, and Zurich, and more recently in Madrid and Milan, and equity-based derivatives have increased in usage rapidly. New market developments and innovations in New York and London are often copied quickly in these other markets, and trading volumes are rising.

Japan. A modern trading market exists in Japan, mainly through the Tokyo Stock Exchange (TSE) on which approximately 1,600 companies are listed. During 1989, when the peak of market activity in Japan was

reached, the market capitalization of the TSE was $4.4 trillion (as compared to $3.5 trillion for all shares then traded in the United States), and the value of shares traded was $2.8 trillion ($2.0 trillion in the United States). After 1989, however, the Japanese market fell steadily for the next several years as a result of financial crises and scandals that brought a period of great speculative activity to an end. During 1993, the Japanese market began a cautious recovery and instituted a number of regulatory changes that were intended to curtail abuses in the future. Foreign investors, who periodically became the most active buyers of Japanese stocks (i.e., more active than Japanese investors themselves), continued to purchase shares on the theory that the bottom had been reached and they had the liquidity to acquire low-priced shares that Japanese institutions did not. Often they were wrong. Although they were licking their wounds, Japanese institutions were learning their lessons, too. More professional standards of investment activity, such as those employed by major international institutions, would have to be used in the future, with greater reliance on research, trading, and portfolio diversification than had been applied in the past.

Changes in Investor Behavior

Participation in international equity investments is a comparatively new development for U.S. and Japanese investors, at least in the post–World War II period, but it is not for Europeans. For many years the most international of all investors were the Swiss banks, which attracted foreign "safekeeping" funds. There was very little to invest in in Switzerland, so the banks were always looking for suitable investment opportunities abroad. During the 1960s and 1970s Swiss banks were the principal foreign investors in U.S. stocks. Subsequently they became substantial investors in Japanese stocks as well. Similar to the Swiss banks were banks and investment companies in Holland, Belgium, and Luxembourg, which turned their attentions toward Japan. Few good investment opportunities existed in their home countries.

Just behind the Swiss as international investors were the British, who have had a long history of overseas portfolio investment. Until 1979, however, Britain had been subject to foreign exchange controls that required that a premium be paid for foreign currency intended for use outside the country. Most other countries in Europe had similar foreign exchange regulations. All were subsequently abolished. Once the foreign exchange controls were lifted in the United Kingdom in 1979, a substantial increase in overseas investment took place, mostly into the United States and Japan. Institutional investors in the United Kingdom have since greatly increased their activities abroad and now hold and trade substantial volumes of international securities of all types. More recently, U.S. and Japanese institutional investors also entered into active programs for investing in inter-

national equities. As a result, the international pool of funds participating in cross-border equities has greatly increased. Indeed, the pool has now become "institutionalized" (much as the U.S. equity markets were in the 1960s), being managed by internationally sophisticated, professional money managers.

Moreover, as non-U.S. markets have become more active and have attracted more attention from investors outside their own countries, they have grown in relative importance. Gradually, share prices in the countries with less-developed markets have risen to international norms. In 1980, some 49% of world market capitalization was attributed to companies from the United States, 10% to companies from the EU, 17% to Japanese companies, and 14% to the rest of the world. By 2001 the U.S. share had grown to 52%, while the Japanese share had declined to 12% and that of the EU countries had increased to 24% (see figure 7-1).

Growth of Pension Funds

Much of the new money flowing into the international equity market has been from pension funds. These have continued to enjoy a substantial inflows of funds each year, especially in Europe and Japan where the practice of providing for retirement benefits through market returns is more recent than in the United States. Not only have total pension assets grown, but (for reasons discussed later in this chapter) there has also been a substantial increase in the percentage of total assets invested in foreign securities. This has been true for pension funds in countries all over the world, as table 7-3 illustrates.

Japanese pension funds have been growing especially rapidly as the country adjusts to an aging population that has not had sufficient funded pension programs in the past. An increasing amount of this money, which is managed by insurance companies and trust banks (and recently opened to foreign money managers) is invested in international equities. As the money managers become more familiar with international portfolio optimization practices (which vary considerably from portfolio management practices in Japan), the Japanese are expected to become increasingly important in the international investment field.

International Application of Modern Portfolio Theory

During the 1960s, a number of academic economists began to develop the basis for what is now known as modern portfolio theory. The theory was based on the idea that the marketplace is, in essence, "efficient," and price-setting instantly reflects information received by market participants. It also maintained that "risk" in individual securities could be measured relative to the market as a whole and that those investors should look at risk and returns in the context of their whole portfolio. This led to further development of the theory of portfolio diversification to secure optimal risk-

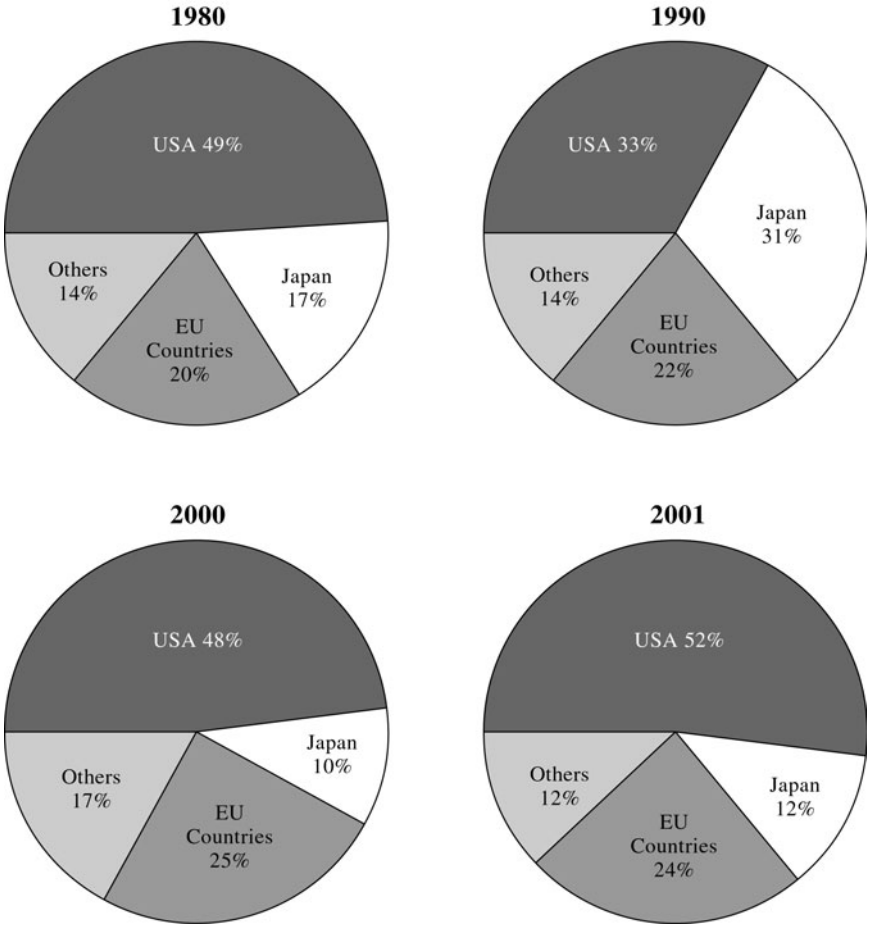


Figure 7-1. Market capitalization by country, 1980, 1990, 2000, and 2001.

adjusted returns, and gradually investors began to act on the advice. But before this could make much difference to the market itself as a whole, the market had to become more institutionalized—that is, it had to consist predominantly of institutional money managers dealing with large portfolios in a competitive context in which their published returns would be important and carefully monitored. The larger the influence of such investors, the more efficient the marketplace would be, thereby confirming further the value of application of the investment theories.

Diversification itself was nothing new. What was different was the use of correlations of the returns of individual stocks with the market as a whole. Optimum diversification could only be achieved if the components of the portfolio had imperfect co-movements with one another and in terms of their expected sensitivity to changes in the values of the market itself.

Table 7-3 Global Pension Fund Statistics, Total Non-Domestic Investment (USD Billions)

	1995	2000	2005
North America			
United States	296	791	1490
Canada	47	70	170
Total	343	861	1,660
Europe			
United Kingdom	213	344	599
Netherlands	59	271	417
Switzerland	31	88	161
Germany	4	19	26
Sweden	0	8	32
Italy	1	2	5
France	4	8	11
Denmark	5	23	50
Ireland	10	26	49
Finland	0	8	20
Norway	0	1	3
Belgium	4	9	13
Spain	0	3	12
Portugal	0	4	10
Austria	0	1	3
Other Europe	0	2	6
Total	331	818	1,418
Pacific Basin			
Japan	164	291	437
Australia	18	35	80
Malaysia	0	0	0
Singapore	0	0	0
Hong Kong	11	15	25
Thailand	0	0	0
New Zealand	1	2	2
Other Pacific Basin	0	0	0
Total	195	344	543
Latin America			
Brazil	0	0	1
Chile	0	4	11
Argentina	0	1	4
Mexico	0	0	0
Other Latin America	0	0	0
Total	0	5	15
Africa, Middle East and Asia			
South Africa	1	3	8
Other Africa, Middle East and Asia	0	0	0
Total	1	3	8
Total	***870***	***2,032***	***3,644***

Diligent investors soon discovered that internationally diversified portfolios (in which investments in different economies around the world would be less than perfectly correlated with each other) had the potential to produce the best overall risk-adjusted portfolio returns. A relatively high degree of correlation exists in the international markets for debt securities; yields adjusted for currency, maturity, and ratings are linked across the principal financial centers. This is not as true in equity securities, where correlation between the Standard and Poor's 500 index and foreign market indices can be relatively low. There remain enough differences between individual equity markets that integration and correlation has been less dramatic than bond markets. This is because stocks represent different economic values in different countries and, indeed, are valued differently in terms of price-earnings ratios and other common measures.

For the international benefits of modern portfolio theory to be in reality, it had to be possible to identify and trade in a significant number of international stocks. That meant that reliable information about foreign stocks and satisfactory market liquidity had to be available. As these investment conditions improved, especially in European and Japanese markets, many institutional investors began to apply what they had learned about theories of portfolio diversification to stocks in other countries. It was not long before fund managers in Europe and the United States began to appreciate these considerations and began to rebalance their own portfolios with more international stocks. Because of a better understanding across all financial centers of modern portfolio concepts—and the as yet small amounts of foreign portfolio investment holding as a percent of total investments it is reasonable to expect increases in foreign investment to continue for some years. InterSec Research Corp. has estimated that pension funds will invest 17% of their assets cross-border at the end of 2002.

The lasting benefit of all this international investing, however, depended on a key tenant of modern portfolio theory: that overall portfolio risk was lowered through diversification into less than perfectly correlated investments, which has been shown especially to apply to international investments. The key (to the theory) is imperfect correlation between most foreign markets and one's own. In a perfectly integrated market, by contrast, the correlation between markets would be perfect and there could be no gain from diversification.

Differences in Valuation

The international markets are not all the same, which is part of their appeal. Differences exist in equity risk exposure in markets where, for example, volatility may be extremely high, information may be scarce, regulation may be inadequate, and market manipulation may be rife compared to the investor's home market. On the return side, differences can exist also in terms of the number of comparatively underpriced growth companies or privatization issues, or in the general economic outlook in countries such

as Korea and Mexico that are undergoing major developmental changes. Differences in the methods of securities valuation can also be significant.

While it may be true that each national market values its equity securities in terms of similar views about how to determine what a future stream of dividends might be worth when capitalized at a locally suitable discount rate, it is also true that great differences can exist between markets that are not explained by such factors.

In the United States, experienced financial institutions, employing what they consider to be the most sophisticated tools for valuing securities, tend to set prices. Despite this, the dot-com 'bubble" of 1993 to 2000 still produced massive misvaluations of equities, despite all the sophistication of research analysts and fund managers. In Japan, fund managers with a large cash flow to invest and enthusiastic individual investors tend to follow the advice of stockbrokers who can create a kind of herd instinct that can move the market more than careful attention to market valuation formulae. In Europe, local markets may be so inactive in particular stocks that they appear undervalued by Americans looking for bargain investments which they believe in the long run will reflect much higher "true" values. Many people believe they cannot apply their own valuation methods to equities that are mainly traded in another country. Instead, one must understand the market as locals do and go with the flow. Why else would a foreigner buy a Japanese bank stock at 50 times earnings unless he or she had reason to believe it could be resold later to another buyer at 80 times earnings?

But as the markets become more closely linked (and as foreign trading becomes as important as any other domestic source of trading), pricing mechanisms ought to converge. The circulation of defensible securities research reports and the linking of trading mechanisms around the world indicate that in some respects the markets have already begun to do so. This even includes emerging markets, with substantial recent evidence that some of them are much more highly correlated with the major markets than they used to be, especially for companies in the euro-zone.

New Issues and Distribution Methods

Shares offered to the market by a company are called "new issues." Generally, the term refers to shares newly issued by a corporation that are sold to the public through an underwritten distribution and which are subject to applicable disclosure, registration, and other regulations pertaining to them. When these shares are sold, they are said to constitute a "primary offering" or, if they are being sold for the first time, an "initial public offering" (IPO). Shares offered for sale by an existing shareholder are done in the "secondary market," which is where ordinary brokerage transactions occur. However, when a large existing shareholder sells shares through a public distribution (as in the case of a privatization issue by a government shareholder), the process is called a "secondary offering," and it too is

Table 7-4 International Equity New Issues*

Year	$(Billion)
1985	4.2
1990	11.5
1995	45.2
1997	99.6
1998	83.6
1999	127.0
2000	185.3
2001	89.1

Source: Thomson Financial Securities Data

*Includes international distributions of national issues and Euro-equity offerings of shares

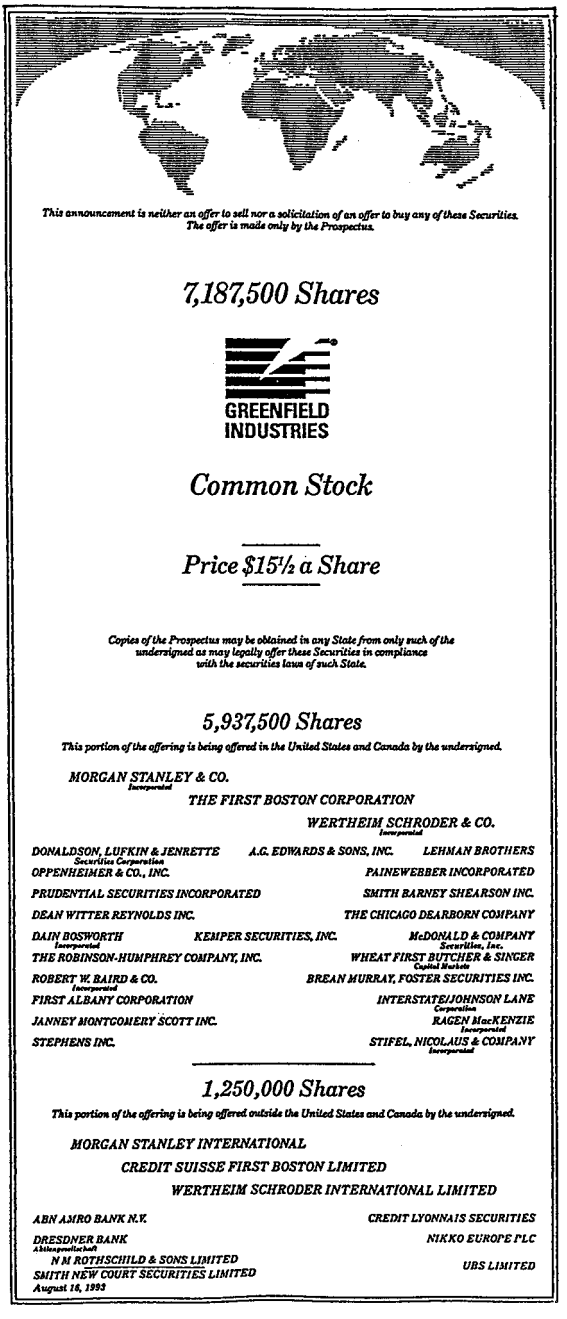
regarded as—and usually is subject to the same regulations as—a new issue. International equity issues have been a growing and continually active part of international capital markets since the mid-1980s, as shown in table 7-4.

Most distributions are insured by a group of "underwriters." The underwriters guarantee the sale of a specified number of shares at a specified price and commission; that is all the underwriters do. The distribution (or sale) of the securities to investors is the responsibility of brokers, who may or may not be included among the underwriters. Some distributions, especially smaller "private placements" (which are usually exempt from national disclosure and registration requirements) are made directly to institutional investors on a "best efforts" basis and are not underwritten, although private placements may also be (and often are) underwritten. Underwriting methods are discussed in the next section.

There are several methods for achieving international distribution of new issues of equity securities.

International Tranches

Issuers may tap equity markets in other countries through an "international tranche" to supplement domestic investor interest. U.S. companies are common users of international tranches, in which the underwriters set aside 15% to 25% of the shares to be offered simultaneously with the U.S. distribution in the European equity markets by a separate group of international underwriters. The international underwriters are usually led by the international affiliate of the lead U.S. underwriter to ensure tight control over the allocation of shares. By agreement, shares allocated to the international underwriters may not be sold back in the United States, and vice versa. International underwriters (except for the U.S. bookrunners) are not included among the underwriters of the domestic U.S. offering. See figure 7-2 for a "tombstone" advertisement of a recent issue with an international tranche.



This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these Securities. The offer is made only by the Prospectus.

7,187,500 Shares

GREENFIELD INDUSTRIES

Common Stock

Price $15½ a Share

Copies of the Prospectus may be obtained in any State from only such of the undersigned as may legally offer these Securities in compliance with the securities laws of such State.

5,937,500 Shares

This portion of the offering is being offered in the United States and Canada by the underwriters.

MORGAN STANLEY & CO. Incorporated

THE FIRST BOSTON CORPORATION

WERTHEIM SCHRODER & CO. Incorporated

DONALDSON, LUFKIN & JENRETTE Securities Corporation — A.G. EDWARDS & SONS, INC. — LEHMAN BROTHERS

OPPENHEIMER & CO., INC. — PAINEWEBBER INCORPORATED

PRUDENTIAL SECURITIES INCORPORATED — SMITH BARNEY SHEARSON INC.

DEAN WITTER REYNOLDS INC. — THE CHICAGO DEARBORN COMPANY

DAIN BOSWORTH Incorporated — KEMPER SECURITIES, INC. — McDONALD & COMPANY Securities, Inc.

THE ROBINSON-HUMPHREY COMPANY, INC. — WHEAT FIRST BUTCHER & SINGER Capital Markets

ROBERT W. BAIRD & CO. Incorporated — BREAN MURRAY, FOSTER SECURITIES INC.

FIRST ALBANY CORPORATION — INTERSTATE/JOHNSON LANE Corporation

JANNEY MONTGOMERY SCOTT INC. — RAGEN MacKENZIE Incorporated

STEPHENS INC. — STIFEL, NICOLAUS & COMPANY Incorporated

1,250,000 Shares

This portion of the offering is being offered outside the United States and Canada by the underwriters.

MORGAN STANLEY INTERNATIONAL

CREDIT SUISSE FIRST BOSTON LIMITED

WERTHEIM SCHRODER INTERNATIONAL LIMITED

ABN AMRO BANK N.V. — CREDIT LYONNAIS SECURITIES

DRESDNER BANK Aktiengesellschaft — NIKKO EUROPE PLC

N M ROTHSCHILD & SONS LIMITED — UBS LIMITED

SMITH NEW COURT SECURITIES LIMITED

August 18, 1993

Figure 7-2. Tombstone advertisement of international tranche issue.

Euroequity Issues

There is an equity equivalent of the Eurobond market, called the "Euroequity" market, which can be used when an issuer wishes to tap a different and larger investor base because its domestic market is insufficient or as a way to avoid domestic market regulations and expenses. As in the case of the Eurobond market, the lack of regulation, the relatively low cost of issuance, and the presence of a large, highly diversified, and very liquid pool of international investment funds has attracted many issuers from all over the world.

The Euroequity market evolved to provide a source of equity finance for European issuers whose domestic markets were too small or inactive to accommodate large institutionally oriented distributions. Equity issues would be indigestible if they were offered only in the home country of the respective companies. Government privatization issues almost always fall into this category because of their large size and the need to attract institutional investors with an adequate trading market liquidity. Almost all of the countries in western Europe have taken advantage of the opportunity to undertake privatization issues of large industrial companies owned by the governments. Privatization issues by non-European governments, rarely are attempted without heavy reliance on the Euroequity market.

Rule 144a Equity Placements

In April 1990 the U.S. Securities and Exchange Commission (SEC) approved its Rule 144a, through which it in effect permitted the sales to qualified institutional investors of securities that are not registered with the SEC in the United States. Such sales are made through "private placements," which are exempt from registration with the SEC and therefore do not involve the full disclosure requirements. This rule was developed on the theory that large, sophisticated investors could look out for themselves and because the United States wanted to attract more international issuers to its capital markets. In practice, the rule was helpful to non-U.S. governments and corporations that wanted to use the U.S. markets but did not want to incur the accounting and legal expenses or be committed to annual U.S. disclosure requirements. Such issuers could arrange a private placement, often on an underwritten basis, to sell unregistered securities, which may be traded in the market, to U.S. institutions.

Rule 144a applies to both debt and equity securities, though in the beginning very few 144a equity issuers appeared. For one reason, the Euroequity market was an effective competitor for issuers seeking foreign investors. For another, U.S. investors had not yet fully warmed up to international equities. As they did, however, they became especially interested in issuers from emerging markets, for example, developing countries with promising economic potential—the growth-stock markets of the future.

Soon U.S. institutions were eager investors in equity (and debt) issues from Mexico, Chile, Argentina, Brazil, and even Peru. Other countries of interest included Korea, Indonesia, the Philippines, Portugal, Greece, Taiwan, Turkey, and Poland. Few (if any) companies from these countries could meet U.S. SEC registration requirements. Early in the market's history, in 1992, more than $5.5 billion of 144a equity issues occurred, approximately 48% of which were international issues. The 144a total was only a small percentage (7.3%) of total U.S. equity issues at the time, but a somewhat more significant percent (24.3%) of total international equity new issues.

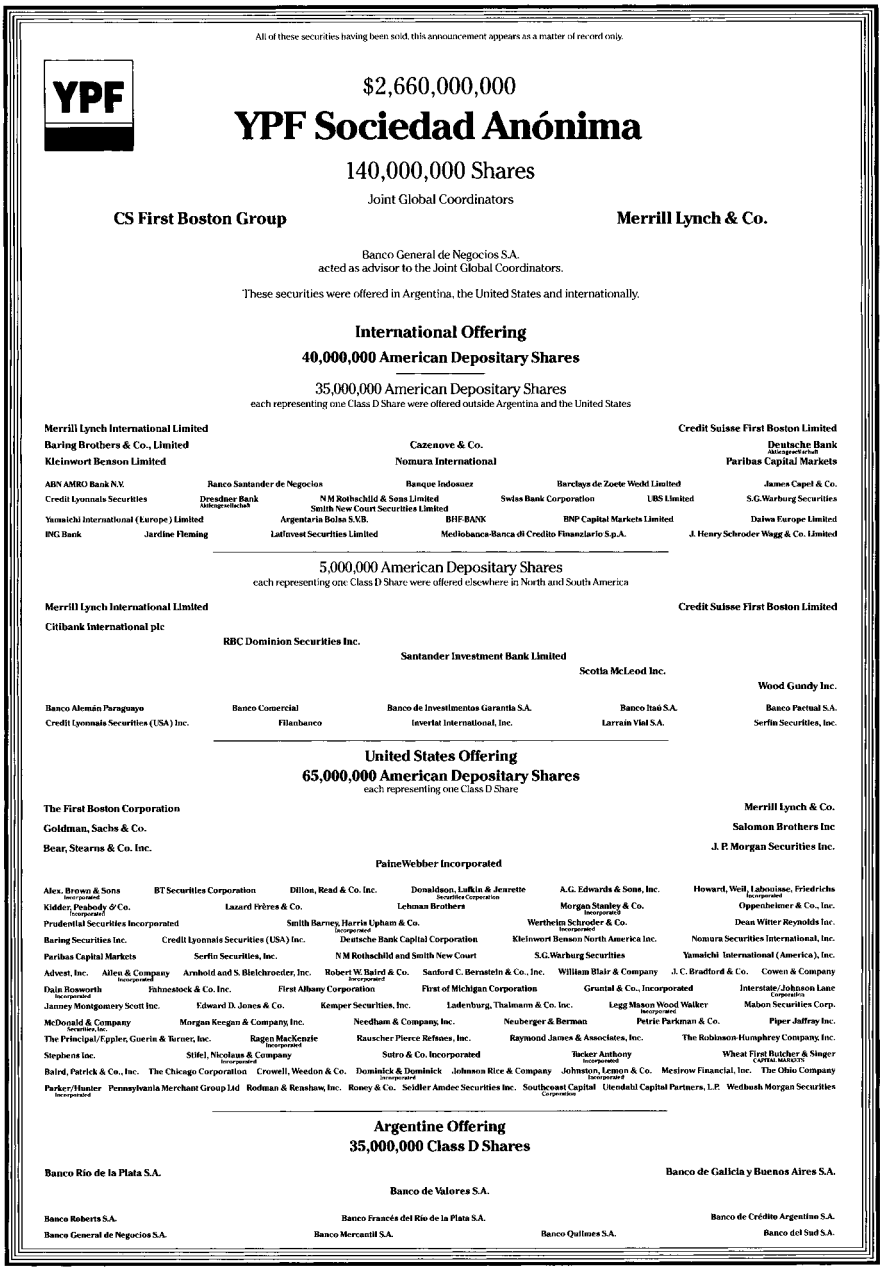
Global Issues

Some of the large Euro-equity issues are in reality "global equity issues" because they involve a combination of a Euroequity offering and additional offerings through separate but simultaneous tranches in other markets. For example, in July 1993 the Argentine YPF issue raised $2.76 billion for the government through coordinated offerings in the Euroequity market, the U.S. market, and the domestic Argentine market (where only 25% of the issue was actually placed) (see figure 7-3). In this case the YPF shares were registered with the SEC, but often the U.S. tranche of global issues (especially for Latin American issuers) is handled according to Rule 144a. The "joint global coordinators" for the YPF issue were CS First Boston and Merrill Lynch, who also led each tranche except the domestic Argentine one.

Japanese Round Tripping

Despite the natural preeminence of European companies in Europe, and the importance of the Euroequity market in global placements, the most prolific users of the Euroequity market in the early years were Japanese corporations. Such heavy Japanese activity in the Euromarkets pushed Japanese securities firms to the top of the underwriting league tables in Europe. The Japanese issues actually were in the form of convertible debentures or debt issues with detachable equity purchase warrants. Both are debt issues with "embedded" stock (call) options. If the options are exercised at the bond maturity date, as the issuer expects at the time of issuance, then the company is obliged to issue new shares of common stock at a price fixed at the time of the original offering. More than $350 billion of these debt-based equity securities—over half the total amount of all Japanese equity securities issued—were sold by Japanese companies from 1984 through 1990.

This volume of new issues overwhelmed all other forms of Euroequities. They were the products of extraordinary times in Japan, in which markets were booming and corporations found it easier to make money



All of these securities having been sold, this announcement appears as a matter of record only.

YPF

$2,660,000,000

YPF Sociedad Anónima

140,000,000 Shares

Joint Global Coordinators

CS First Boston Group — **Merrill Lynch & Co.**

Banco General de Negocios S.A.
acted as advisor to the Joint Global Coordinators.

These securities were offered in Argentina, the United States and internationally.

International Offering

40,000,000 American Depositary Shares

35,000,000 American Depositary Shares
each representing one Class D Share were offered outside Argentina and the United States

Merrill Lynch International Limited — **Credit Suisse First Boston Limited**

Baring Brothers & Co., Limited — **Cazenove & Co.** — **Deutsche Bank Aktiengesellschaft**

Kleinwort Benson Limited — **Nomura International** — **Paribas Capital Markets**

ABN AMRO Bank N.V. — Banco Santander de Negocios — Banque Indosuez — Barclays de Zoete Wedd Limited — James Capel & Co.

Credit Lyonnais Securities — Dresdner Bank Aktiengesellschaft — NM Rothschild & Sons Limited — Swiss Bank Corporation — UBS Limited — S.G.Warburg Securities

Smith New Court Securities Limited

Yamaichi International (Europe) Limited — Argentaria Bolsa S.V.B. — BHF-BANK — BNP Capital Markets Limited — Daiwa Europe Limited

ING Bank — Jardine Fleming — Latinvest Securities Limited — Mediobanca-Banca di Credito Finanziario S.p.A. — J. Henry Schroder Wagg & Co. Limited

5,000,000 American Depositary Shares
each representing one Class D Share were offered elsewhere in North and South America

Merrill Lynch International Limited — **Credit Suisse First Boston Limited**

Citibank International plc

RBC Dominion Securities Inc.

Santander Investment Bank Limited

Scotia McLeod Inc.

Wood Gundy Inc.

Banco Alemán Paraguayo — Banco Comercial — Banco de Investimentos Garantia S.A. — Banco Itaú S.A. — Banco Pactual S.A.

Credit Lyonnais Securities (USA) Inc. — Filanbanco — Inversat International, Inc. — Larrain Vial S.A. — Serfin Securities, Inc.

United States Offering

65,000,000 American Depositary Shares
each representing one Class D Share

The First Boston Corporation — **Merrill Lynch & Co.**

Goldman, Sachs & Co. — **Salomon Brothers Inc**

Bear, Stearns & Co. Inc. — **J. P. Morgan Securities Inc.**

PaineWebber Incorporated

Alex. Brown & Sons Incorporated — BT Securities Corporation — Dillon, Read & Co. Inc. — Donaldson, Lufkin & Jenrette Securities Corporation — A.G. Edwards & Sons, Inc. — Howard, Weil, Labouisse, Friedrichs Incorporated

Kidder, Peabody & Co. Incorporated — Lazard Frères & Co. — Lehman Brothers — Morgan Stanley & Co. Incorporated — Oppenheimer & Co., Inc.

Prudential Securities Incorporated — Smith Barney, Harris Upham & Co. Incorporated — Wertheim Schroder & Co. Incorporated — Dean Witter Reynolds Inc.

Baring Securities Inc. — Credit Lyonnais Securities (USA) Inc. — Deutsche Bank Capital Corporation — Kleinwort Benson North America Inc. — Nomura Securities International, Inc.

Paribas Capital Markets — Serfin Securities, Inc. — NM Rothschild and Smith New Court — S.G.Warburg Securities — Yamaichi International (America), Inc.

Advest, Inc. — Allen & Company Incorporated — Arnhold and S. Bleichroeder, Inc. — Robert W. Baird & Co. Incorporated — Sanford C. Bernstein & Co., Inc. — William Blair & Company — J. C. Bradford & Co. — Cowen & Company

Dain Rauscher Incorporated — Fahnestock & Co. Inc. — First Albany Corporation — First of Michigan Corporation — Gruntal & Co., Incorporated — Interstate/Johnson Lane Corporation

Janney Montgomery Scott Inc. — Edward D. Jones & Co. — Kemper Securities, Inc. — Ladenburg, Thalmann & Co. Inc. — Legg Mason Wood Walker Incorporated — Mabon Securities Corp.

McDonald & Company Securities, Inc. — Morgan Keegan & Company, Inc. — Needham & Company, Inc. — Neuberger & Berman — Petrie Parkman & Co. — Piper Jaffray Inc.

The Principal/Eppler, Guerin & Turner, Inc. — Ragen MacKenzie Incorporated — Rauscher Pierce Refsnes, Inc. — Raymond James & Associates, Inc. — The Robinson-Humphrey Company, Inc.

Stephens Inc. — Stifel, Nicolaus & Company Incorporated — Sutro & Co. Incorporated — Tucker Anthony Incorporated — Wheat First Butcher & Singer CAPITAL MARKETS

Baird, Patrick & Co., Inc. — The Chicago Corporation — Crowell, Weedon & Co. — Dominick & Dominick Incorporated — Johnson Rice & Company — Johnston, Lemon & Co. — Mesirow Financial, Inc. — The Ohio Company

Parker/Hunter Incorporated — Pennsylvania Merchant Group Ltd — Rodman & Renshaw, Inc. — Roney & Co. — Seidler Amdec Securities Inc. — Southcoast Capital Corporation — Utendahl Capital Partners, L.P. — Wedbush Morgan Securities

Argentine Offering

35,000,000 Class D Shares

Banco Río de la Plata S.A. — **Banco de Galicia y Buenos Aires S.A.**

Banco de Valores S.A.

Banco Roberts S.A. — **Banco Francés del Río de la Plata S.A.** — **Banco de Crédito Argentino S.A.**

Banco General de Negocios S.A. — **Banco Mercantil S.A.** — **Banco Quilmes S.A.** — **Banco del Sud S.A.**

Figure 7-3. Tombstone advertisement of YPF issue.

through financial investments than through the manufacture of products. Japanese companies would borrow all they could to invest in the stock and real estate markets, a process the Japanese called *zaitech*. Many companies found it much cheaper to borrow from the Euromarkets than from banks, and advantageous to issue new shares at price/earnings multiples above 75 times in order to raise money for investments.

The Japanese convertible bond and equity warrant issues, which were offered as packages with extremely low coupon rates (sometimes as low as 1%), then were stripped by investors into (1) the warrants that were sold directly into Japan and (2) deep discount bonds that were bundled together with an interest rate swap and offered to other investors, mainly Japanese banks, as floating-rate notes, on a LIBOR basis, which would offer an attractive yield. In other words, the Japanese issuers were retaining Japanese underwriters to manage vast amounts of issues of Euromarket securities that were to be sold almost entirely to investors back in Japan! It was ironic that the country most celebrated in the world for its excess savings and huge balance of payments surpluses should rely so heavily on capital markets outside its own borders for corporate financing. Why did they do this?

For two reasons. First, the companies wanted more funding than they could take out of the Japanese domestic market through the issuance of straight equity shares. So they looked abroad for ideas and settled on the debt with warrants approach because it was cheap. The shares would not be issued until the warrants expired, so they "didn't count" for earnings per share calculations, and Japanese investors did not penalize the companies for the dilution. The only cost they incurred was the annual coupon, and at 4% or less, this was almost negligible (especially when denominated in U.S. dollars, which were weakening at the time).

Second, even though the investors in both the bonds and the warrants would be Japanese, the scheme could not be done in Japan because only a limited number of Japanese companies were qualified by local regulations to issue unsecured bonds. Also, the costs and regulatory delays in issuing bonds were well in excess of what the Euromarkets offered.

So, a lower-cost, more "user-friendly" financing opportunity was presented outside Japan, and Japanese companies moved quickly to take advantage of it. This is yet another example of the change-inducing effects of the globalization of capital markets—in this case, one that was beneficial to Japanese issuers. The Japanese Ministry of Finance (MOF) ultimately attempted to slow the migration to London by effecting certain overdue regulatory reforms to the Tokyo new-issue process (and by threatening to require overseas warrants sold into Japan to be registered with the MOF).

Although the Japanese stock market frenzy ended with a slump that began in late 1989, Japanese companies continued to use the Euromarket as a substitute for their own market. However, the greater portion of Japanese financing has now returned to Tokyo. Thus a better market abroad triggered a deregulatory response in the home market, one that was not

intended by regulatory officials, but one that nevertheless had to be implemented in the interest of preserving the order and effectiveness of their domestic markets.

Underwriting Methods

Underwriting is the process of assuring an issuer that an offering will occur for a specified number of shares at a specified price per share. In effect it is an insurance policy (hence the term "underwriter"). But what is being insured can vary greatly, depending on which underwriting method is employed. The methods differ between the U.S. market, the Euroequity market, and the traditional British market. Virtually all national markets use one or the other (or a combination) of these methods.

Underwriting in the United States

In the United States, underwriting procedures are designed to obtain the highest price for the seller of the securities being offered. This is usually done by forming a syndicate of securities firms that will agree to purchase the shares from the seller and resell them immediately to investors. The price is not fixed until just before the offering is made to the public, after a period during which well-briefed salesmen from the underwriters have marketed the issue to their customers. The customers are not committed to purchase shares until they accept the final price, but sales personnel talk to them about probable price levels to make judgments as to where and how much they will buy. This process is called "building a book" and is essential to precise pricing efforts. A successfully priced issue is one in which the entire issue is sold out at the agreed offering price and the issue opens for trading at a premium of no more than about 10%. The underwriting syndicate in such an issue is only exposed to a minimal holding period between the purchase and the confirmation of sales with customers. Of course, if the issue is mispriced, or if the market changes before the distribution is complete, underwriters can suffer losses.

To minimize these risks and to provide strong potential support in the aftermarket, underwriters generally overallot shares, and companies usually agree to provide the underwriters with a "Green Shoe option." Under such an option (named for the company that first employed it, the Green Shoe Company), the underwriters may call on the company to increase the size of the issue by an additional 10% to 15% or so. The lead underwriter will allocate to the selling brokers (based on their reported orders for shares) 10% to 15% more shares than are actually being issued. Thus the lead manager, on behalf of the underwriting syndicate, has gone "short" shares, having sold shares it did not own but is still required to deliver.

Almost all underwritings involve some degree of short position, which the lead manager covers by purchasing shares in the aftermarket to stabilize

the offering price. If demand for the shares is weak, then the lead manager will purchase unsold or unwanted shares in the market (from the other underwriters or their customers) to support the offering at the original offering price. If the demand is strong, then the underwriters will exercise the Green Shoe option to create the shares to cover the short position. Otherwise they would have to buy them in the market at a premium price because of the strong demand. Paying a premium for the shares substantially increases the cost to the underwriters of covering their short position. In exchange for granting the Green Shoe option, the issuer expects tighter and more aggressive pricing for the issue.

From the issuer's point of view, some negatives are associated with the U.S. underwriting procedures. First, the market risk stays with the issuer: while the issue is being prepared for the market, the seller must register the shares with the SEC and wait a few weeks for authorization to proceed with the offering. Nothing can be done about this delay, but under the U.S. underwriting method, any market decline during the SEC review period is the issuer's risk, not the underwriters'. It is possible to issue new equity securities under the "shelf registration" procedures established by SEC Rule 415, but very few companies wish to announce new share issues that might or might not occur over the next two years for fear of the effect of the "overhang" such an announcement might have on the market price of the stock.

All the underwriter is insuring in a U.S. transaction is the price agreed with the seller the night before the offering is made—not a great risk under ordinary market conditions. The underwriter provides more useful service acting as a broker or distributor for the issue by providing the sales effort needed to achieve the highest possible price for the offering. Ideally, this would be reflected by stimulating widespread interest in the offering, its purpose, and the company's future prospects so as to generate a higher stock price than would have existed if no offering were made at all. In other words, the new issue would not have resulted in a lowering of the share price to reflect the greater number of shares to be outstanding after the offering. When such is the case, the only cost to the seller is the gross spread (commission) paid to the underwriters and the out of pocket expenses associated with the issue. This result of an underwriting, however, is not insured: the seller must rely on the underwriter's best efforts in distributing the shares. These efforts may be frustrated by a variety of factors at the issuer's expense.

Typically, IPOs have been underpriced in the United States by 10% to 15%. Despite the purported benefits of the bookbuilding approach, underpricing reached record levels during the tech boom of 1998–2000 and the frenzy among investors that was often incited by the underwriting firms' research analysts. These market inefficiencies, together with high underwriters' commissions of about 7% and outsize IPO allocations to the "favored few," became a source of much controversy and a blemish on U.S. equity markets.

Underwriting Euroequities

The U.S. bookbuilding method of underwriting is used in the Euromarket, but there are several significant differences. Perhaps most important is the fact that the market does not require any waiting period while registration procedures are completed. Most European and Japanese issues enter the market on virtually no notice, so sellers need not be exposed to market risk while they are waiting for the offering to proceed. U.S. issues must still be registered if the shares might be resold in the United States. As a practical matter, however, for all but the best-known companies, some sort of marketing period to generate demand is essential if a steep discount in the underwriting price is to be avoided.

Because most of the European underwriters on which the lead manager must rely have been banks with a limited securities distribution capability (except when distributing to customer accounts within the bank) and an unwillingness to admit that they cannot place all the shares they have agreed to underwrite, the lead manager is unable to rely on the prepricing order book as much as in the United States. It may also be more difficult to maintain a fixed offering price during the underwriting period, as some underwriters will sell their unsold shares in the interdealer market or back in the home country market. This significantly inhibits the stabilization efforts of the lead manager. Thus precise pricing is more difficult to achieve and stabilization is more erratic and unreliable than in the United States, although major European firms are building increasing capable sales forces in Europe.

British Underwriting

In the United Kingdom and in some other parts of Europe, an older system of underwriting is used, which many people refer to as the "British" or "front-end" underwriting method. In this system, the announcement of the transaction, the offering price, and an agreement with a group of underwriters to insure, or "backstop," the issue is made simultaneously, two or three weeks before the issue will be available for trading. That day the underwriters arrange a "subunderwriting group" to reinsure their commitment. Subunderwriters are usually institutional investors who are prepared to take down their share of any portion of the issue that should remain unsold after its completion. The bulk of the total commission paid by the issuer is made available to the subunderwriters as an insurance premium. Subunderwriters may reduce their risk to the extent that they subscribe to purchase shares in the offering. Most of the subunderwriters expect to be invited into all underwritings during the year, and therefore they see the risks as being diversified against a pool of many underwritings for which significant fees, in aggregate, can be earned.

British and many other European companies provide their shareholders

with "preemptive rights," or the right to purchase new shares of the company before any nonshareholder. As an inducement to shareholders, the subscription rights are offered at a discount. This discount may vary from 5% to about 25%. The share price will be reduced by the market to reflect the dilution in the number of shares to be outstanding, and the rights will have value equal to the difference between the new share price and the subscription price. The rights can be sold if the shareholder decides not to subscribe.

Because notification of shareholders in rights issues takes about two weeks for the offer and to receive their subscriptions, there is a waiting risk for U.K. issuers, too. In the United Kingdom, however, this risk is assumed by the underwriters (and the subunderwriters). Their risk is tied to market movements, as well as to mispricing by the underwriters. Until the subscription period ends, it is impossible to know to what extent the issue has been "taken up" by shareholders or by purchasers of rights.

Apart from arranging the subunderwriting syndicate, brokers have little to do in the process. Nor do the underwriters, including the lead underwriter handling the issue, have much to do with marketing. This system recognizes that the main institutional investors in the market will be the likely buyers. So they are used as subunderwriters and are paid a fee for using their capital to prop up the issue while individual and other investors go through the subscription process. The definition of a successful issue is one that is fully subscribed, not fully priced. In fact, some believe the more oversubscribed the issue, the more successful it is. Unfortunately, such oversubscription tends to result in a sharp rise in the stock price when it is free to trade; put another way, the subscription price tends to be set sufficiently low to be sure that oversubscription occurs. Alternatively, if the issue is undersubscribed, the subunderwriters can sustain substantial losses. In the U.K. system, priority is given to getting the deal done (with existing shareholders if possible) without regard to price.

The British method was once used in the United States and in Japan, when preemptive rights were popular with many large companies and their principal investors. The last such "rights issue" occurred in the United States in the late 1960s and a bit later in Japan. They went out of style because companies wanted to broaden their shareholder bases to include new investors. They wanted more competition for their newly offered shares, more flexibility to take advantage of market opportunities abroad, and more opportunities to influence the market price by prepricing sales efforts. And they wanted to avoid reporting large dilution in the earnings and book value per share as a result of the discounts associated with rights issues. Investors were agreeable, so companies began to vote out their preemptive rights.

The British method is still in use in the United Kingdom, where the large institutional investors are unwilling to give up preemptive rights. Privatization and other secondary new issues, however, can be made directly to the market, as in the United States. But for the most part, the British

underwriting method continues to be used. Some privatization issues, however, have involved a considerable amount of prepricing sales and marketing efforts and other innovations so as to obtain the best from both the U.S. and the U.K. systems.

Combining the Systems

Global offerings that involve tranches from different parts of the world often find disadvantages in forcing all of the tranches to use the same underwriting method. It can be disadvantageous to U.K. or European underwriters without strong external securities distribution capability to have to compete with U.S. firms for share allocations, especially when these firms are free to sell in Europe through their formidable sales forces there. It can also be disadvantageous to U.S. firms to have to act as underwriters of U.K. issues during the subscription period, without access to subunderwriters.

A large global share issue was the sale of 2.2 billion shares of the British Petroleum (BP) Company in October 1987. This transaction, valued at $12 billion, which was underwritten according to the British method on October 15 for subscription before October 28, was divided about equally between the domestic U.K. market and the markets outside of the United Kingdom. The October 19, 1987 stock market crash, which caused the BP share price to drop more than 30%, occurred during the subscription period. As a result, the offering was almost completely unsubscribed, and the entire issue was left with the underwriters. Four U.S. underwriters had committed among them to underwrite $1 billion of the BP shares to be sold in the United States. They pleaded with the British treasury to stop the issue, to no avail. Their losses totaled more than $250 million. The issue had been a disaster, but the international syndicate held and did its job, despite extreme duress.

A decade later, however, U.K. privatization issues were still being done according to the British method. From the government's point of view, of course, the British method of underwriting proved itself to be far superior to the U.S. method during the BP share offering. Nonetheless, various steps have been taken in the United Kingdom to improve the effectiveness of global offerings by combining aspects of both systems.

One of the important ways to do this, while still sticking to the British method of underwriting, is to provide for a bookbuilding effort by requiring a "tender offer" to be made by investors to receive shares after the subscription period has ended. Under such an arrangement, the issuer can reset (upward) the offering price based on the tenders received, but only after the risk of underwriting has terminated. To support a tender offer approach, issuers have learned to circulate a preliminary prospectus (sometimes called a "pathfinder") to institutional investors to prepare them for analyzing the investment opportunities on offer. Brokers then follow up with them, American style, to urge them to tender for shares. Underwriters have also adopted other American practices, such as Green Shoe over-

allotment options and using an institutional "pot" to set aside shares to be sold by the lead managers to large institutions. Although most large global offerings—those over $500 million in value—have relied on regional syndication efforts coordinated by one or more lead managers, in 1993, a $7.5 billion privatization issue for British Telecom (its third) was distributed through a single global syndicate, with all members having unreserved access to all investors, wherever in the world they were. Further innovation and experimentation will surely continue.

Listing Shares on Foreign Exchanges

For over 20 years, companies have considered listing their shares on foreign stock exchanges to promote local investment in them, to provide a quotation in the shares for the benefit of local employees, and to gain appropriate recognition as multinational firms. Frequently, however, such listings proved to be expensive, and very little trading on the local exchanges occurred. As foreign investors, especially in Europe, became more sophisticated, they preferred to trade in U.S. shares on U.S. markets, where they believed they could obtain better execution. The same came to be true for Japanese and American investors who found trading in overseas shares to be more efficiently done in the home-country markets. These developments diminished to some extent the need on the part of American and Japanese companies to list their shares abroad.

In the United States, however, listings by foreign companies increased significantly during the 1980s and 1990s. In the United States, "listings" is a term that includes all foreign companies that report annually to the SEC and therefore can be freely traded on stock exchanges or in over-the-counter markets. The companies listed in the United States want to tap the large U.S. equity markets, especially at a time when U.S. investors are increasing investments abroad and purchasing new issues of foreign debt and stocks. In 2001, the NYSE listed 954 international companies from 52 countries, more international listings than any other stock exchange around the world. See table 7-5.

Table 7-5 Foreign Companies Listed on Major Foreign Exchanges, 1995–2001

	1995	1996	1997	1998	1999	2000	2001
United States	673	756	918	893	895	971	954
London	531	532	467	466	448	448	409
Germany*	N/A	N/A	N/A	210	234	245	235
Paris	194	189	184	183	169	158	N/A
Tokyo	77	67	60	52	43	41	38

Data: International Federation of Stock Exchanges (FIBV), 2002.
*Floor trading, excluding the market segment "Freiverkehr" (unofficial regulated market)
N/A = not available

To qualify as a "reporting" company in the United States, a foreign corporation must provide most of the information required by the SEC of U.S. companies. For example, it must supply financial statements prepared according to U.S. generally accepted accounting principles (GAAP), or at least show and reconcile the differences between the company's home country accounts and GAAP. This undertaking alone is expensive, time-consuming, and more illuminating than most European and Japanese accounting standards require. Many prospective issuers balk at these requirements and forego the opportunity to be listed in the United States as a result.

However, during the 1990s, market forces drew many foreign companies to the U.S. equity market for new issues. Some issued private placements of equity securities under Rule 144a, but increasingly others preferred to undertake the burdens of becoming a reporting company in order to have access to the broader market and listing on the New York Stock Exchange.

Regulation of International Equity Markets

Vast amounts of cross-border capital flows have begun to integrate markets across the globe, influencing pricing, market behavior, and investor expectations, yet securities regulation is still a national concern and varies enormously between countries. Both local and international investors increasingly demand that markets be fair and reasonably transparent and that regulations be enforced. Yet the process of convergence toward an international regulatory norm has only just begun. Many questions are being raised by regulators around the world and by market practitioners, and efforts have begun to seek answers that are acceptable all around.

What Should Be Regulated?

There appears to be a consensus that three areas of activity should be regulated:

Industry structure and competition. The broadest forms of competition should be encouraged, consistent with providing for the capital adequacy and soundness of market-makers, underwriters, and brokers.

Protection of retail investors. Many countries provide "truth in investing" regulations that require minimum disclosure standards for new issues, and annual reporting by companies whose shares are publicly traded. Although these standards vary greatly, efforts are under way at the EU level and through an ad hoc effort by the United States, Canada, and Britain to establish common standards that each can use in the others' countries. Regulators are more relaxed about protecting institutional investors and other wholesale market players,

thus the unregulated Euroequity market and the various private placement markets for equity transactions, including Rule 144a transactions in the United States, continue to be undisturbed. The SEC, however, has been adamant about not changing its accounting standards for foreign companies becoming reporting, or publicly traded, companies.

Protection against securities fraud. Fraud can appear in a thousand forms, and many equity markets are not fully equipped to prevent it. Regulations against market-rigging, insider trading, "stock parking," account churning, and "front-running" vary considerably between the major countries and often do not even exist in many markets. But at least countries are now aware that these problems exist, and some movement toward achieving an international standard can be expected over the next few years.

Some Governing Principles Emerge. In general, certain governing principles appear to have emerged as a result of the reforms of the 1970s and 1980s and the efforts by the BIS and the EU to provide a framework for increasing competition while still maintaining a stable financial system, although there is still considerable disagreement as to how these should be applied. A consensus has formed around the following points:

Regulation should be as light as possible, but not so light as to be ineffective. Too much regulation kills the competitiveness of a financial center; but so does regulation that is not supervisable or enforceable.

Minimum solvency standards for the securities industry must be established, and these must be consistent with standards applicable to the banking industry. Standards covering bank capital adequacy must be applied, one way or another, to the securities industry as well. The insolvency of a large investment bank could represent a threat to the global financial system. Therefore such firms need to be subject to minimum capitalization rules also. In reality, such firms are already subject to minimum capitalization requirements of the various stock exchanges and financial market regulators. But these need to be applied on a consolidated basis.

A level playing field should be established for banks and investment banks. In Europe, "universal banking," which permits a full range of securities activities by banks, has become the model for the future. In the United States, the Glass-Steagall Act, which separated banking and investment banking in 1933, was repealed in 1999. The Japanese equivalent of Glass-Steagall, Article 65 of the Japan Financial Law, was repealed in 1994.

Market surveillance is necessary, and so are enforcement powers. Most countries agree that the SEC, as a regulatory body, works well. But they question the cost and inefficiency of settling matters through the

legal system. In Britain the Financial Services Authority (FSA) oversees several self-regulating organizations (SROs), but it has resisted building up a large (and aggressive) market surveillance staff. In Japan, the MOF (in response to public pressure) has formed a securities "watchdog" unit. Originally with a tiny staff and no enforcement powers, it brought several major actions against securities firms in 1999–2001. Everywhere questions are raised about the unwanted aspects of an aggressive SEC-type system, few alternatives that appear effective have been put forward.

Retail services need the most regulation. Many kinds of financial services are now sold directly to the public: discount brokerage, investment management services, mutual funds, pension investment programs, and life insurance with stock market returns, among others. These need to be regulated to ensure that unsophisticated investors are not exploited. At the same time, sufficient regulation of market behavior or professionals needs to occur to ensure that the markets as a whole are fair and unmanipulated.

How Does All This Get Brought Together? There are various "decision makers" in the regulatory arena. Broadly, these include (1) the Bank for International Settlements (BIS), which acts as a neutral sounding board on regulatory matters concerning banks, and the various national central banks (like the U.S. Federal Reserve and the Bank of England) who make up the ownership of the BIS; (2) the EU Commission, which prepares the banking and securities industry "directives" that set EU policy under the Single Market Act; (3) the various securities regulators, the stock exchanges, and the law courts that increasingly (even in Europe) are relied on to resolve complex regulatory issues in dispute; and (4) public opinion as reflected in the media.

Convergence of policy also occurs through market interaction and regulatory "competition," especially from the budding financial centers of tomorrow. Regulators consult with each other and argue the merits of alternative approaches. Growing familiarity with practices in well-regulated countries creates dissatisfaction in those countries that lack good regulation. The media publicize these matters, and gradually things change. Already, for example, new laws or regulations aimed at insider trading and protecting minority shareholder rights have been applied in a widening array of countries.

Competing in International Equities

The global market for equity securities is vast and involves many powerful competitors. No single firm will be successful in commanding a significant share of all the national markets for equities. But the rapidly growing cross-border trading activity in international equities is heavily concentrated in

a few countries, and participants in this market segment are capable of significant improvements in market share or of being displaced by more effective competitors.

Secondary market activity in international shares within one's own country is perhaps the place where competitors must begin to develop their strengths. U.S. brokerages have become proficient in offering U.S. shares to international investors, and in offering international shares to U.S. investors, principally institutions. European firms in Europe and Japanese firms in Tokyo must do the same. In each case, not only is a firm competing with its traditional domestic competitors but also it is up against the biggest and best of the foreign firms. Once successful in dealing in international securities with one's own clients, an ambitious firm can then attempt to compete abroad for the international business of nonclients.

Comparative Advantages

Firms have quite different comparative advantages in the international equities business. U.S. firms are especially keyed to institutional investors, including European institutional investors. Many U.S., U.K., and continental European banks or securities firms are also substantial money managers and know about the markets because of their experience as investors. There are a great many money managers in the international arena, however, and only a small percentage are able to use their in-house placing power and influence to attract lead managerships of international equity new issues.

Some firms will attempt to specialize in covering retail demand for international investments, including the demand for international or specific country mutual funds. Some firms prefer to be even more specialized, as, for example, concentrating only on global banking or insurance. In all cases, however, to be a successful competitor a firm must be recognized as having broad "placing power." The more the better.

Those firms that can place international issues will be invited into or will be able to lead underwriting groups for new issues. They will also be able to profit from trading opportunities related to the issues they have underwritten.

Institutional Emphasis

Most firms agree that when operating abroad they must emphasize institutional business because of the difficulty of creating a network of branch offices abroad and of luring loyal customers away from their traditional banks and brokers. Some, like Merrill Lynch, have tried overseas retail business with some success; they have also maintained a focus on the institutional side. Despite the lower commissions, institutional business is the only way to build up trading volume quickly. This provides the firm with customer activity and keeps it "in the market," knowing what is going on. However, institutional business is very competitive and hard to break into, although it can be done.

To succeed in institutional business, a firm must offer three basic services: sales coverage, research, and market-making. All of these can be expensive, yet if they are better than the competition's, business will soon follow. Generally, to win business from institutional customers, a firm must offer services that are so good that the customer wants to make room for them. Often this means starting small, with a major effort in a specialized area, from which the firm can expand outward.

Traditionally, firms would offer research and trading support to institutions from all over the world, but only in home-country shares. Merrill Lynch would offer its research on General Motors to institutions in Europe and Japan, as well as in the United States. But Japanese brokers did not sell Dutch stocks, and U.S. firms did not promote German bank shares. Each participant stuck to what it knew best. Such tidiness no longer exists.

Research in International Equities

In an attempt to reclaim from U.S. investors a share of the commission volume on foreign stocks lost over the years to European and Japanese firms, U.S. brokers first began to make trading markets in New York in a variety of popular international stocks. Then they began to promote the concept of global industries, in which they would attempt to recommend the best stocks in the world in, say, the auto industry. Research coverage then was applied to BMW, Fiat, Toyota, and other companies, in addition to the big two from Detroit and Daimler Chrysler. Next, analysts began to focus on which countries and stocks their customers should be in to catch the next rising market, such as Mexico, Spain, or Taiwan. Before long, the firms found themselves conducting macroeconomic research on various international economies and following dozens of large-capitalization non-U.S. companies.

At first, a firm's clients may doubt its ability to offer knowledgeable international advice, but if the quality of the firm's research is as good as the best domestic research, then it will soon gain a good reputation and will be sought out. Commission business and trading opportunities usually follow. This process is very expensive. Good analysts are expensive and often not productive for some time. It can take years to achieve a reputation for across-the-board excellence in research. Even then, their credibility has been seriously eroded by conflicts of interest in their role in corporate finance and touting particular stocks in which they or their firms have an interest. When the process succeeds, however, it provides the firm with a strong international reputation for competence that enables it to attract a significant market share.

Trading and Market-Making

Researchers must trade in the securities they recommend, but traders do not have to offer research in the securities they trade. Some firms prefer to compete only as market-makers in international equity securities—that is,

without offering research services. For years, there has been an active over-the-counter market in New York in international stocks engaged in by firms that were specialists in trading, not research. This business has expanded greatly in recent years, especially as institutional investors have become more active in international shares and began to look more closely for the best execution prices. Market-makers have expanded their activities too, often to include memberships on the London and Tokyo Stock Exchanges. Also, more non-U.S. firms have become members of the New York Stock Exchange to improve their ability to execute U.S. orders for their non-U.S. clients. And investment banks have bought some of the leading specialists in stock trading.

Like large commitments to international research, these activities are expensive, not only due to the cost of the stock exchange seats but also because a firm must become subject to capital and reporting regulations of the other exchanges and commit substantial resources to back-office operations. In addition, the management time involved in getting established and in building up local trading connections can be considerable. A firm must have a substantial volume in the shares traded on these exchanges to operate profitably. In New York and London, commission rates are fully negotiable, and in Tokyo more recently they are as well. However, several firms have succeeded in recent years by developing opportunistic trading approaches such as arbitrage (program) trading and specialized focus on certain stocks. Again, the firms that successfully pursue concentrated strategies of international trading will end up with the strongest franchises and the largest market shares.

New Issues

Some firms have preferred to compete in the international equities business by emphasizing new issues and underwritings, rather than becoming quite so committed to the secondary markets. Firms with an effective corporate marketing capability, or with a special ability to place issues with funds under the firm's own management, have often succeeded in gaining mandates to lead-manage public offerings of international equity issues. Such issues, do have to be priced competitively and distributed skillfully. Secondary market-making and research coverage has to be provided, even if by different firms than the lead manager. It is possible, of course, by virtue of the relationship between banker and client, for firms without developed capabilities in research or trading, and without convincing placing power, to win mandates. But it is much more difficult to do so now than in the past. Large international equity issues can be extremely profitable for lead managers; as a result, there is always keen competition for almost every management opportunity. Most of the managerships are won by firms with the ability to demonstrate across-the-board qualifications. Co-managerships and other lesser positions, however, are still made available quite often to firms with fewer demonstrable qualifications, but a longer

and closer relationship with the issuer. Most firms provide both debt and equity services as part of their capital market activity. The two can be highly complementary, especially where such hybrid securities as convertible debentures and debt with warrants are concerned.

The Effect of the Euro on Equity Markets

The introduction of the euro in 1999 should increase intra-European cross-border funds flows in equities. Home-country preferences, dictated by some regulators and conservative investment managers, will erode with the removal of the threat of foreign exchange losses. Increasingly, practitioners will become accustomed to thinking along European or EU boundaries, rather than along national boundaries. For the next few years this may be most pronounced among the 12 euro-zone countries.

Restructuring Effects

A major factor influencing cross-border equity flows is the considerable restructuring of industrial Europe that has long since begun and is expected to continue for many more years. The principal goal of this effort, echoing the goals of American corporations in the 1980s, has been to improve the economic performance of corporations—their competitiveness and profitability for shareholders. These efforts to improve performance have already been applied to many European conglomerates and industrial companies, state-owned enterprises, and regulated industries such as banking and insurance.

Restructuring through mergers (chapter 8) and privatizations (chapter 9) involve cross-border funds flows, especially when the buyer and seller are from different countries, but also when the acquired company is partly owned by foreigners. Subsequent efforts to restructure that company may involve changes in management, in product lines, in asset holdings, and in capital structure. To the extent that restructuring companies are successful, they tend to attract a new set of shareholders, especially those capable of appreciating the effect of these steps on future market valuation. Such new shareholders often include sophisticated foreign investors and fund managers. The restructuring effort may also attract the attention of market observers, strategists, and research analysts, resulting in an upgrade in the public appeal of the company and further investment from outside the country.

Privatizations have had similar effects on cross-border funds flows. Large issues have created enormous numbers of new stockholders and liquid secondary trading markets, which especially appeal to large foreign investors. After privatization, the newly freed company may itself seek acquisitions or divestitures, or it may direct investments in neighboring countries. Because of the company's size relative to others in the country, its

stock may become part of the national market index, causing passive index fund investors to buy and sell shares regularly.

Competitive Effects

Increased competition for stock exchange business will continue to intensify the efforts by the respective firms to service investor and corporate clients. Continental European exchanges have begun to compete (as well as link) with London's institutional business in actively traded stocks in Germany, France, and Switzerland. These efforts will increase the level and quantity of professional services available in the equity marketplace, bolster trading activity, and in general lead to closer integration of the intra-European market for equity securities.

As they did in the United States during the 1960s and 1970s, such efforts will lead to growing participation in the markets by institutional investors and more intense competition between those seeking to service them. It will also mean that the institutions themselves will become increasingly exposed to the pressures of investment performance. This means the investors will have to attempt to improve their own records of performance by insisting on high standards of professional skills that deliver exceptional returns. These investors will favor investing in growing or restructuring companies. They will be forced to give up historical investment ties to underperforming companies. Such investors will no longer look for their investments on a national basis but will look for the best companies in Europe in particular industries.

Continuing Market Integration

The euro-denominated stock markets have become the world's second largest in terms of market capitalization and trading volume. The Euro-12 plus Switzerland is even larger, representing market capitalization and trading volume levels that are 57% and 44%, respectively, of those of the United States, and 300% and 600%, respectively, of those of Japan. This new European market is now distributed over 12 different stock markets that, with few exceptions, will continue to have a high national concentration. For those looking for currency diversification as well, there are also the markets in the United Kingdom, Sweden, Denmark, Norway, and Switzerland.

However, as investors become more familiar with the euro, fungibility may be created between stocks from different countries. There has been an increase in the correlation in stock market returns between the different European countries in recent years, caused by increasing European cross-border trade, portfolio investment, and acquisitions, and this correlation may rise further as a result of the market integrating effects of the euro. This may be seen in one sense as a negative development that could reduce investment activity by some asset-holders seeking diversification under the

protocols of modern portfolio theory. To the extent that market liquidity increases as a result of growing fungibility, however, trading and investment activity on the part of large European institutions (especially pension funds) should also increase. As fungibility increases, markets begin to cohere as if they were under a single trading and regulatory regime such as exists in the United States. This may create substantial advantages to investors in the European market that are absent today. Among these could be major increases in block-trading activity, indexing, investor services and discounts, shareholder activism that promotes improved corporate governance, and anti-fraud enforcement. Such advantages should contribute significantly to further improvements in operating and competitive conditions of the European stock markets.

Trends and Issues for the Future

A great deal has happened in a very short time to the international equities market, and much is happening still. International activity in equity markets gives every indication of being a permanent and growing feature of the investment business.

The world equity markets are not nearly as well integrated as the debt markets. Debt issues are "commodities" defined by quality, maturity, and the yield curve. Swap markets permit arbitrage activity that eliminates price differences for the same commodity in other markets. Equities are different. Each stock is different. Markets have different methods of valuation which—although converging with one another—are still fairly far apart. But other aspects of the international equity markets are integrating more rapidly. Regulation, competitive access, the skills and services offered, and attitudes about international portfolio diversification are some of these. Governments continue to want good markets to receive their large privatization issues, and countries that have been cut off from valuable capital market activity are now finding it possible to attract foreign capital. However, some of these countries, enlarged by the former Soviet bloc in eastern Europe, are learning that to attract capital, they have to compete for it by creating the most open and efficient marketplaces they can.

New methods of international distribution are also being tried. In a short period, the world has gone from foreign issues sold in one market, to Euroequity issues, to globally coordinated, simultaneously offered, multiple-tranche issues. How else could an Argentine oil company raise nearly $3 billion in a single issue?

The demand for services to professional investors is rising to U.S. levels in the equity markets of Europe and Japan. New standards of investment performance are being adopted, which will create more competition and more services and will result in better, more liquid markets for all equities interesting enough to attract international investors.

Summary

In equities, as in international bonds, issuers tap international markets to increase the pool of available funds, lower costs of raising capital, expand their investor base, and avoid domestic regulatory complications. Investors move to international markets to improve portfolio performance and lower risks. Both groups' interests have been furthered by the erosion of regulatory barriers, including exchange controls, limits on ownership, limits on participation in domestic markets, and obstructive listing and trading practices.

While governments and regulatory agencies have made some progress in standardizing procedures, full integration is a long way off. Many non-U.S. issuers are discouraged from the otherwise attractive U.S. market by the stringent listing requirements of the SEC. New issues by Japanese issuers of Eurobonds with warrants—positioned to attract Japanese investors—clearly were intended to circumvent onerous regulatory requirements of the domestic market. Pricing conventions in the secondary market continue to exhibit national divergences.

But the emergence of a single world equity market is already discernable. The large investment houses, committed to supporting globalization of institutional investment, stand prepared to make markets 24 hours a day in selected stocks traded in all major managers. That infrastructure, built during the bull market of the 1980s, is now being consolidated, sharpened, and challenged by new opportunities and competitive pressures.

Note

1. ADRs, sometimes called American Depositary Shares, are issued by a U.S. bank and reflect a deposit with the bank abroad of shares of a foreign stock. The ADRs are quoted and traded in the United States, and transactions are settled and dividends are paid in dollars as a convenience to U.S. investors. However, many institutions today prefer to own the underlying shares directly to have access to the home country trading markets.

II

COMPETING IN GLOBAL ADVISORY AND ASSET MANAGEMENT SERVICES

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8

Global Mergers, Acquisitions, and Advisory Services

In addition to raising capital for corporations through the issuance of new debt or equity securities or bank loans, capital market services include the giving of advice on a variety of complex matters that a corporation must deal with in order to evaluate or accomplish particular financial transactions. Such transactions are usually ones that require specialized knowledge of the markets involved, and they also often require a network of contacts and extensive knowledge of local practices that a corporation itself is unlikely to possess to the degree necessary to ensure success. Advisory services are provided by both commercial and investment banks. They have been, however, a specialty of investment banks for a long time since they often involve the valuation of new or unusual securities by the market.

Advisory services are provided on an "agency" basis for a fee that reflects the value added by the banker in the transaction. Typically, a small retainer fee is agreed upon, which is payable regardless of the outcome of the transaction, with the main part of the fee being dependent on the completion of the transaction and usually based on an agreed percentage of its value. Among such financial advisory services are those involving mergers, acquisitions and divestitures, recapitalizations, leveraged buyouts, creative "financial engineering" for new facilities or projects, real estate finance, and a variety of other transactions.

Advisory services follow the markets for the transactions they involve. International advisory services are simply advice on mergers, restructurings, and the rest applied to cross-border transactions or to transactions that are carried out in another country.

The Market for International Merger Advisory Services

The international dimension to the mergers and acquisition business is not at all confined to the growing number of important cross-border and non-U.S. transactions that occur every year. It also is involved with many transactions that are never completed or are completed differently. Hoffmann La Roche, the large Swiss pharmaceutical firm, did not succeed in acquiring the American Sterling Drug Co. in the United States some years ago; Eastman Kodak did. But Hoffmann La Roche was a participant in the transaction anyway—as a potential buyer that, in this case, actually stepped forward to make an unsolicited bid. For *every* large transaction, there are potential bidders beyond the border, whether or not they come forward. Those who advise in the business have to know their thinking and their telephone numbers. They have to be in touch. And by being in touch, the advisers learn new things about the foreign companies, and vice versa. Soon the advisers find themselves with a new client, and the circle expands.

The United States and the United Kingdom are the largest markets for financial advisory services, and their investment banks represent the greatest repository of financial advisory know-how. This is partly because of the large volume of merger and acquisition transactions that occur in these countries, but also because the underlying capital markets are active in many innovative ways that have not as yet caught on in the national capital markets of other countries. However, because of the effects of globalization in finance and changes in the underlying capital market structures in other countries, in time we can expect other financial centers to assimilate, in one form or another, the practices of corporate reorganizing and restructuring that are common in Britain and America.

The Intra-European Market

The market for merger and acquisition (M&A) services within Europe differs considerably between the United Kingdom and continental Europe. Corporations in the United Kingdom have been able to benefit from a well-developed market for corporate control since the 1950s. A comparatively large number of publicly owned corporations exist in Britain, and shares of these companies have been, and continue to be, mainly owned by financial institutions. As compared to the rest of Europe, share markets in Britain, are active, investment information is plentiful, and prices of shares are held to be fair representations of the value of corporations. Takeover transactions in the United Kingdom are governed by the Takeover Panel, a self-regulatory organization, which is authorized to determine the rules of fair play. Next to the U.S. market, the British market is the largest in the world for M&A transactions, accounting in 2000 for approximately one-third of all intra-European merger transactions.

On the continent, different conditions exist. Many enterprises, including numerous very large ones, are not organized as publicly owned, limited-

liability corporations as they are in the United States and Britain. A study by Booz Allen Acquisition Services for the European Economic Community in the early 1990s showed, for example, that only 54% of the top 400 companies in the European Union (EU) were then publicly owned, versus 99% in the United States. Of the top 100 domestic companies, 67 were publicly quoted in the United Kingdom, 56 in France, 45 in Germany, and fewer than a third in all other EU countries combined. Furthermore, the study reported, in the three largest EU economies, only a relatively minor share of the domestic GNP could actually be accessed through public takeovers. Nor had many of the continental European countries at that time a tradition of, or experience with, market-driven domestic M&A activity. As a result, only a comparatively small percentage of enterprises in continental European countries had by then participated in such transactions. From 1990 through 2000, however, nearly $2.5 trillion of intra-European merger transactions occurred, expanding the European merger market experience dramatically.

Accordingly, the environment on the continent for M&A transactions is now much more compatible with that of the United Kingdom. Investment information is more readily available, transactions tend to be negotiated through experienced intermediaries and reflect shareholder concerns, the acquisition of minority stakeholdings and other corporate alliances still occur but are much less common than before, hostile activity is much less scorned and increasingly accepted, and sophisticated tactical and financial maneuvers are now fairly common. Some of the largest merger transactions ever to occur, such as the acquisitions of Telecom Italia by Olivetti in 1999 and of Mannesman by Vodaphone Airtouch in 2000, have occurred within continental Europe.

European Industrial Restructuring

One reason for the increase in continental M&A activity has been the growing recognition of the need for industrial restructuring in Europe following the adoption of the single European market and of the Economic and Monetary Union (EMU) by the EU countries. Originally announced in 1983, agreed in 1987, and implemented at the end of 1992, the Single Market Act required the free movement of goods, capital, people, and ideas to enhance economic growth in the European Economic Community (now called the European Union, or EU) by moving toward free markets and more open competition. EMU was implemented in 1999 by 11 of the 15 countries comprising the EU. The private sector in the EU has not only been invigorated by these steps, it has also been greatly enlarged by continued large-scale privatization programs that involved selling shares in government-owned industrial corporations to the public. Once in public hands, such companies would be run more efficiently and would be governed according to market forces. These new developments put considerable pressure on European corporations, including the recently privatized

ones, to rethink their corporate strategies and make changes in their business alignments, a process which was often facilitated by undertaking transactions as buyers or sellers in the growing "market for corporate control," which is what economists call the merger and acquisition market.

The post-EMU internal European market of the early twenty-first century will require larger, more competitive enterprises able to reap significant economies of scale and economies of scope, particularly in such industries as transportation, information technology, telecommunications, financial services, food products, consumer electronics, and pharmaceuticals. As in the waves of mergers and acquisitions that have from time to time rolled over the United States, the current (and first-ever) wave of European restructuring is driven by underlying industry economics and global competitive shifts. Some of this restructuring in Europe has already occurred through the large number of transactions completed in the 1990s, but still this total reflects a small proportion of all the restructuring that European industry will require in order to adjust to its new market-oriented, more competitive economic environment.

Restructuring Elsewhere in the World

The principal market forces causing U.S. and European restructuring were also evident in other parts of the world, particularly in market-oriented economies like Canada and Australia. But they were increasingly visible also and resulted in increased merger activity in the period after 1995 in emerging markets in Latin America, Southeast Asia, and Japan. Activity in these areas of the world accounted for approximately 20% of global transactions in 2000. In Japan, in particular, corporate restructuring is believed to be necessary, and some signs suggest that it may follow the European practice of adopting mergers and acquisitions as a means to do so before very much longer.

Improved Financial Markets

The powerful economic forces that have driven changes in Europe and the United States have forced traditional concerns and practices to bend to market actions in a number of countries. The rapidly increasing liquidity of European capital markets has made more nontraditional, market-oriented alternatives possible. No longer must an entrepreneur look for a friendly bank or competitor to buy all or part of his holdings upon his retirement. He or she can now sell shares at a decent price in the open market (through an initial public offering) or hire an investment banker to find a suitable party—a fellow national or a foreigner—to buy the company. And financing can also be available in the capital markets for the buyer.

Bolder Corporate Actions

No longer must an industry suffering structural difficulties be forced to hold onto businesses that no longer fit. It can now dispose of them in the market. And of course, no longer must a healthy company seeking to expand across European borders build up new businesses in other countries step by step. It can now purchase a complete going concern from someone else at a market price.

For many European executives, like their American counterparts, the conviction that their objectives can only be achieved in the short run through acquisition activity will be powerful. Consequently, as has been the case in the United States and the United Kingdom, a determination to pursue acquisitions despite objections of the target company will introduce, to a much greater extent than previously, hostile takeover efforts, such as Olivetti's effort to acquire control of Telecom Italia. Unless it is opposed by public policy—which, although much more relaxed on the matter of hostile offers than in the past, still differs considerably from country to country—the hostile takeover attempt can be expected to become much more common in the Europe and Japan of the 2000s.

Investor Reactions to Takeovers

The growing concentration of shareholdings in institutional portfolios subject to a progressively higher performance orientation serves to increase the emphasis on realizing underlying equity values. More competition among investment managers, more liquidity, and greater room to maneuver will require all financial managers to become more performance-oriented than they have been in the past. Thus, investment managers should be more inclined than in the past to favor takeovers and short-term returns in preference to maintaining long-term holdings out of loyalty or inertia. This change has already occurred to a significant degree in the United Kingdom. Such shifts in continental European investor behavior are likely—although perhaps not to the extent, for example, as has developed in the United States, where performance orientation appears to be at a maximum.

Acquisition Finance

Ample financing continues to be available from banks anxious to earn large fees and spreads on M&A transactions. Under the Bank for International Settlements, risk-based capital adequacy standards (that lump all corporate lending into one category), M&A loans are advantageous for most banks, which can earn significantly increased spreads in takeover financings without any increased charge against capital than for a loan to a high-grade corporation. Liquidity is also available for M&A financings from investment funds that purchase high-yield bonds and subordinated debt issues of

acquiring corporations. Such funds have been widely sold to private, institutional, and corporate investors in the United States and in Europe.

Because of national differences among the countries concerning the ways in which the market for corporate control is regulated, and the unpredictability of national antitrust intervention, risk arbitrage markets in Europe have not fully developed. Until new and transparent national and regional regulations (e.g., in the EU) covering antitrust considerations and takeover behavior on the part of principals are promulgated, the various markets will remain, relative to the U.S and U.K. markets, comparatively fragmented and inefficient. Once new regulations are agreed, as is anticipated, the markets should become integrated and comparatively efficient, enabling risk arbitrage activities to flourish and, in general, ease the process of M&A completion considerably.

Know-How

Finally, sufficient M&A "technology"—both homegrown and that developed in the United States and adapted to conditions elsewhere—is now in place to facilitate a large increase in merger transactions.

Other Financial Advisory Services

Most banks offer additional advisory services in addition to mergers and acquisitions such as the following:

1. *Hedging of financial risks*. Advice is given on how to manage liabilities and financial risk exposures for companies and other banks. This entails structuring of tailor-made derivative securities for which the bank will act as principal. These services are discussed separately in chapter 4.
2. *Share ownership*. More international companies are undertaking programs designed to promote ownership of their securities by investors in capital markets around the world. As a result, bankers arrange listings on international stock exchanges and of unregistered "private placements" of debt and equity securities of companies with institutional investors in the United States, Japan, and Europe.
3. *Leveraged buyouts*. More international companies are showing interest in leveraged buyouts. So far this activity has been restricted mainly to management buyouts of subsidiaries that parent companies have agreed to sell; however, many observers believe a spreading of this activity will continue into continental Europe and elsewhere.
4. *Project finance and financial engineering*. Direct investments in factories and other facilities around the world can be financed in various creative ways—for instance, through the sale of adjustable-rate

preferred stock, private placements, lease arrangements, commercial paper, and various forms of nonrecourse financing. Such transactions present opportunities for bankers to come up with and to communicate high value-added financing ideas.

5. *Real estate*. Many corporations have real estate that can be refinanced or sold and leased back. Such transactions involve a highly specialized, increasingly global business. For those bankers active in real estate finance, many opportunities are created, and many more are expected to be as real estate transactions of the sort conducted in the United States begin to appear in Europe and in Japan.

The Structure of International M&A Deal Flows

Between 1985 and 2000 the pattern of worldwide M&A activity—broadly defined to include mergers, acquisitions, tender offers, purchases of stakes, divestitures, and leveraged buyouts (LBOs)—has changed considerably. Transactions entirely within the United States first peaked in 1988 and then declined sharply to a level of one-third the peak volume just five years later, then built up once more to peak most recently in 2000 with a volume of deals just under $1 trillion. American cross-border transactions and transactions entirely outside the United States also declined after 1989 and 1990, respectively, but much less rapidly. After 1993, however, the American and the world markets recovered and began rising steadily to reach the (then) record level of $2.4 trillion of completed transactions in 2000. However, the following year the volume of such transactions declined sharply, reflecting world wide market conditions.

The Action Moves to Europe

Table 8-1 shows combined M&A activities on a worldwide basis for the period 1985 to 2001, when approximately 100,000 public transactions involving mergers, tender offers, purchases of stakes, divestitures, and LBOs with a market value of $12.8 trillion were completed. Another 113,000 transactions also occurred, for which no pricing information was reported. Of the valued transactions during this 17-year period, approximately 43% of the value involved transactions between U.S. companies. Nearly $4.8 trillion, or 41%, were transactions entirely outside the United States—that is, in which only non-U.S. companies (or non-U.S. subsidiaries of American companies) were involved—and $1.7 trillion, or 15%, were cross-border transactions in which U.S. parent companies acted as buyers or sellers with non-U.S. counterparts.

The predominance of U.S. to U.S. transactions obscures important changes that have been occurring abroad. Whereas the value of U.S. domestic transactions in 2000 was $931 billion, about five times the volume

Table 8-1 *Volume of Completed International Merger and Corporate Transactions United States (1985–2001) (in millions of US dollars)*

			Cross-Border									
	Domestic U.S.		Buyer U.S.		Seller U.S.		Total Cross-Border		Outside U.S.		Global Total	
Year	No.	$M	No.	$M	No.	$M	No.	$M	No.	$M	No.	$M
1985	815	192,294	30	4,034	99	11,898	129	15,932	166	24,842	1,110	233,068
	(88)		(79)		(122)		(201)		(124)		(413)	
1986	1,205	200,913	46	2,672	212	36,658	258	39,331	347	54,597	1,810	294,841
	(1,369)		(78)		(177)		(255)		(307)		(1,931)	
1987	1,357	203,936	62	8,551	227	41,662	289	50,213	797	96,177	2,443	350,326
	(1,409)		(142)		(173)		(315)		(560)		(2,284)	
1988	1,642	293,194	91	7,039	324	70,817	415	77,856	1,664	140,331	3,721	511,381
	(1,370)		(164)		(226)		(390)		(1,015)		(2,775)	
1989	2,005	250,096	157	25,136	456	60,449	613	85,585	2,048	227,824	4,666	563,505
	(1,969)		(250)		(293)		(543)		(1,817)		(4,329)	
1990	1,741	124,874	154	16,604	453	56,350	607	72,954	2,218	236,187	4,566	434,016
	(2,448)		(267)		(378)		(645)		(1,936)		(5,029)	
1991	1,795	108,464	209	13,376	318	27,159	527	40,535	2,564	202,397	4,886	351,396
	(2,050)		(327)		(266)		(593)		(3,894)		(6,537)	
1992	2,173	119,264	249	14,991	263	18,513	512	33,505	2,348	163,769	5,033	316,539
	(2,035)		(310)		(158)		(468)		(3,339)		(5,842)	
1993	2,011	101,068	212	13,696	224	21,215	436	34,911	2,448	125,755	4,895	261,734
	(1,855)		(366)		(134)		(500)		(2,989)		(5,344)	

1994	2,898	199,784	284	19,089	319	39,299	603	58,388	2,867	148,738	6,368	406,910
	(2,319)		(455)		(192)		(647)		(3,347)		(6,313)	
1995	2,822	218,545	370	38,111	328	68,391	698	106,502	3,235	227,762	6,755	552,808
	(3,002)		(578)		(223)		(801)		(4,054)		(7,857)	
1996	3,495	330,667	409	34,354	350	50,111	759	84,465	3,395	298,607	7,649	713,739
	(3,324)		(634)		(265)		(899)		(3,681)		(7,904)	
1997	3,601	448,288	475	54,909	423	47,034	898	101,943	3,871	388,311	8,371	978,542
	(3,573)		(599)		(272)		(871)		(3,069)		(7,513)	
1998	3,669	801,832	656	111,303	433	180,850	1,089	292,153	4,697	505,623	9,455	1,599,609
	(4,166)		(863)		(339)		(1,202)		(4,824)		(10,192)	
1999	3,072	588,728	569	104,722	536	198,687	1,105	303,409	5,578	797,512	9,755	1,689,649
	(4,114)		(897)		(448)		(1,345)		(7,428)		(12,887)	
2000	2,911	930,917	668	92,076	712	240,767	1,380	332,843	7,157	1,143,942	11,448	2,407,702
	(4,029)		(1,025)		(526)		(1,551)		(9,157)		(14,737)	
2,001	2,062	378,993	439	67,548	453	86,073	892	153,621	5,913	559,292	8,367	1,091,906
	(2,824)		(527)		(355)		(982)		(7,719)		(11,525)	
Totals	39,274	5,491,856	5,080	628,212	6,130	1,255,933	11,210	1,884,145	51,313	5,341,666	101,798	12,757,668
	(41,944)		(7,661)		(4,547)		(12,208)		(59,260)		(113,412)	

Source: Thomson Financial Securities Data.
Note: Numbers in parentheses denote additional deals for which no values were available.

of such transactions in 1985, U.S. cross-border transactions have grown much more rapidly, more than 20 times. Also, the value of deals completed outside the United States was about 20 times larger in 2000 than in 1985.

The competed acquisitions data have also been broken down by Standard Industrial Classification (SIC) codes identifying the primary business of firms on both sides of each transaction. Table 8-2 shows European M&A deals for 1985 through 2000 valued at $50 million or more by major industry category of the firm undertaking the transaction and (b) of the target. The financial services industries were the most heavily involved as acquirers in European M&A transactions. Three of the top five most active industries (by value) were investment and commodity firms, banks, and insurance. The other two were telecommunications and electric, gas, and water distribution. Likewise, financial services firms were often targets in Europe. Banks and insurance companies were among the top five most active seller industries, which also included telecommunications; electric, gas, and water distribution; and drugs. We discuss mergers within the financial services industries later in this chapter.

Table 8-2 shows that the industry segments that have been the most subject to restructuring through M&A transactions in the EU correlate significantly with those involved with M&A activity in the United States during the same period. This is not surprising, as the underlying economic forces affected these newly globalized industries in similar ways on both sides of the Atlantic.

Cross-Border Transactions

During the 16-year period 1985–2000, cross-border transactions accounted for 26% of all M&A transactions involving U.S. corporations, and 68% of these deals were inward investments, most of which involved European buyers. Clearly, European corporations were not interested only in the EU internal market. For many years they had recognized the importance of deploying more of their business activities into the United States, where the domestic economy had been expanding rapidly and fears of possible protectionism interrupting market access through imports were rising. During the 1980s, European and Japanese companies began to increase direct investment in the United States, which remains the world's largest market for just about all industrial and consumer products. In this respect, European corporations were acting similarly to American companies during the 1950s and 1960s when a high level of de novo investment and acquisition took place in Europe to shore up U.S. market positions and competitive capabilities there. U.S. companies remain the largest direct investors in other countries today and currently maintain about 25% of their manufacturing capability outside the United States.

U.S. cross-border transactions have included numerous large transactions in which European corporations acquired control of an important U.S. corporation. Among these were Daimler-Benz's $40 billion merger

Table 8-2 *Rankings of Industry Groups of U.S. and European Sellers, 1985–2001*

Target Industry	United States			Europe		
	Target Rank	Rank Value ($mils)	No. of Deals	Target Rank	Rank Value ($mils)	No. of Deals
Telecommunications	1	867,621.5	2,435	1	606,485.1	1,427
Commercial Banks, Bank Holding Companies	2	732,340.7	4,870	2	562,117.0	2,930
Radio and Television Broadcasting Stations	3	671,746.8	2,513	14	106,011.3	1,233
Oil and Gas; Petroleum Refining	4	583,849.5	3,556	7	208,608.6	1,494
Business Services	5	582,810.0	13,349	10	172,055.8	11,081
Electric, Gas, and Water Distribution	6	378,870.5	1,268	4	304,662.5	1,608
Insurance	7	340,629.2	2,919	3	350,086.5	2,504
Investment & Commodity Firms, Dealers, Exchanges	8	335,258.6	3,627	11	171,581.5	4,600
Electronic and Electrical Equipment	9	310,202.7	3,085	13	113,099.2	2,699
Food and Kindred Products	10	303,080.0	2,159	8	207,966.9	5,103
Motion Picture Production and Distribution	11	297,504.0	859	43	19,995.7	641
Drugs	12	291,857.7	1,565	5	234,442.5	1,210
Measuring, Medical, Photo Equipment; Clocks	13	281,102.4	3,609	26	52,944.3	1,951
Prepackaged Software	14	245,695.5	4,613	34	39,527.0	2,788
Chemicals and Allied Products	15	227,609.6	1,942	9	172,304.2	2,508
Credit Institutions	16	203,138.8	877	37	30,818.7	509
Real Estate; Mortgage Bankers and Brokers	17	188,469.1	3,829	6	208,646.3	3,562
Health Services	18	184,048.7	3,968	48	15,547.3	691
Communications Equipment	19	182,094.1	1,360	32	43,354.1	896
Computer and Office Equipment	20	171,776.2	1,629	45	17,887.9	706
Printing, Publishing, and Allied Services	21	166,779.7	2,721	15	104,526.4	3,643
Hotels and Casinos	22	161,412.7	1,490	19	84,529.8	1,446
Machinery	23	161,392.2	2,727	21	68,536.6	3,894
Transportation Equipment	24	152,552.6	1,055	18	89,348.7	1,938
Metal and Metal Products	25	138,550.5	2,732	12	118,601.7	3,947
Transportation and Shipping (except air)	26	130,483.3	1,784	16	96,617.4	4,082
Paper and Allied Products	27	129,724.7	756	17	91,237.2	1,489
Savings and Loans, Mutual Savings Banks	28	116,649.4	3,212	57	957.3	14
Retail Trade-General Merchandise and Apparel	29	103,291.5	715	30	45,332.8	704
Miscellaneous Retail Trade	30	100,191.1	2,559	28	48,988.6	2,151
Retail Trade-Food Stores	31	97,889.3	645	22	67,834.3	906
Wholesale Trade-Nondurable Goods	32	86,917.3	1,997	31	45,153.3	2,764
Aerospace and Aircraft	33	85,367.1	428	40	25,841.6	316
Wholesale Trade-Durable Goods	34	84,456.0	3,492	23	67,175.5	4,368
Mining	35	77,771.0	864	29	45,525.1	722
Textile and Apparel Products	36	66,748.5	1,185	38	30,551.6	2,206

(continued)

Table 8-2 Rankings of Industry Groups of U.S. and European Sellers, 1985–2001 (continued)

Target Industry	United States			Europe		
	Target Rank	Rank Value ($mils)	No. of Deals	Target Rank	Rank Value ($mils)	No. of Deals
Rubber and Miscellaneous Plastic Products	37	64,657.7	1,223	36	34,884.4	1,595
Stone, Clay, Glass, and Concrete Products	38	64,516.5	770	20	69,569.2	1,972
Retail Trade-Eating and Drinking Places	39	64,283.6	1,086	27	51,238.5	1,079
Sanitary Services	40	56,717.2	908	49	15,143.4	525
Air Transportation and Shipping	41	49,221.9	449	35	35,427.8	689
Tobacco Products	42	49,120.8	55	33	40,980.5	104
Amusement and Recreation Services	43	46,390.8	946	41	24,319.1	973
Soaps, Cosmetics, and Personal-Care Products	44	46,311.2	472	39	27,368.6	515
Advertising Services	45	44,509.9	744	42	21,082.2	1,031
Repair Services	46	37,967.1	555	50	13,383.7	623
Wood Products, Furniture, and Fixtures	47	32,051.1	818	44	18,072.3	1,235
Construction Firms	48	31,893.2	1,366	24	64,413.0	2,588
Miscellaneous Manufacturing	49	27,352.5	823	51	12,357.2	820
Agriculture, Forestry, and Fishing	50	26,895.5	528	47	15,885.7	720
Retail Trade-Home Furnishings	51	15,402.7	498	46	16,057.7	485
Holding Companies, Except Banks	52	12,409.8	64	25	54,449.0	325
Personal Services	53	9,256.6	330	53	8,829.1	245
Other Financial	54	8,256.3	183	54	3,866.9	62
Leather and Leather Products	55	5,166.4	163	52	10,307.5	323
Educational Services	56	4,805.5	293	56	1,177.1	210
Social Services	57	3,742.0	184	58	650.5	62
Miscellaneous Services	58	3,184.2	102	59	476.1	82
Public Administration	59	2,549.0	107	55	1,938.7	128
Legal Services	60	219.9	145	60	183.1	251
Unknown	61	88.8	10	61	96.4	3
Nonclassifiable Establishments	62	44.0	3	62	68.0	17
Industry Totals		9,946,896.3	105,219		5,211,125.5	101,393

Source: Thomson Financial Securities Data.
* = tie.

with Chrysler Corp., announced in May 1998, and British Petroleum's $48 billion deal with Amoco a few months later, which, in turn, was followed by BP's acquisition of Atlantic Richfield in 1999.

On other occasions, European corporations acquired the outstanding minority interests in their majority-owned U.S. subsidiaries. In 1970, British Petroleum (BP) exchanged certain Alaskan oil production interests for an increasing share interest in the Standard Oil Company (Sohio), which reached 53% in 1978. In 1987 BP decided to acquire the remaining 47% through a $7.9 billion tender offer to shareholders. Similar acquisitions of minority interests were also undertaken by Royal Dutch Shell and Philips, the large Dutch electronics concern.

Divestitures of companies that no longer suited their foreign owners also took place. Imperial Group, a U.K. tobacco company, which acquired the Howard Johnson restaurant chain in 1980, sold it in 1985. BAT Industries, another large U.K. tobacco, retailing, and insurance concern, acquired Gimbel's department stores in 1973 and sold it in 1986. Later, under attack from corporate raider Sir James Goldsmith, BAT sold the rest of its retailing businesses, to focus only on tobacco and insurance. In 1998, BAT sold its insurance businesses to Zurich Insurance. The international aspects of the merger and acquisition business thus involve both the buying and the selling of companies, big and small. They also involve frequent changes in corporate strategy, which in one year may justify an acquisition of a company that in another year would be sold.

Cross-border transactions have also involved a number of Japanese and other Asian corporations. On the whole, Japanese corporations appear to have preferred making direct investments in the United States or in Europe through the construction of new facilities rather than through the purchase of businesses. Frequently, such projects have involved imaginative low-cost leasing or other financing schemes that were arranged by U.S. financial advisers. Other transactions, however, have involved the purchase of facilities or lines of business from U.S. companies and converting them to Japanese manufacturing methods. On other occasions, Japanese companies have purchased minority stakes in U.S. companies, particularly in the steel industry, as a basis for securing a source of production in the United States. Some Japanese companies—notably electronics giants Sony and Matsushita and tire giant Bridgestone, but also other industrial companies, banks, and trading firms—have acquired 100% interests in U.S. corporations, and on one noteworthy occasion in 1987, a Japanese company, Dai Nippon Ink, acquired a U.S. company, Reichhold Chemicals Co., through a hostile takeover bid.

Non-U.S. Transactions

Of the transactions entirely outside the United States between 1985 and 2000, approximately 61% have been intra-European deals, of which transactions entirely within the United Kingdom (the largest component of intra-European deals) accounted for about 45%. European corporations have been active on three fronts: in domestic mergers and consolidations, in intra-European cross-border transactions, and in transactions in the United States. Table 8-3 shows the value of completed international merger and corporate transactions for Europe during 1985–2000. Table 8-4 shows the volume of completed Intra-European M&A transactions by country. This table illustrates the concentration of activity within domestic markets in the United Kingdom, France, and Italy, the countries with the most open (or least closed) M&A markets. It also shows the rising importance of European cross-border transactions, especially by German companies.

Table 8-3 Value of Completed International Merger and Corporate Transactions Europe, 1985–2001 (in millions of U.S. dollars)

			Cross-Border					
	Intra-Europe		European Buyer		European Seller		Total Cross-Border	
Year	No.	$M	No.	$M	No.	$M	No.	$M
1985	84 (62)	11,508	51 (47)	6,335.3	32 (64)	2,511.3	83 (111)	8,846.6
1986	219 (184)	20,693	119 (85)	19,642.8	55 (58)	15,747.3	174 (143)	35,390.1
1987	581 (351)	54,852	142 (102)	28,123.6	81 (131)	13,259.0	223 (233)	41,382.6
1988	1,252 (728)	86,430.3	235 (164)	37,623.6	145 (174)	17,020.5	380 (338)	54,644.1
1989	1,507 (1,211)	130,115.7	316 (206)	39,120.7	225 (317)	35,150.8	541 (523)	74,271.5
1990	1,440 (1,191)	127,225.9	274 (219)	46,841.6	310 (361)	50,897.9	584 (580)	97,739.5
1991	1,430 (2,926)	117,248.5	220 (202)	21,445.8	316 (406)	32,346.5	536 (608)	53,792.3
1992	1,462 (2,667)	91,022.0	179 (116)	8,201.6	274 (328)	34,825.2	453 (444)	43,026.8
1993	1,290 (2,100)	59,946.1	183 (150)	12,519.1	247 (391)	20,446.7	430 (541)	32,965.8
1994	1,538 (2,335)	85,586.5	241 (163)	30,836.3	292 (445)	26,265.9	533 (608)	57,102.2
1995	1,686 (2,655)	151,763.3	302 (253)	41,195.0	296 467	31,165.0	598 214	72,360.0
1996	1,677 (2,109)	193,258	313 (291)	48,685	306 (472)	24,505	619 (763)	73,190
1997	1,959 (1,795)	242,449	345 (223)	45,451	381 (432)	33,086	726 (655)	78,537
1998	2,467 (3,048)	305,851	470 (376)	191,741	534 (689)	99,616	1,004 (1,065)	291,357
1999	3,266 (5,320)	575,528	585 (508)	216,611	466 (679)	75,380	1,051 (1,187)	291,991
2000	3,632 (6,504)	661,670	741 (639)	302,645	483 (702)	94,114	1,224 (1,341)	396,759
2001	2,778	317,617	496 (443)	89,096	344 (543)	59,688	840 (986)	148,784
Totals	28,268 (40,540)	3,232,764	5,212 (4,187)	1,186,114	4,787 (5,725)	666,025	9,999 (9,912)	1,852,139

Source: Thomson Financial Securities Data.
Note: Numbers in parentheses denote additionals deals for which no values were available.

The remainder of the non-U.S. transactions have been, in descending order of transaction value, intra-Canadian, intra-Australian, and intra-Asian (including a comparatively small but growing activity in Japan). In aggregate, transactions not involving U.S. corporations grew to approximately 58% of the worldwide total in 1991, up from about 11% in 1985, before dropping back to 48% of the worldwide total in 2000. Non-U.S.

Table 8-4 *Volume of Completed Intra-European M&A Transactions by Country, 1985–2001 (in U.S. $ million)*

Country of Buyer	Year	Country of Seller Company					Totals Buyer
		UK	France	Italy	Germany	Other European	
UK	1985	9,186.2	0.0	0.0	0.0	12.2	9,198.4
	1986	12,806.4	23.8	0.0	1.0	80.4	12,911.6
	1987	33,500.1	302.6	125.9	341.4	576.3	34,846.3
	1988	42,890.3	1,213.5	409.1	369.7	1,158.4	46,041.0
	1989	55,799.6	1,221.8	305.7	344.6	3,289.9	60,961.6
	1990	27,549.1	2,597.4	115.1	1,245.9	4,054.5	35,562.0
	1991	30,689.0	624.4	39.5	316.5	1,526.7	33,196.1
	1992	17,250.8	1,141.8	402.4	796.4	10,558.6	30,150.0
	1993	20,536.1	5,318.2	46.4	516.1	1,219.0	27,635.8
	1994	22,127.0	4,508.0	83.0	542.0	3,723.0	30,983.0
	1995	68,943.2	1,924.6	433.3	2,995.3	3,417.9	77,714.3
	1996	57,794.8	871.6	273.0	405.1	4,250.7	65,591.2
	1997	67,260.2	3,950.8	199.5	1,454.7	1,632.1	89,187.3
	1998	89,490.2	6,773.8	400.4	3,069.7	7,474.4	107,208.5
	1999	124,814.0	2,620.1	1,058.7	2,227.0	23,298.6	154,218.4
	2000	207,330.9	13,742.3	118.5	4,820.9	28,813.6	254,826.2
	2001	89,967	2,453	204	3,755	8,045	104,424
France	1985	0.0	10.7	0.0	0.0	0.0	10.7
	1986	5.9	1,285.7	520.9	0.0	32.1	1,844.6
	1987	316.6	1,958.9	343.3	0.0	0.0	2,618.8
	1988	3,209.6	7,716.3	428.7	310.2	1,392.5	13,057.3
	1989	5,727.5	15,906.5	837.3	2,044.8	4,296.7	28,812.8
	1990	3,195.0	12,648.4	3,380.9	502.9	4,548.4	24,275.6
	1991	621.3	17,005.5	1,627.8	5,437.1	3,118.4	27,810.1
	1992	211.3	9,696.5	406.8	2,454.8	4,053.2	16,822.6
	1993	39.5	6,646.6	288.6	217.1	673.8	7,865.6
	1994	840.0	9,352.0	39.0	15.0	703.0	10,949.0
	1995	2,254.3	9,971.8	143.0	237.7	1,790.0	14,396.8
	1996	912.9	31,359.0	0.0	13.5	5,343.7	39,625.1
	1997	6,845.7	40,340.1	929.7	2,846.7	3,237.8	54,200.0
	1998	5,149.5	24,900.9	7.6	186.0	11,521.6	41,765.6
	1999	4,074.6	43,332.3	298.5	25,803.7	16,265.0	89,774.1
	2000	58,295.6	36,865.4	2,771.9	4,907.4	15,129.3	117,969.6
	2001	3,975	29,566	2,350	1,049	9,675	46,615
Italy	1985	16.8	0.0	165.0	0.0	0.0	181.8
	1986	0.0	0.0	1,199.4	129.0	0.0	1,328.4
	1987	0.0	20.4	8,039.9	0.0	1,050.8	9,111.1
	1988	0.0	504.9	1,509.6	429.3	887.7	3,331.5
	1989	7.9	294.4	8,523.6	180.6	0.0	9,006.5
	1990	68.6	602.8	15,752.9	772.3	518.8	17,715.4
	1991	71.9	335.1	4,415.4	356.1	536.9	5,715.4
	1992	10.6	2,279.3	4,589.9	747.6	308.2	7,935.6
	1993	0.0	156.5	2,535.8	2.3	102.9	2,797.5
	1994	0.0	281.0	7,542.0	54.0	1,475.0	9,352.0
	1995	189.4	103.5	4,972.0	299.1	575.1	6,139.1
	1996	2.3	419.2	11,794.3	0.0	225.6	14,437.4
	1997	0.0	397.6	22,758.9	24.7	2,669.6	25,849.9
	1998	0.0	539.9	29,158.7	288.6	272.9	30,260.1
	1999	264.8	200.2	96,898.1	924.6	2,775.7	101,063.4
	2000	6,295.5	713.1	59,764.9	3,757.3	7,488.2	78,019.0
	2001	342	1,338	20,253	409	3,670	72,627

(continued)

Table 8-4 *Volume of Completed Intra-European M&A Transactions by Country, 1985–2001 (in U.S. $ million) (continued)*

Country of Buyer	Year	Country of Seller Company					Totals Buyer
		UK	France	Italy	Germany	Other European	
Germany	1985	0.0	0.0	0.0	898.5	445.0	1,343.5
	1986	425.0	0.3	887.4	980.0	0.0	2,292.7
	1987	167.0	414.8	0.0	452.8	0.0	1,034.6
	1988	59.2	154.0	866.1	2,518.7	39.6	3,637.6
	1989	2,378.4	1,341.3	37.5	2,649.4	1,466.0	7,872.6
	1990	1,499.7	2.2	53.2	2,101.5	1,341.9	4,998.5
	1991	456.7	8.5	0.0	13,697.8	1,242.0	15,405.0
	1992	986.5	10.5	39.0	7,157.3	1,511.3	9,704.6
	1993	167.1	458.6	0.0	3,401.6	1,796.3	5,823.6
	1994	11.0	1,350.0	470.0	5,893.0	877.0	8,601.0
	1995	4,226.7	3.4	341.7	3,476.6	3,069.3	11,117.7
	1996	943.6	196.2	521.7	3,184.6	4,708.1	11,550.2
	1997	2,753.7	557.8	49.3	18,975.4	7,472.9	29,809.1
	1998	1,490.5	2,076.5	614.1	12,841.0	5,442.8	22,464.9
	1999	47,770.8	1,122.4	8,581.8	19,428.5	7,084.2	83,987.7
	2000	12,652.4	3,690.9	646.2	16,379.8	14,893.4	48,262.7
	2001	151	1,713	37	40,260	4,552	46,713
Other European	1985	268.5	0.0	0.0	0.0	505.5	774.0
	1986	828.6	0.0	0.0	0.0	1,486.7	2,315.3
	1987	574.9	188.9	26.8	239.0	6,211.6	7,241.2
	1988	7,540.9	1,028.6	2,098.7	0.0	9,694.7	20,362.9
	1989	2,074.3	4,040.7	158.9	902.5	16,285.7	23,462.1
	1990	7,245.7	1,285.1	436.9	2,794.8	32,911.9	44,674.4
	1991	2,730.7	838.2	529.5	651.6	30,371.9	35,121.9
	1992	1,845.4	4,087.4	272.3	196.2	20,007.9	26,409.2
	1993	775.4	207.2	1,956.6	327.6	12,556.8	15,823.6
	1994	1,669.0	3,934.0	9.0	1,390.0	16,130.0	23,132.0
	1995	6,085.0	313.4	321.6	4,206.7	31,566.4	42,493.1
	1996	6,252.5	3,479.9	175.4	2,472.9	58,530.9	72,907.6
	1997	1,801.8	1,601.0	161.7	2,045.1	61,456.8	67,066.4
	1998	10,712.4	35,884.1	31,418.9	19,936.5	207,899.4	305,851.3
	1999	35,240.0	20,672.4	1,629.4	13,939.3	150,383.4	221,864.5
	2000	39,938.4	5,270.2	253.3	2,517.1	114,721.1	162,700.1
	2001	35,794	4,672	8,159	13,329	92,049	154,183
Totals seller	1985	9,471.5	10.7	165.0	898.5	962.7	11,508.4
	1986	14,065.9	1,309.8	2,607.7	1,110.0	1,599.2	20,692.6
	1987	34,558.6	2,885.6	8,535.9	1,033.2	7,838.7	54,852.0
	1988	53,700.0	10,617.3	5,312.2	3,627.9	13,172.9	86,430.3
	1989	65,987.7	22,804.7	9,863.0	6,121.9	25,338.3	130,115.6
	1990	39,558.1	17,135.9	19,739.0	7,417.4	43,375.5	127,225.9
	1991	34,569.6	18,811.7	6,612.2	20,459.1	36,795.9	117,248.5
	1992	20,304.6	17,215.5	5,710.4	11,352.3	36,439.2	91,022.0
	1993	21,518.1	12,787.1	4,827.4	4,464.7	16,348.8	59,946.1
	1994	24,647.0	19,425.0	8,143.0	7,894.0	22,908.0	83,017.0
	1995	81,698.6	12,316.7	6,211.6	11,215.4	40,418.7	151,861.0
	1996	65,906.1	36,325.9	12,764.4	6,076.1	73,059.0	196,127.5
	1997	78,661.4	46,847.3	24,099.1	25,346.6	76,469.2	266,112.7
	1998	106,842.6	70,175.2	61,599.7	36,321.8	232,611.1	507,550.4
	1999	212,164.2	68,147.4	108,466.5	62,323.1	199,806.9	650,908.1
	2000	324,512.8	60,281.9	63,554.8	32,382.5	181,045.6	661,777.6
	2001	130,229	60,282	63,555	32,383	91,319	377,768

Source: Thomson Financial Securities Data.

and U.S. cross-border transactions—that is, international transactions from the point of view of U.S. investment bankers—have grown from 17% of worldwide transactions in 1985 to 69% in 1991 (49% in 2001), as shown in table 8-1.

Special Characteristics of European M&A Transactions

European merger transactions have been propelled by several broad economic and political forces during the past decade. These forces include globalization effects on industrial competitive structure, integration of financial markets and the free flow of capital across borders, aggressive privatization policies, and the effects of the single European market and monetary union. In addition, both the collapse of the communist powers in eastern Europe, and the effort to bring these countries into a general European capitalistic society, and a perverse, low-growth–high-unemployment economic environment throughout Europe have created great pressures for improved competitive performance and efficiency. Clearly, these forces, in aggregate, have become extremely powerful—perhaps so powerful as to be irresistible even by the long-entrenched practices and attitudes about corporate control and governance that have existed in Europe, especially on the continent, for generations. These practices and attitudes have centered on close control of corporations; nonmarket valuation of shares to be transferred, effecting control through minority positions in a large network of stakeholdings; and resistance to hostile takeovers, leveraged buyouts, and the advice of independent advisers. Now, after several years of observation, we can conclude that the market forces have inculcated many changes into the European marketplace—changes that appear to be deep and irreversible. These changes have been accompanied by a variety of regulatory reforms in national markets and at the EU level that will increase the efficiency of the marketplace. As this process continues, in 10 years or so it may not be possible to describe especially distinctive characteristics of the market for corporate control in continental Europe, as compared to the United States or Britain

The EU's takeover directive was nearing completion in mid-2001 after 12 years of work, when the German government had second thoughts. The directive required bidders who acquired control of a company to make an offer to all shareholders on the same terms, and prohibits frustrating defensive tactics unless these have been approved by shareholders—in effect barring poison bills that do not have shareholder approval. The German government resisted this provision, reflecting a basic antagonism to a free and transparent market for corporate control. Yet in the absence of this provision, the entire EU takeover code is relatively meaningless. Shareholders who feel damaged by poison pills do continue to have access to the courts, however.

Table 8-5 Partial Ownership Positions as a Percentage of All Completed U.S. and European M&A Transactions, 1985–2001 (in percentage terms)

		European Seller[b]		Intra-European Deal[c]	
Year	U.S. Seller[a]	U.K.	Rest of Europe	U.K.–U.K.	Europe–Europe
1985	6.30	14.21	25.13	5.09	25.59
1986	17.12	7.15	38.14	6.51	39.05
1987	15.09	37.01	8.12	28.12	7.96
1988	11.77	24.03	42.25	12.58	42.72
1989	25.50	25.53	34.76	30.02	34.13
1990	13.82	22.20	20.74	20.91	17.57
1991	11.53	38.84	25.33	20.58	20.99
1992	7.62	41.42	31.98	41.97	29.17
1993	11.15	9.78	54.15	7.02	49.58
1994	14.33	24.92	48.84	24.33	54.97
1995	16.75	18.67	55.93	11.43	61.51
1996	12.92	18.85	30.77	14.73	28.24
1997	17.49	8.47	25.10	10.36	44.05
1998	8.72	23.31	52.99	18.62	54.27
1999	12.77	18.32	59.66	24.86	65.39
2000	9.32	11.88	67.54	10.60	64.96
2001	13.53	11.90	54.55	11.12	56.79
Average	13.28	20.97	39.76	17.58	41.00

Source: Thomson Financial Securities Data.

Note: Partial ownership positions involve open or privately negotiated stake purchases of stock or assets. Data include only completed transactions. Data are classified according to announcement date of a transaction, not taking into consideration when a transaction is completed. Percentage values denote the fraction of total volume that involves partial stakes.

[a]Completed partial stakes as a percentage of total volume of completed transactions in which the seller was a U.S. company.

[b]Completed partial stakes as a percentage of total volume of completed transactions in which the seller was a company from the U.K. or the rest of Europe.

[c]Completed partial stakes as a percentage of total volume of completed intra-European transactions in which the seller was a company from the U.K. or the rest of Europe.

Minority Stakeholdings

Table 8-5 compares partial ownership positions (stakes) as a percentage of all completed M&A transactions in the United States, the United Kingdom, and for the rest of Europe for the period 1985–2001. Compared with those in the United States, stakeholding transactions were almost three times as prevalent in transactions involving non-U.K. European corporations, indicating a uniquely European modus operandi. European companies appear to favor stakes for several reasons, including the concept of forging a "strategic alliance" for a common purpose, offensive or defensive, without giving up their own independence; the idea that a gradual commitment to a final arrangement is wiser, cheaper and reversible; and because in many situations a substantial minority stakeholding can assure de facto control of a company. In the United States, by comparison, acquirers are motivated by tax, accounting, and legal reasons to prefer 100% ownership. The

American practice of minority shareholder litigation and class action lawsuits makes the elimination of minority interests especially important to many companies, although these companies often recognize that when in Rome, Brussels, Lyon, or Dusseldorf, it may be acceptable to abide by local customs.

Some academic observers have suggested that lengthy European liaisons and courtships, or "trial marriages," may lead to full mergers that prove to be more lasting and beneficial than some of the more impulsive, opportunistic U.S. acquisitions that often appear to fail in delivering expected benefits. This may be the case, but many Europeans still prefer a perpetual minority stake to a 100% purchase; in many situations, for example, the buyers or sellers of the stake want above all to preserve a particular status quo, even though it may be economically inefficient. Sometimes the structure of stakeholdings can enable the holder of a relatively small position to effect operating control of another company. Nevertheless, the tide seems to be running out on minority investment positions. Strategic alliances, for example, involving, say, a 10% cross-shareholding between two competing companies from different countries, may appear shrewdly strategic when announced. But such alliances frequently do not produce the intended synergies, and each company may find itself within a few years unable to influence policies in the company allied with it—and, indeed, in serious competition with it. Also, recently minority shareholder lawsuits—such as that by shareholders of the Belgian company Wagon-Lits against the French group, Accord, in 1992—blocked a below-market transfer of control. Increasing investment in companies like Wagon-Lits by powerful institutional investors from the United Kingdom or the United States makes these types of challenges more likely in the future.

Leveraged Buyouts

Around 1985, leveraged buyouts began to appear in Europe, especially in the United Kingdom, where they appeared in two forms: Management Buyouts (MBOs), in which existing management would receive financing sufficient to purchase the company from its owner, usually a large company no longer wanting the business, or Management Buyins (MBIs), in which new management and investors would take over a company on a highly leveraged basis. The inspiration for these transactions came from the United States where the LBO boom reached its peak in 1988 (the year of the famous RJR-Nabisco deal), and 25% of all completed U.S. transactions were LBOs. Table 8-6 compares LBO activity in the United States with the United Kingdom and the continent for 1985–2001. From the mid-1980s to the mid-1990s, activity was greater in the United States (where public financing of LBOs through the sale of junk bonds was available) than elsewhere. More than a trivial amount of LBO transactions occurred in Europe between 1987 and 1992, as divestitures increased and funds were made available to stake financial entrepreneurs. After 1994, LBO activity

Table 8-6 Leverage Buyouts as a Percentage of All Completed U.S. and European M&A Transactions, 1985–2001 in percentage terms)

		European Seller[b]		Intra-European Deal[c]	
Year	U.S. Seller[a]	U.K.	Rest of Europe	U.K.	Rest of Europe
1985	13.43	4.45	0.00	8.70	0.00
1986	16.45	;1.67	0.85	3.83	0.00
1987	19.73	7.84	0.72	9.92	7.60
1988	31.10	8.00	3.67	12.09	4.29
1989	11.18	8.94	3.18	14.53	3.52
1990	6.60	4.64	2.21	11.05	2.33
1991	4.56	5.67	5.19	8.54	5.81
1992	6.60	6.78	1.91	14.96	2.15
1993	5.37	9.13	1.61	7.86	1.67
1994	2.97	8.69	0.83	9.99	0.83
1995	1.40	5.43	1.03	7.20	1.27
1996	0.28	5.22	0.40	5.77	0.36
1997	1.30	7.84	1.29	14.60	2.64
1998	0.40	4.70	1.69	8.06	1.25
1999	1.34	9.29	2.07	15.22	1.19
2000	2.58	5.55	3.62	7.50	2.51
2001	1.94	15.38	8.91	21.67	7.84

Source: Thomson Financial Securities Data.

Note: Leverage buyout (LBO) is defined as a transaction in which an investor group, investor, or investor/LBO firm, acquires a company, taking on an extraordinary amount of debt, with plans to repay the debt with funds generated from the company or with revenue earned by selling off the newly acquired company's assets. Data include only completed transactions. Data are classified according to announcement date of a transaction, not taking into consideration when a transaction is completed. Percentage values denote the fraction of total volume that involves LBOs.

[a]Completed LBOs as a percentage of total volume of completed transactions in which the seller was a U.S. company.

[b]Completed LBOs as a percentage of total volume of completed transactions in which the seller was a company from the U.K. or the rest of Europe.

[c]Completed LBOs as a percentage of total volume of completed intra-European transactions in which the seller was a company from the U.K. or the rest of Europe.

dropped in both the United States and Europe due to deteriorated market conditions for high-risk securities, although continental Europeans have continued to use MBOs and MBIs as a way to establish positions in the U.K. market since that time.

Hostile Takeovers

Takeover attempts made directly to shareholders that are opposed by management are called "hostile" offers. In the early 1980s, when hostile offers again became highly visible in the United States and Britain, there was little ambiguity as to whether or not an offer was hostile. Management usually criticized the offer as disruptive and undervalued; those on the other side pointed to management failures that had depressed the value of the company's shares. Both in the United States and Britain, hostile offers were

fairly common; in a market dominated by independent financial institutions, such struggles for corporate control often are needed to decide conflicts that arise between a company's managers and its owners.

During the 1980s, however, defense measures evolved, and different ways to protect shareholders against undervalued offers emerged. It no longer was normal for management to complain about a bid it did not like; instead, management was sent looking for viable alternatives. One result was to obscure the difference between hostile and friendly offers. By the end of the 1980s, it became clear that a friendly offer was one that was immediately declared such by the target company, and all other offers were "unsolicited" or "nonfriendly" offers. Table 8-7 shows unsolicited or nonfriendly takeover offers as a percentage of all completed offers in the United States, the United Kingdom, and in the rest of Europe for 1985–2001.

Table 8-7 also shows the extensive use of unsolicited offers in Britain, where permitted defensive maneuvers are much more limited than in the United States, and a significant incidence of unsolicited offers in the rest of Europe. Only completed deals are included; a number of unsuccessful unsolicited offers—such as the attempt on Navigation-Mixte by Paribas (France) in 1989, Sandoz's effort to acquire Schering A.G. in 1990 (Switzerland and Germany, respectively)—and Pirelli's effort to take over Continental A.G. (Italy and Germany, respectively) in 1991–1992 are not included.

Before the 1980s, hostile offers were virtually unheard of in continental Europe, where concentrated holdings among insiders was the norm. This began to change during the 1980s, as institutional holdings increased, markets improved, and trading volume increased and as financial professionals from Britain and America became interested in the European scene. By the end of 1993, many highly visible hostile takeover attempts had been launched in France, Italy, Sweden, Germany, Denmark, Spain, Ireland, Portugal, and Switzerland. Such efforts included the attack on Société Génerale de Belgique by the Italian industrialist Carlo de Benedetti in 1987, various struggles for control of Montedison in Italy, the takeover of Feldmuhle-Nobel by the Flick brothers in Germany in 1989, the Nestle and Indosuez's joint effort to takeover Perrier, and Krupp's acquisition of Hoesch Steel. The effort by de Benedetti demonstrated that Belgium had far fewer legal barriers to takeover than had been assumed, and that the fact that the "right" people might own a corporation did not itself prevent takeovers.

After this and some of the other early European hostile deals by well-established companies, attitudes began to change: attention was paid to the actual performance of target companies and the management teams that led them, to the position of minority shareholders in change-of-control situations, to the rules affecting disclosure of share accumulations, and to the restrictions on voting shares acquired by unwelcome holders. In 1991 the Amsterdam Stock Exchange limited the number of barriers to hostile takeovers that Dutch companies had relied on for

Table 8-7 Unsolicited or Non-friendly Offers as a Percentage of All Completed U.S. and European M&A Transactions, 1985–2001: Number of Deals and Percentage of All Deals

	United States						United Kingdom							
			Cross Border[b]						Rest of Europe[d]					
	U.S. Domestic[a]		U.S. Buyer		U.S. Seller		U.K. Domestic[c]		U.K. Buyer		U.K. Seller		Rest of Europe[e]	
Year	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1985	385	22.3	10	5.9	24	11.2	12	14.6	1	14.3	2	18.2	13	12.1
1986	456	17.7	17	7.8	39	10.6	29	11.1	2	12.5	3	13.0	12	6.7
1987	691	25.0	21	7.1	70	15.8	57	9.2	3	5.7	6	15.0	30	8.2
1988	598	19.8	35	8.5	50	8.0	100	8.1	5	2.6	19	17.1	85	10.4
1989	833	20.9	47	7.6	79	9.3	415	27.2	11	4.4	36	23.1	119	8.9
1990	1010	24.0	27	4.3	52	6.1	252	20.5	6	2.8	27	15.3	134	7.9
1991	748	19.3	59	8.5	25	4.2	130	12.7	6	2.9	15	11.5	332	7.5
1992	600	14.1	54	7.3	33	7.0	75	8.0	4	2.2	11	10.4	332	8.0
1993	572	12.4	46	5.8	40	8.3	88	8.8	8	4.5	5	5.3	404	12.0
1994	746	14.4	61	6.9	56	10.1	88	8.0	7	3.6	5	6.3	407	13.2
1995	777	14.2	54	22.1	65	44.8	78	34.3	8	2.1	5	6.2	222	21.9
1996	1027	15.1	72	6.9	63	10.2	62	5.4	13	6.6	3	3.3	290	12.4
1997	519	7.2	40	3.7	48	6.9	51	3.5	13	5.3	3	2.9	185	9.4
1998	478	6.1	89	5.9	27	3.5	60	3.1	10	3.4	10	5.7	296	3.8
1999	302	4.2	98	6.7	31	3.2	73	3.3	19	5.0	22	8.5	879	11.5
2000	245	3.5	168	9.9	55	4.4	102	4.3	50	11.6	26	7.4	1593	16.8
2001	124	2.5	89	8.3	21	2.6	38	2.0	35	11.1	6	3.0	1,708	23.0
Average	595	14.3	58	7.8	42	9.8	101	10.8	12	5.9	10	10.1	414	11.4

Source: Thomson Financial Securities Data.

Note: Hostile offers are defined as those transactions in which the acquiring company proceeds with its offer against the wishes of the target companys management. Data include only completed transactions. Data are classified according to announcement date of a transaction, not taking into consideration when a transaction is completed. Percentage values denote the fraction of total deals that involves partial stakes.

[a]Completed hostile deals as a percentage of total deals of completed transactions in which the buyer and seller was a U.S. company.

[b]Completed hostile deals as a percentage of total deals of completed transactions in which the buyer or seller was a U.S. company and the counterpart is a non-U.S. company.

[c]Completed hostile deals as a percentage of total deals of completed transactions in which the buyer or seller was a company from the U.K.

[d]Completed hostile deals as a percentage of total deals of completed transactions in which the buyer or seller was a company from the U.K. and the counterpart is a continental European company.

[e]Completed hostile deals as a percentage of total deals of completed transactions in which the buyer or seller was a continental European company.

years, and in 1992 it issued a warning to 20 listed companies that had not complied. Later in 1992, the chief of Germany's leading fund management company, a subsidiary of the Deutsche Bank, called for a code of practice to permit and regulate contested takeovers in Germany. Similar actions have occurred in other parts of Europe. Hostile deals, though once shunned and thought of as out of step in Europe, have become quite familiar and accounted for 23% of all deals completed in Europe in 2001 outside the United Kingdom.

Converging Regulations

Since the Single Market Act and the various efforts at financial market reforms that have occurred in most of the principal European countries, attempts have been made by EU and member countries to devise a common set of takeover rules and procedures. In general, there are two approaches to choose from, but as yet no EU directive on takeover policy has emerged, as the approaches are quite different. One approach—the British model—involves a set of rules designed to protect minority shareholders from unfair transactions. This system depends on full disclosure and proceedings according to established rules. The other system—sometimes called the German model, though many other countries follow similar practices—protects the rights of major shareholders, such as banks and insurance companies, to act paternalistically and responsibly, though not always visibly, in the interest of all shareholders. Market forces are eroding the viability of the German model, but the Germans are still working toward a compromise between the two systems.

Regulations that affect takeovers are numerous. These include antitrust regulations, securities laws, or regulations relating to fraudulent practice, such as required disclosures, trading restrictions (such as insider trading), and prohibitions against making false markets. There are also rules, codes, and established procedures prescribed by stock exchanges or self-regulatory bodies that may or may not be supported by enforcement powers. These various tiers of regulation can be imposed at national and at the EU levels. Until a few years ago, they were vastly different from one another, creating a confusing and often uneven playing field for participants. Efforts have been made to harmonize regulations, but progress through the end of 2001 has been modest, though efforts continue.

Regulation at the EU level has so far been confined to the antitrust sector. There are two governing principles in effect: one, that of "subsidiarity" (a concept of EU governance that extends into all aspects of the common market), which provides that the EU will make no decision on issues that can equally well be decided nationally; the other, that of "compatibility with the common market," which restricts EU actions to matters affecting the whole of the EU only. The EU regulations that were passed in 1990 provide the following:

1. Only deals involving combined worldwide sale of €5 billion, or two or more companies with EC sales of €250 million, will be reviewed by the EC's "merger task force."
2. The merger task force must report within one month after announcement whether it believes the deal is compatible with the common market.
3. If it reports doubts, then it has four months to resolve them and either approve the deal, block it, or insist on modifications.

After 12 years of operation, the 100-person staff of the merger task force had reviewed more than 600 transactions but had blocked only a handful, and then on terms that allowed the transaction to continue if the companies involved sold off certain overlapping assets. After 1999, however, the European antitrust reviews became more extensive (especially for large, highly visible deals such as MCI–Sprint, Time Warner–AOL, and General Electric–Honeywell), and a number of major deals were affected by the European positions.

At the national levels, regulatory bodies like Britain's Mergers and Monopolies Commission and Germany's Cartel Office rule on deals below €5 billion in size and are required by national regulations to consider mainly national competitive effects. These bodies usually decide within a few weeks of an announced transaction whether they see a competition problem. If they do, a more extensive review, taking as long as six months, is undertaken before the deal can be completed. During this period the bid is usually withdrawn, but it may be reinstated after the review if the buyer decides to do so. In terms of securities laws, there are also considerable differences. Under the British system, all share accumulations above a threshold of 1% of outstanding shares have to be announced to the market; once a bidder accumulates 30% of the stock of the target, he or she is obligated to make an offer to all the rest of the shareholders at the same price. Once a bid is announced, certain time schedules must be adhered to. The intent is to create a "level playing field" on which neither bidder nor defender would have any kind of advantage over the other and the market could decide the outcome on a fair and unimpeded basis.

To referee the conduct on the playing field, the British system relies on the Takeover Panel, a nongovernment body staffed by professionals seconded by their firms and a small permanent staff. The panel has issued rules (the Takeover Code) that must be observed, previously only at penalty of sanction but now legally enforceable by the government. The panel has the power to rule on disputes as they occur, and its decision is binding. Lawsuits are only rarely involved. The process is generally regarded as flexible, timely, fair, and efficient. Although they are different in many details from takeover procedures in the United States, which rely mainly on court actions in the state of incorporation of the defending company, the basic principles and objectives are very similar. Moves to accommodate the Anglo-Saxon model have been made in France and a few other countries, and are the basis of the draft European Takeover Directive, which requires a statutory body to regulate mergers. The British, in particular, think this could be cumbersome.

Merger and Acquisition Services

The basic distinction among M&A services is whether the service is offered to the buyer of a company or to a seller, and especially in the case of the

latter, whether the sale is voluntary or involuntary. In each country local practices governing M&As differ considerably. For example, in the United States, legal considerations and tactics are of paramount importance; there is a wide range of maneuver open to both sides, and the pursuit and defense of companies can be quite aggressive. In most other countries, aggressive legal actions are much less common, and the room for tactical maneuvering is less, but still the quality of the advice received by the company attempting to capture or escape the other will have much to do with the outcome.

Seller Representation

When advising a seller—whether a victim of a raid, a corporation seeking to divest a subsidiary, or a family hoping to sell the inherited business to "nice people"—the role of the adviser starts with accepting the obligation to provide objective and experienced counsel and to assist the client in coping with the psychological trauma involved. There is almost always psychological trauma involved: buying and selling companies permits much room, which is almost always used, for emotional involvement and anxiety on the part of those directly affected by the outcome. Spending the time with a client to explain what lies ahead and what realistically can be expected often helps lessen trauma that might otherwise be experienced later in the transaction.

A seller's adviser will perform the following tasks in the course of the assignment:

1. Based on a thorough understanding of the company's business, a review of current market data and the banker's own experience, value the company and advise the client what the probable selling price range is.
2. Analyze a list of possible buyers, including all names of possible buyers furnished by the client and LBO investors, to determine the most likely buyers and the ability of each to obtain financing for the transaction.
3. Explain how these particular buyers would go about making an evaluation of the company and what the effect of the acquisition would be on the financial statements and stock price of each of them.
4. Prepare materials describing the company, based on information supplied by it, that emphasizes the points of value to a buyer but is also in all respects fair and objective.
5. Contact potential buyers at decision-making levels and serve from then on as the exclusive contact person for buyers.
6. Control the process of distributing information to prospective buyers and providing opportunities for such buyers to ask questions about the business and meet with management, and so on.
7. Construct a bidding process to create an auctionlike situation aimed

at getting the highest price for the seller (or to maximize any other factors that may be important to the seller).
8. Advise on the financing structure of the transaction to get the maximum advantage for both sides.
9. Ensure that all important nonfinancial terms are settled at an early stage, and see that post-agreement documentation flows smoothly.

This process is fairly straightforward. For larger-sized transactions, a number of international names will be included on the list of prospective buyers, which will be up to the banker to contact at the appropriate level. In all transactions, the banker's work is complemented by that of lawyers, accountants, tax experts, and other advisers selected by the seller.

Raid Defense

When defending a company against a raid, the banker, in addition to complying with all the regulatory and legal requirements of the country involved, must assist his client in evaluating quickly his or her own and the shareholders' alternatives. The principal lines of defense usually are that the raider has offered too low a price for the company or that the takeover would violate antitrust regulations and should be prohibited by the government. In the former, the defender must convince institutional shareholders that they would be better off backing existing management; in the latter, the case has to be made to regulatory authorities and the politicians who control them. Neither is easy. Once an opposed takeover effort has begun, it is very difficult to escape without either selling the company to someone (the raider, or a "white knight") or instead undergoing a substantial self-reorganization or recapitalization.

Over the years, defenders have learned that they receive a higher net price for their shares by playing hard to get. No one accepts a first or even a second unsolicited offer. Tactics are employed to maximize the public visibility of the transaction with the hope of attracting additional suitors. To persuade prospective buyers that they must increase their bid, the defender must be credible—with respect to its wish not to be acquired, and with respect to the viability of its alternatives. If the buyer senses a lack of credibility, it will not raise its bid further and, indeed, may even lower it.

Buyer Representation

Buyer assignments usually begin in one of three ways: the buyer has already identified a target and wishes an investment banker to assist in executing the transaction or in confirming the valuation placed on it; the investment banker brings an acquisition idea to a buyer and is retained to pursue it; or the buyer has only a general idea about what is wanted and hires a banker to search for suitable targets and to pursue any that are accepted by the buyer. Many bankers are willing, even eager, to conduct buyer

searches for their clients as a way to develop relationships with prospective clients. Frequently, however, these searches do not result in a completed transaction, and therefore they are considered low-probability assignments that well-established bankers may choose to reject.

Until recently, many international corporations did not fully understand how to use investment bankers and frequently did not act on their advice because they were not comfortable with it. Such corporations disliked the idea of a competitive auction process to acquire a particular target. They preferred direct, off-market, one-on-one negotiations; but the seller and its banker knew that more aggressive bidding would result from an auction. The inexperienced international buyer would often balk at these procedures or bid too low to win. Usually, however, when an international company has been through the process unsuccessfully once, it adapts and does much better the next time.

When representing a buyer, a banker will perform the following tasks:

1. Conduct a thorough review based on all publicly available information about the target and all of its subsidiaries. Advise as to the probable price range necessary to acquire the target, bearing in mind the advice that would be given to the target if the target had asked the banker to sell the company.
2. Advise as to the likelihood of the target's receptiveness to an invitation to enter into discussions aimed at a merger and on how the target will react when apprised of a client's interest, what it will consider to be its options, and what actions it is likely to take.
3. Prepare a list of probable white knights and an analysis of the pro forma effect on each of these companies of an acquisition of the target company, as well as an analysis of a self-tender or leveraged buyout transaction by the target.
4. Evaluate each of those options in detail. Play the role of the seller's adviser in the circumstances. Devise tactics accordingly.
5. Prepare recommendations on the financial structure of the transaction and how the buyer should best proceed to arrange financing for the transaction. Advise also on the probable reaction of the stock market and rating agencies to the buyer's purchase of the target company.
6. Advise on the initial approach to the target, the value to be suggested, and steps for following up.
7. Function as a continuous liaison between client and target, or target's bankers, looking for and heading off problems all the way to the closing.
8. Advise on the changing tactical situation and responses to communications from the target or other bidders.
9. Arrange for the purchase of shares through a tender offer.
10. Assist in arranging long-term financing for the transaction and in selling assets that are not to be retained.

There are other steps and functions that occur within these categories; however, much of what goes on in an acquisition situation is in response to moves undertaken by the other side. It is essential that good communications and mutual understanding exist between banker and client in order to be able to respond to the changing circumstances in the most timely and effective way.

Even companies that know the buyer well and might like to be acquired will nowadays still impose an auction process on a sale of the company to protect shareholders' interests. In this context, there are no longer any more friendly, easy deals. European and Japanese buyers of U.S. companies have had to adapt to a tougher, more abrasive environment when seeking acquisitions. Many, of course, have already done so and perhaps will apply their newfound toughness to future transactions in their home areas.

It is perhaps predictable that as M&A activity and tactics spread across the Atlantic and the English Channel, and perhaps someday across the Pacific, much of the rough and tumble of the U.S. market, with its heavy emphasis on aggressive legal maneuvering, will travel with it. The growing acceptability and effectiveness of hostile offers in Europe is an early indication that this is already happening.

Globalization of Financial Advisory Services

Few sources of revenue are more attractive to investment (and all other types of) bankers than merger and other high value-added fees. A loan involves a commitment of a bank's capital and offers the risk of nonrepayment. A bond or equity issue requires the bank's underwriting commitment and exposes it to market risk. A swap involves booking a contingent asset or liability. But advisory fees are earned exclusively as a result of putting the firm's skills and knowledge to work, not, as is increasingly the case in other parts of the international banking and securities business, as a result of committing the firm's capital. And the fees, commensurate with the added value of the service, are considerable. On transactions of several hundred millions of dollars, fees average around 1% of the purchase price.

Of course, it is natural to expect leading financial firms to be in the business of providing advice and executing transactions in their own countries on behalf of foreign companies. They are selected because they have the knowledge of local markets, practices, and personalities that will be required to complete the transaction. The same is true when an American company wishes to obtain advice in a foreign market. In Germany, for example, a U.S. company might seek the advice of a German bank to complete a transaction; it might also, retain a U.S. banker whose investment banking skills and international knowledge it respects to help the company interpret the advice of the German banker. The reverse is perhaps also true: when German companies seek U.S. advice, they may also retain a German bank to help understand it.

What is new in recent years, as a result of the globalization of financial markets and the spreading worldwide presence of major financial services firms, is the movement of international firms into the business of providing indigenous financial advice. An example is the growing involvement of U.S. investment banks in the intra-U.K. M&A business, long the exclusive preserve of British merchant banks.

There are several reasons U.S. firms became involved in this activity. As their London operations and their senior British staff expanded, so did their knowledge of the U.K. merger market and the companies involved, and the relationships they enjoyed with them. Many of these companies were ones that the U.S. firm had already done business with in the United States. Also, many U.S. firms began to become familiar with U.K. merger transactions as a result of purchasing stocks of U.K. companies subject to takeover bids—that is, participating in risk or merger and arbitrage—and, in following such companies in their research departments for the benefit of U.S. investor clients.

Perhaps most important, was the fact that, like capital markets, the merger business had become globalized. Networks and procedures now exist to enable buyers and sellers of companies to participate in a single marketplace for corporate control. And the agents and brokers who are capable of providing advice and guidance to their clients seeking to use the marketplace are the bankers with the infrastructure, the trained personnel, and the contacts with the worldwide corporate community.

For some years U.S. companies looking to be sold sought to include international companies in the bidding. Now the same thing is happening in Europe. For example, if a U.K. company is to be sold voluntarily, or otherwise is attempting to escape the unwelcome embrace of a U.K raider, it is common practice to look for alternatives in the United States and elsewhere in the world. These alternatives can include selling the company either to a white knight or to a group of investors seeking to buy the company as an LBO. To find an international LBO opportunity, or a white knight, one has to be able to access potential participants in the United States and the rest of the world quickly, efficiently, and confidentially. U.S. firms have this capability and, after a slow beginning, it has become fairly common to see U.S. investment banks working alongside, or in place of, British merchant banks in raid defenses in the United Kingdom and in seller representations in the rest of Europe.

Some U.S. firms also have become involved in giving advice to European companies acting as buyers of other European companies, so as to better be able to value companies for the global merger market and to respond to the evasive moves of their targets.

Table 8-8 shows league table rankings for international merger and acquisition activity for 2001. The high representation of U.S. firms, especially the investment banks, is evident from is table.

The experience of a number of U.S. firms in Europe and elsewhere has encouraged many others to embark on efforts to enter the indigenous busi-

Table 8-8 Worldwide Announced M&A, 2001: Credit to Target and Acquiring Advisers

Rank	Adviser	Ranking Value ($ Mil)	Market Share (%)	No. of Deals
1	Goldman Sachs & Co.	637,594.5	29.5	372
2	Morgan Stanley	560,918.5	25.9	359
3	Merrill Lynch & Co. Inc.	529,210.6	24.5	282
4	J.P. Morgan	474,317.9	21.9	436
5	Crédit Suisse First Boston	418,561.6	19.4	481
6	Citigroup/Salomon Smith Barney	306,231.5	14.2	349
7	UBS Warburg	294,999.1	13.6	261
8	Deutsche Bank AG	237,230.7	11.0	271
9	Lehman Brothers	196,770.4	9.1	164
10	Dresdner Kleinwort Wasserstein	127,693.2	5.9	98
11	Lazard	111,221.2	5.1	195
12	Rothschild	93,913.4	4.3	186
13	Bear Stearns & Co. Inc.	82,295.5	3.8	79
14	Quadrangle Group LLC	72,476.2	3.4	2
15	CIBC World Markets Inc	38,646.4	1.8	110
16	Greenhill & Co. LLC	37,306.3	1.7	18
17	BNP Paribas SA	36,875.3	1.7	111
18	Banc of America Securities LLC	36,625.9	1.7	80
19	RBC Capital Markets	32,167.6	1.5	76
20	Cazenove & Co.	29,891.0	1.4	30
21	ABN AMRO	29,529.9	1.4	157
22	Mizuho Financial Group	29,328.4	1.4	82
23	Société Générale	27,595.1	1.3	87
24	Sal Oppenheim Jr. & Cie KGaA	23,814.8	1.1	21
25	Gresham Partners	18,906.9	.9	13
Subtotal with Financial Adviser		1,746,511.6	80.7	6,327
Subtotal without Financial Adviser		416,715.0	19.3	26,893
Industry Total		2,163,226.6	100.0	33,220

Source: Thomson Financial Securities Data.

ness for merger and other financial advice in other countries. It takes several years to develop a strong franchise in a particular market, but the rewards appear suitable to many to undertake the effort to build up local capabilities. Not all markets are equally penetrable by foreigners, nor do mergers and related transactions—or those involving a comparable degree of financial sophistication—represent equally attractive opportunities in all countries. However, many observers believe that as Europe and Latin America experience greater amounts of corporate restructuring, a new and broader market will develop for financial advisory services of virtually all types. Ultimately, this phenomenon can be expected to spread to Japan, where it will undoubtedly change its shape somewhat to conform to unique Japanese cultural considerations that eschew outright takeover activity.

Thus, many new competitors have entered the field, including investment bankers who specialize in investing as principals in takeover or LBO situations, and small firms of specialized advisers. Commercial banks have

also set up M&A departments and developed special capabilities in leveraged and related transactions. All participants in the mergers business now have to recognize the considerable strategic implications resulting from the globalization of mergers, restructuring, and financial advisory services.

Mergers in the Financial Services Industry

Mergers and acquisition transactions within the financial services industry—that is, between and among banks, insurance companies, securities firms, and asset managers, and including partial ownership acquisitions—have been extraordinarily active since 1985. Indeed, nearly half by value of all global M&A transactions in the period 1985–2001 have involved this diverse, far-flung, and rapidly changing industry. In total, more than $9 trillion of financial services transaction took place during the 17-year period, involving banks, insurance companies, and securities firms (see table 8-9).

Among the transactions involving banks, insurance companies, and securities firms (all components of the modern universal bank), nearly half of all transactions involved commercial banks acquiring other commercial banks. Banking deals, together with insurance companies acquiring other insurance companies and securities firms acquiring other securities firms, accounted for 76% of all transactions during the period 1985–2001. Only 24% of the deal flow involved acquisitions of different types of businesses.

Drivers of Change

Before 1985, both the United States and Europe were surely overbanked, with about 15,000 banks in the United States and approximately 10,000 in Europe. Both environments had long believed that banks were special entities and had to be not only regulated, but also protected to ensure their solvency. The protection mainly ran to restrictions on competition from banks in other parts of the continental scene and from nonbanking enterprises. Efficiency, which could result in lower cost services to the banks' customers, was of less concern than were stability and solvency. To doubly ensure that this would be so, some countries, especially France and Italy, cloaked the major banks in government-controlled ownership. In effect all banks were public utilities. To a somewhat lesser degree, so were the insurance companies.

All of this began to change during the 1980s, a sad decade for banks in which most experienced huge losses from mismatched assets and liabilities and from nonperforming domestic and international loans, many of which were made in a careless manner. Banks in the United States and in Europe had to undergo a long period of internal restructuring in order to emerge in the early 1990s as significant competitors again. During the re-

Table 8-9 Completed Global M&A Transactions, 1985–2001 ($ billions—thousands of transactions)

	1985				2001				17 years 1985–2001			
	$ Value	%	No.	%	$ Value	%	No.	%	$ Value	%	No.	%
U.S. Domestic												
All industries	193	82.5	0.9	59.3	464.0	34.8	5.2	24.1	8,206.6	45.4	93.9	36.0
All financial services	47.9	82.3	0.7	77.7	261.0	31.3	2.4	22.6	4,173.5	44.0	46.2	36.2
U.S. Cross-Border												
All industries	15.7	6.8	0.3	21.7	200.4	15.0	2.0	9.3	2,268.0	12.6	26.8	10.3
All financial services	6.3	10.8	0.3	8.6	99.9	12.0	0.5	4.7	711.2	7.5	8.6	6.7
Non-U.S.												
All industries	24.8	10.7	0.3	19.0	669.9	50.2	14.4	66.7	7,591.7	42.0	140.0	53.7
All financial services	4.0	6.9	0.1	8.6	472.4	56.7	7.7	72.6	4,609.4	48.6	72.9	57.1
Total												
All industries	233.0	100.0	1.5	100.0	1,334.3	100.0	21.6	100.0	18,066.3	100.0	260.7	100.0
All financial services	58.2	100.0	0.9	100.0	833.3	100.0	10.6	100.0	9,494.1	100.0	127.7	100.0

Data: Thomson Financial Securities Data, Author calculations.

covery period, many weak banks were merged into stronger ones, for which protective barriers had to be set aside. Banks changed management and business strategies, cut costs, and "downsized" significantly. New management teams began to look at their strategic destiny differently: no longer would banks attempt to offer all their services all over the world; instead, they would cut back on less-promising products and services and begin to concentrate on their basic businesses, offering retail services in their home region.

Some banks in Europe preferred to combine with other large banks in their own countries to present a more formidable presence there. Surely they were influenced by both the EU's Second Banking Directive, which permits banks to operate anywhere in Europe, and by the Basel Agreement, which provided for new rules on bank capital adequacy to which all European governments, the United States, and Japan had subscribed. This agreement required all banks to have the same minimum amount of capital to ensure their financial stability, making it possible for competition between them to shift to the quality and cost of their services. Banks believed they had to be bigger to withstand competitive assaults from other banks in their home markets and to be able to launch successful competitive attacks of their own into their neighbors' markets. As a result, a process of substantial consolidation within European countries began in France, Italy, Spain, Holland, and Switzerland and in Scandinavia. Some of the most important of these consolidations occurring since 1995 include BNP and both Société Génerale and Banque Paribas ($37 billion), UBS and Swiss Bank Corp. ($23 billion in value), Lloyds Bank and Trustee Savings Bank ($15.5 billion), Banco Santander and Banco Central Hispano ($11.6 billion), Unicredito and Credito Italiano ($11 billion), and Bayerische Vereinsbank and Bayerische Hypo bank ($7 billion).

Restructuring

But mergers into bigger players was not all. Restructuring of basic businesses became the next major theme. This involved reorganizing branch networks, closing marginal ones, and upgrading the services offered; shifting the mix of businesses, mainly to favor consumer loans and credit cards; and restructuring the wholesale and investment banking businesses to become more competitive with independent, integrated securities firms. They also began to look for more ways to effect expense controls, to increase fee businesses, and to enter nonbanking businesses such as insurance and asset management. Larger banks acquiring smaller enterprises, and attempting to lower costs and streamline products and services, have affected some of the latter activities. Crédit Suisse has been actively restructuring itself with acquisitions of (the minority interest) Crédit Suisse First Boston, Volksbank, Winterthur insurance, and Donaldson, Lufkin & Jenrette. Swiss Bank Corp., its cross-town rival, has also been active in changing its business through major acquisitions of O'Connor Group (derivatives), S. G.

Warburg, Brinson Partners (institutional asset mangers), Dillon Read, and most significantly by engineering a merger with (and control of) a weakened Union Bank of Switzerland. It has since then also acquired with Paine Webber in the United States. Other banks have put forward more cautious programs for expanding into new skill areas through mergers. ABN Amro and ING (both created from large mergers in Holland), Société Génerale, and Dresdner Bank acquired securities firms, all of which were cross-border transactions.

Other firms have attempted to effect their restructuring through dispositions of businesses, rather than acquisitions. Crédit Lyonnais, after several years pursuing an unsuccessful policy of acquiring banks and industrial companies to make itself into a *banque* industrial, has, under new management, tried to unwind some of these transactions by selling them off. The big Germans—Deutsche, Dresdner, and Allianz—frequently describe the reduction of their industrial holdings as long-term policy. In 1997, both of the largest British banks, Barclays and National Westminster, divested most of their investment banking and brokerage businesses, having failed to make an adequate return in them over the preceding decade.

Cross-Border Banking

Part of many banks thoughts of restructuring have included developing exposure in other non-European markets. After a number of years of struggling with difficult acquisitions in the United States, a number of European banks decided to withdraw and sold their U.S. businesses. Others, of course, took a different approach. UBS acquired the American investment banks Dillon Read and Paine Webber; after attempting for a long time to build its own investment banking in the U.S., Deutsche Bank acquired Bankers Trust in 1999 for $10 billion. In another sector, retail and private banking, HSBC Holdings (which already owned Marine Midland bank in the United States), acquired Republic New York Corp. and its affiliates from financier Edmund Safra for $10 billion. Hong Kong & Shanghai Banking Corp. also acquired a 70% interest in a distressed Seoul Bank and invested over $1 billion in Latin American banking paper in 1997 when such paper was very inexpensive.

Insurance Too

Because of the positive effects of the restructuring efforts among banks in Europe, the once-sleepy insurance industry has also begun to reshape itself, fearing perhaps the competitive powers of banks to enter their businesses. The industry also appears to be taking shareholder value seriously and has commenced a series of major reorganizations.

Germany's Allianz is the largest insurance company in Europe. Its returns on equity have been improving as a result of a large internal restruc-

turing effort and by intra-European expansion. In early 1998, it acquired France's third largest insurer, Assurances Generales de France, after defeating a hostile takeover effort by Italy's Assicurazioni Generale. In 2001, Allianz acquired Dresdner Bank. The second largest insurance company is AXA-UAP, a French group that recently combined and that owns a controlling interest in the Equitable Group in New York (which, in turn, controls the money manager Alliance Capital). AXA also announced a $5.6 billion acquisition of Guardian Royal Exchange in January 1999.

Third largest is the Zurich Group, which acquired BAT Group's insurance interests (Eagle Star in the United Kingdom, and Farmers Group in the United States) in 1998, creating a $35 billion market-capitalization company. Before that deal Zurich had acquired two big American money managers, Kemper and Scudder, Stevens and Clark, and Threadneedle Asset Management in London.

European insurance industry mergers have also occurred within less powerful groups and in other countries. In the United Kingdom, Commercial Union merged with General Accident ($22.5 billion) and Royal Insurance merged with Sun Alliance. There were also acquisitions by AEGON of Transamerica ($10 billion) and Providan ($3 billion). Also important were acquisitions of insurance companies by banks (Winterthur by Credit Suisse, $10 billion) and of banks by insurers (Generale de Banque by Fortis, $14 billion; Banque Bruxelles Lambert by ING, $5 billion). Though not involving European insurance companies per se, the $140 billion merger of Travelers Group with Citicorp in 1998 created a banking–insurance brokerage colossus that would affect all parts of the industry.

Competing in International Financial Advisory Services

The market for international advisory services, because of its globalized characteristics, has been increasingly indistinguishable from financial advisory services conducted in the United States and the United Kingdom. Competing successfully in this market has more to do with basic competence in financial advisory work than it does with its international overlay, but at the same time, without international capabilities, even a firm with a strong reputation in the field may lose business to those operating on a global basis.

This would be the point of view of an American investment bank that is active in the M&A business. For such a firm, cross-border transactions are not separated from those that occur in the United States, and the distinction between "domestic" and "international" mergers has faded. The U.S. firm, however, would view the offering of merger advisory services to the indigenous market in, say, Australia as a separate international business.

A German bank, in contrast, having had little opportunity to participate in the part of the worldwide M&A activity that involves German

companies, might look at domestic and international mergers differently from the American firm. So would the Japanese banker, for whom international mergers are rare indeed, but domestic ones are even rarer.

This does not mean that only U.S. and British firms will be able to compete in the international merger advisory business of the future, but they do have the advantage of being firmly in place at the game's beginning. Some European banks, such as BNP-Paribas and UBS-Warburg, for example, have a long history of merger-related activity. Those other continental European and Japanese firms who want to become involved will find various ways to do so. They can acquire firms with an existing franchise in the merger field, as the Deutsche Bank did through the purchase of Morgan Grenfell & Co., a prominent U.K. merger house. Or, they can create a jointly owned international firm, such as CS First Boston, that can operate somewhat independently from its parents in the more free-wheeling markets in London and New York. Or they can hire experienced professionals to conduct the mergers business for them. Perhaps renowned merger "stars," like those leaving U.S. investment banks to set out on their own, will be induced to align themselves with Daiwa Securities, or ABN-Amro Bank, or Banco di Roma. Several have already lined up with other large international firms. European houses have set up shop in the United States before, with their eyes on the high value-added investment banking business. Lazard Fréres formed a French–British–American partnership around 1900 that is today a specialized, extremely potent firm in the M&A business. The European Rothschild firms have a U.S. affiliate, Rothschild, Inc., that has been quite active in representing European firms seeking to buy companies in the United States

Developing a Strategy

To compete in the top bracket of the world M&A market, however, requires of every participant that it develop a strategy for the business that is consistent with the rest of the firm's business and is one that the firm can gain strong support for throughout its organization. A prospective entrant—be it a domestic commercial bank, a foreign bank, or an investment bank not in the business—must address three fundamental issues:

1. Mergers and acquisitions are essentially an aggressive and highly visible if not controversial activity. Can the rest of the firm's business, which may depend heavily on close, long-standing client relationships, survive the transition? Will clients draw back from the relationship if they fear that the firm might align itself with another client planning an unwelcome approach?
2. Costs, both out-of-pocket and contingent, are considerable. Is the firm prepared to pay the cost of fielding a world-class team of merger specialists, which requires both highly paid executives and a sizeable support staff and, increasingly, expensive international fa-

cilities? Is it prepared for the next step, too: to take equity and junk bond positions in client transactions for its own account? Is the firm prepared to accept the consequences of failure and exposure to considerable litigation?

3. Is the firm prepared to grant the autonomy to the M&A team that it needs to act quickly and aggressively and to allow it a kind of relationship priority with chief executives and other top executives of client companies?

Many players will feel the future rewards are worth the trouble and the money. Others will try to find a niche that does not require such a heavy commitment. Perhaps they can avoid unfriendly deals or focus on helping clients with smaller, domestic transactions. Other banks will find the unexpected problems of the M&A business to be significant, and they may lose enthusiasm for being in the forefront.

Commercial banking is essentially a relationship business in most of the world in which loyalty is expected and rewarded. Banks as lenders have loan portfolios to maintain and to do so requires them to maintain credit information about their clients, some of which is highly confidential. Banks must guard carefully against breeches of the "Chinese Wall," which separates information retained in one part of the bank from being used by another, and from developing conflicts of interest, which can occur when one client wants to acquire another who does not wish to be acquired. Commercial banks, and perhaps some European Universal Banks, may also discover that their particular comparative advantages in the global competition for financial services—a large capital base and a large, client service organization—are not necessarily helpful in the area of merger related services. Capital is not important in an advisory business, and their large sales organizations may not, in fact, have good access to chief executives.

Many banks will decide that they are better off in the business of lending to their clients, especially when they need acquisition financing, than in competing in a business they may not be especially good at or have the stomach for. Other banks will disagree, feeling that the future of wholesale banking is unattractive and that they must develop competence in the merger and acquisition field, with its many related transactions, in order to retain a prominent position in domestic and international financial services of the 2000s and beyond. Such banks obviously look at mergers and related services as part of a general restructuring of the banking industry.

Dangers and Pitfalls

A strategy that is well tailored to the bank's own circumstances and effective and credible execution capability and a well-coordinated marketing effort will surely produce results in time. There are many things that can go wrong, however, and many will. Top management must be prepared to stand by the commitment to be in the advisory business despite setbacks

and occasional embarrassments. This is often easier said than done. Some of the difficulties that must be faced are the following.

Autonomy versus Control. The firm must find the balance between freedom for well-informed professionals to peruse transactions aggressively and having reliable assurance that the system is under control—that the young tigers are not overlooking important legal, regulatory, and ethical issues in their quest for success.

Not Controlling the Client. Clients like things to be done their way, but often clients are wrong, stubborn, or misinformed. Under such circumstances they must be controllable; that is, the adviser must be able to get the client to sit down and understand the issues correctly and at least behave legally. An uncontrollable client at the very minimum can be embarrassing or can tie the firm to an unpromising player in the game, perhaps at the cost of having to refuse another. At worst, such a client can get the firm involved in serious trouble or ugly litigation and can gravely risk its reputation.

Fee Cutting. In a free market, fees are there to be cut. If cutting them makes it easier to land an assignment, then they tend to get cut. The newcomer must realize the reason that merger fees have remained where they are for so long is that they are, in the end, reflective of value (or the expectation of such value) created by the efforts of the adviser for the client. The major clients know this, or in due course are persuaded of it. Cut-rate surgeons, lawyers, or financial advisers are not always looked upon as the most valuable or reliable. Banks seeking to gain entry to the mergers business will invest heavily in the capability to participate in it. Markets of the future are not predictable, and merger activity may, as during the period 1989–1992, again decline sharply. Fee cutting to get into the game may be difficult to reverse once it is established and, in any case, may remove some of the economic incentive for entering the business in the first place.

Internal Discord. There are many opportunities for internal discord within a firm that is active in providing merger and related high value-added services. Elite corps of young aggressive professionals with insufficient regard for their seniors are a constant problem, especially when they are earning salaries and bonuses that are multiples of the seniors'. The merger team's need for immediate (and often exclusive) access to client chief executives, and its need for restricting information to a need-to-know basis, can be highly irritating to conventional colleagues. Ordinary bankers can become frustrated by their inability to reach members of the merger squad or have them attend meetings with other clients. These complaints are balanced by those of the advisory group that the ordinary bankers in the firm are excessively conventional, stodgy, bureaucratic, and overly conservative in terms of new clients to take on and transactions to do for them. The only

resolution of difficulties like these is good leadership of the unit by experienced, mature professionals respected by both sides of the house, along with a firm-wide understanding and acceptance of what they are trying to do.

Summary

For U.S. and U.K. investment banks, providing international advisory services has been a natural extension of providing the same services domestically. Increasingly today, whether the client is a buyer, a reluctant seller, or a willing target, tapping the international market for better terms than can be accessed domestically is often advisable and sometimes imperative. Banks with a strong local M&A team and an international presence—primarily U.S. investment houses—have been well positioned to take advantage of this aspect of globalization.

To some extent, the European and the Japanese environments have lacked the freely accessed capital markets and strict legal framework that have fostered the U.S. and U.K. M&A business. As globalization continues, however, a convergence of market conditions for M&As will occur. The evolving environment will have more of the transparent Anglo-Saxon characteristics than the continental European or Japanese.

As an activity generating substantial fees but requiring no direct commitment of the bank's capital, M&A and related advisory work has proved to be an irresistible attraction to many. Newcomers should be warned, however: M&A activities may not coexist easily with relationship banking in the same firm. Managing the M&A department is highly challenging. One must control the customer without alienating him and control the team without stifling it. One must maintain the delivery networks and the firm's image, knowing which deals to pursue and how to pursue them and which to decline. All demand skills specific to the M&A business are increasingly projected into an international dimension.

9

Privatization

Privatization has become a key dimension of the world capital markets over the past two decades, and Europe has been the global leader in transferring state-owned assets in both manufacturing and services industries to the private sector. In part, this is because the state has historically taken a major direct role in the economy of most of the European countries, rooted in the great depression of the 1930s and World War II. The depression shifted businesses to state ownership or control, as failing enterprises were taken over by governments or by banks which later came under government control. For example, the war left the German government with large legacy stakes in the economy—at both the federal and state levels—in companies like Lufthansa and Volkswagen, while substantially all of eastern European enterprise ended up in state hands. Elsewhere, strong socialist tendencies in the United Kingdom, *dirigiste* policies in France, and some of both in Italy and other European countries increased still further the degree of state participation in the economy from the late 1940s until well into the 1970s. Perhaps the last major expansion of state control in Europe was the nationalization of the banks in France at the outset of the Mitterrand administration in 1981. By that time the pendulum had already begun to swing in the other direction.

By the early 1980s the state accounted directly and indirectly for perhaps half of the GDP in the European economies. Direct government involvement in commercial activities was substantial in many of them, so that governments owned large amounts of assets that could potentially be sold as privatization began to take hold a global phenomenon. As a result of these privatizations, the share of state-owned enterprises (SOEs) in the GDP of the OECD countries declined from about 10% in the mid-1970s to about 7% in the late 1980s and perhaps 5% at the end of the 1990s. In all, governments raised almost $800 billion by direct sales and public share offerings in the two decades from 1977 to 2000. In the OECD coun-

tries during the 1990s, primary and secondary privatization share offerings accounted for over 55% of all equity offerings in Europe. And in countries like Italy and Spain they account for over 70% of stock market capitalization by 2000.

The Great Debate

There has always been a lively debate in Europe and elsewhere about the kinds of activities that properly belong in the public sector and the private sector. With the organization of economies by means of central planning and command structures increasingly discredited—and assessments of its cumulative damage surpassing even the expectations of the most vociferous critics—one long-standing model of economic organization progressively lost its appeal. Countries that followed it (voluntarily or not) searched for alternatives. "Market orientation" became the key, but itself encompassed a broad array of more or less subtle historical and contemporary gradations. It is arguable that the role the market played in such economic renaissance "success stories" as West Germany and Japan in the 1940s and 1950s, South Korea and Singapore in the 1960s and 1970s, Hong Kong and Chile in the 1980s, and perhaps Mexico and China in the 1990s is more distinguished by differences than similarities. And in eastern Europe of the 1990s, the search for appropriate systems progressed under conditions of crisis and chaos rarely imposed on the general public.

Some 200 years after his death, Adam Smith's ideas in the 1970s and 1980s began to dominate the debate on the proper organization of economic activity more strongly than ever. The "invisible hand" guides people, seeking to improve their own well-being, in pursuing their interests in such a way that it produces the greatest good for the greatest number by allocating labor, capital, and intellectual and natural resources in the most efficient possible manner. Smith predicated his positions on the idea of free markets and perfect competition, in which many relatively small players interact, with none sufficiently powerful to affect prices and competition. He was silent as to who would regulate competition, and how, so as to achieve this ideal competitive condition. The interaction of the market would provide for individual success and failure: the winners would indeed win, and the losers lose. However eagerly one wanted to be a winner, fear of being a loser would affect economic behavior. The aim was to have an economic system with a level playing field that would optimize results for society, thereby maximizing economic welfare, growth, and opportunity.

The world Smith and his disciples such as Walter Bagehot, Alfred Marshall, Joseph Schumpeter, Friedrich Hayek, Milton Friedman, and Ayn Rand described became increasingly compelling, repeatedly beating back challenges from alternative visions of society, ranging from the Fabian socialists of the nineteenth century to the Fascists and Marxists in the twentieth century. Even milder forms of government planning and control, such

as French intervention in the private sector and the much-touted Swedish welfare state, eventually lost much of their appeal or began to sink under their own weight. Challenger after challenger rose, only to be discarded into time's trash bin of unworkable ideas.

Perhaps there was a lesson here, having to do with human nature. The free market that Adam Smith described seemed to be the one form of economic organization that most closely aligned with what people really do perceive as being in their own interests. Even when an alternative system was imposed for a very long time, as Marxism-Leninism was over a good part of the world for well over half a century, the invisible hand creeps in again through black markets, mini-capitalism, work-minimizing behavior and a host of other ways now thoroughly familiar in the history of Soviet-style command economies. All the excitement surrounding the "transformation economies" of eastern Europe and the "emerging markets" of Latin America and Asia really involved little more than the invisible hand being allowed more room to apply its touch. Even the most modern writers on business affairs—running the gamut from "new" models of competitive advantage of companies and countries and "new" trade theory, to the "new" ideas of core competencies of corporations—usually end up on closer examination to be little more than old wine in new bottles: essentially, vintage Adam Smith repackaged and retailed to a broader public market.

If the invisible hand so dominates the landscape of economic ideas, then government intervention should be calibrated against its market impact in the cold light of how people are most likely to respond, not according to some social thinker's ideas about how they *ought to* respond. Any such intervention needs to be tested as to whether it is effective in making the market work more efficiently or, if it is not (which is usually the case), whether it works *with* market incentives or against them and, ultimately, whether the social gains achieved by the intervention outweigh the loss in market efficiency.

Where free markets have been permitted, they have left powerful performance benchmarks behind, and recent history certainly suggests that policies that deviate too far from them are doomed to eventual failure. Indeed some have argued that what is good for free-market capitalism is ultimately good for society—indeed, that every other system which has been tried has fared less well. Still, even the most free-market-oriented countries have chains of social and economic policies that constrain excessively aggressive market behavior. In this sense, the *political* process, democratic or otherwise, invariably comes up with ways of guiding the *economic* process in the direction of results that depart (sometimes significantly) from what would happen under totally free market conditions. The need for such forms of government guidance is to be found in the failure of market mechanisms to produce socially acceptable results.

That the notion of state-owned enterprises as a viable tool of government intervention increasingly appeared to be a relic of the failed economic

models of the past—and a bad fit with the growing dominance of free-market thinking—is hardly surprising. And the debate focused even in the early postwar years on what kinds of activities should properly fall into the government domain continues to this day. Increasingly, private ownership became the "default" solution, albeit sometimes with a significant degree of government regulation. SOEs had to justify their existence based on a lack of socially superior alternatives, a position that became increasingly untenable across a broad spectrum of economic activities.

What kinds of activities properly belong in the public sector? The concept of "public goods" helps provide some guidance. There are certain things the free market is not good at providing—those whose value is hard to identify and to allocate among beneficiaries in rough proportion to the benefits received, even as others (as free-riders) are able to enjoy them without sharing in their cost. National defense, public parks, survival of endangered species, and public safety are possible examples. Others, ranging from public schools and hospitals to airports, highways, and postal services, are arguable. Vigorous discussion has developed in many countries about the efficacy of market-based solutions to such problems as environmental pollution and maintenance of fisheries—solutions that are "incentive-compatible" and vest resource-users with ownership rights that make it clearly in their own interests to manage that resource on a sustainable basis. So even though the market demonstrates some weaknesses when costs and benefits cannot easily be allocated, it can nevertheless be used to provide cost-effective solutions for social problems involving public goods. On the whole, however, "public goods" provide a durable rationale for government intervention to allocate costs and benefits of shared resources effectively. But only, of course, to a point beyond which economic efficiency will suffer unacceptably.

A related issue involved industries where there are "natural monopolies," such as water supply, where privatization could lead to abuse of monopoly power. Proponents of privatization argue that watchful and vigorous government regulation can do this job equally well, so that privatization can harvest the benefits of improved efficiency without incurring the costs of monopolization.

As thinking on public goods and natural monopolies evolved alongside the more general thrust toward market-based solutions to problems of resource allocation and economic growth, together with the catalytic effects of technological change, the line between public and private ownership has shifted toward the latter—sometimes at dramatic speed.

Historically, SOEs have been particularly prominent in banking, telecommunications, postal services, electric and gas utilities, airlines, railroads, defense-related manufacturing, banking, and certain "strategic" industries such as coal and steel. In many cases, private-sector activity has existed alongside SOEs for extended periods of time, and even after SOEs have been transferred to the private sector the government may continue to hold an equity stake.

First on the list for transfer from the public to the private sector may be primary and manufacturing activities in industries such as mining, agribusiness, automobiles, steel, pharmaceuticals, and the like. Next are commercial services such as airlines, broadcasting, trucking, and other forms of public transport, as well as financial services. Then come parts of the economic infrastructure such as electric power, water and sewage systems, telecommunications, rail lines, highways, tunnels and bridges, and airports and air traffic control systems. And there is the "social infrastructure," comprising such often controversial elements as hospitals and schools, security services, and even the criminal justice system. The consensus has emerged that the state ought to be confined to a limited range of "core" economic activities that have strong public good or natural monopoly characteristics, although the prevalence of wide variations in thinking on these issues among countries and over time is not very surprising.

Why Privatize?

With the philosophical and political debate on the allocation of economic functions between the private and government sector providing the context, the arguments for privatization are clear:

- To raise revenue for the state through privatization proceeds or to stanch the fiscal drain arising from direct and indirect subsidies of inefficient SOEs. This "fiscal" objective of privatization may be politically controversial, since the government gives up a potential stream of earnings from privatized SOEs for current sale proceeds, but gains from the presumed relief from having to give future subsidies. On a present-value basis, which is larger can be the subject of lively debate. The fiscal arguments are given additional weight in the European context by a strong antisubsidy stance taken by EU competition authorities in industries like air transport and banking.
- To promote economic efficiency in the internal operations of the affected enterprises. The poor performance of many SOEs has been widely documented in studies comparing their cost and efficiency levels with private-sector companies in the 1970s and early 1980s, and later confirmed in studies of pre- and post-privatization performance differentials. The potential for substantial efficiency gains through privatization is no longer a contested notion.
- To reduce government interference and politically based distortions in the economy and, with it, reduce the potential for corruption, cronyism, and perverse effects on income distribution.
- To encourage competition and market-based discipline in the affected industries, particularly when those industries are themselves becoming global in nature.
- To encourage wide share ownership among the general population, both

directly and though retirement accounts and mutual funds, and thereby develop a broad and deep financial market that will serve as an efficient and dynamic allocator of capital. Liquid capital markets and performance-driven institutional asset managers, in turn, help ensure effective corporate governance and management attention to shareholder value.

- To respond effectively to globalization of industries and international consolidation which includes cross-border M&A activity and various types of joint ventures and strategic alliances in industries such as telecommunications and air transport. Arguably, privatization is necessary to fully develop effective business strategies in dynamic sectors of the global economy.

Various studies have shown that managers of SOEs have little incentive to improve quality and service or cut costs or innovate, so that only in rare cases when such considerations are unimportant does public ownership involve relatively low social costs. Moreover, politicians use SOEs to reward political supporters through mispricing of products, investments in low net present value projects, cross-subsidization, overstaffing, suboptimum plant location, and the like. So privatization almost invariably creates significant gains in performance. Nor are alternatives to privatization such as reduced subsidies and deregulation an effective substitute to the kinds of performance improvements that can be obtained through private ownership.

Empirical studies of privatization show how significant performance improvements attributable to privatization can be. A survey of 15 such studies covering several thousand privatizations in over 50 countries concludes that performance of SOE's compares poorly with comparable private-sector firms and improves dramatically after privatization in terms of efficiency and profitability, as well as increased capital spending and reduced leverage. And even where employment has been reduced, there is a disproportionate improvement in labor performance and (arguably) an increase in employment opportunities in other sectors of the economy.[1]

Privatization activity tends to have different phases, depending on the industry involved. SOEs already operating in what are competitive commercial markets tend to be sold early. Public utilities and telecoms privatizations tend to occur somewhat later and sometimes require substantial restructuring prior to sale, as well as putting in place a viable regulatory framework to govern critical infrastructure activities newly allocated to the private sector. By far the greatest volume of privatization is in telecommunications, where dramatic technological change and industry globalization have dramatically amplified the conventional arguments for privatization.

Privatization can assume disproportionate importance in the banking sector due to its central role in capital allocation and the payments mechanism, as well as in monitoring and governance of nonfinancial enterprises. In many countries, state-controlled banks have exerted a strong influence

over nonfinancial businesses through credit rationing and non-arm's-length lending. Indeed, in some countries, control of banks has been vested in borrowing enterprises. In the absence of strong prudential regulation and adequate credit analysis, this is often a recipe for disaster. Privatization share sales to the public in the presence of major institutional investors such as pension funds and mutual funds, in contrast, tends to encourage the shift from a governance system based on large, stable shareholdings to one based on portfolio fluidity and emphasis on shareholder value.

Patterns of Privatization in Industrial Countries

The global privatization deal flow can be divided into three activity zones:

1. Privatization in the countries that are members of the Organization for Economic Cooperation and Development (OECD)—that is, the developed market-economy countries of Europe, North America, Japan, Australia, and New Zealand—with the later addition of Turkey, Mexico, Korea, Poland, the Czech Republic, and Hungary;
2. Privatization in countries of eastern Europe and Asia undergoing the transition to market-based systems (including those joining the OECD and applying for EU membership);
3. Privatization in non-OECD developing countries.

Much attention has been focused on privatization in the transition economies because privatization was key to a successful launch of a market-based economic system, and on the emerging market countries because privatization promised important gains in the efficiency of resource allocation and the rate of economic growth. Indeed, during the late 1980s there was far more dramatic privatization in emerging market countries than in OECD countries, usually promoted by the International Monetary Fund and the World Bank as being central to successful economic stabilization and development and the requisite degree of economic discipline. And in the early 1990s all eyes were on eastern Europe, where efforts ranged from successful mass privatizations in Poland and East Germany to botched efforts in Russia that were marked by corruption, manipulation, and failure to carry out accompanying legal, regulatory, and fiscal reforms.

As Figure 9-1 shows, during the period 1990–1998 the bulk of this activity, as measured by privatization proceeds to the government, occurred in the OECD countries—$485 billion out of a global total of $698 billion (69%)—although this is lower than the OECD share of combined global GDP. The EU accounted for $301 billion in privatization proceeds during this period. Overall, global privatization reached a peak of $153.8 billion in 1997 and declined thereafter, mainly because of the financial crisis in Asia and in emerging markets generally.

Historically, European privatization after World War II began in Ger-

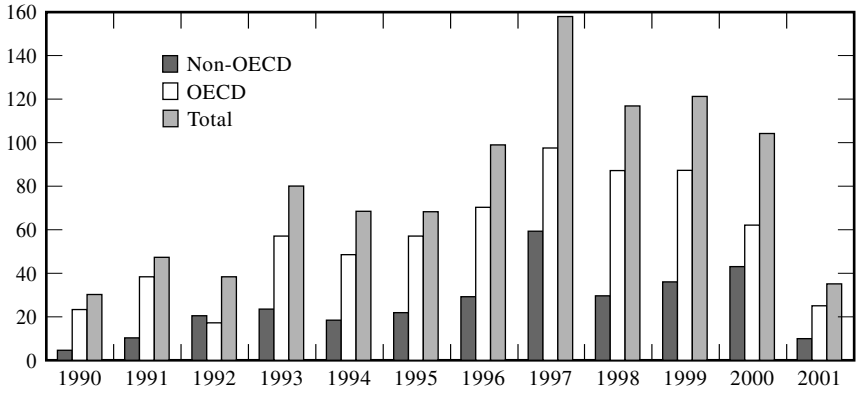

Figure 9-1. Global amounts raised from privatization (US$ billion). (Sources: OECD based on national statistics, World Bank, UBS Warburg, and *International Financing Review,* from 1997).

many under the Konrad Adenauer government, with the 1961 sale of the state's majority stake in Volkswagen AG to the general public. Placement of shares with small investors was emphasized. This was followed in 1965 with sale of electric power supplier VEBA which evolved into the present EON. In both cases, subsequent poor performance of the German stock market soured the general public on equities, and the government was forced into shareholder bailouts.

It was almost 20 years after the first German efforts that the first massive privatization program was launched by the government of Margaret Thatcher in Britain, and this had far-reaching effects on redefining the appropriate role of the state in economic activities in Europe and beyond. The first transaction was British Telecom in 1984, a highly successful public offering, followed by massive privatizations of British Airways; British Petroleum; British Airports Authority (BAA); British Rail, Cable and Wireless; and British Aerospace. All involved share sales to institutional and retail shareholders in the United Kingdom and abroad and reduced the proportion of SOEs in the U.K. economy from over 10% of the GDP in 1978 to virtually zero when the Conservatives left office in 1997. Just about all of the privatized firms became highly efficient and vibrant domestic and often global competitors in their respective sectors of economic activity. Privatization undoubtedly played a key role in transforming the British economy from the perennial butt of jokes in the 1970s to arguably the most dynamic in Europe at the end of the 1990s. A broad political consensus had been reached in the United Kingdom, with Labour shifting its position from bitter opposition to privatization and threats of renationalizations in the early days of the Thatcher initiative to strong support of what had been achieved by the time Tony Blair took office.

France embarked on an ambitious program of privatization under the

government of Prime Minister Jacques Chirac in 1986, which privatized 22 companies worth $12 billion in the following two years, a process that was halted (but not reversed) by the socialists in 1988. Privatization was resumed by the Edouard Balladur government in 1993 and continued under the Lionel Jospin government, often with spectacular successes such as the $7.1 billion France Telecom IPO in 1997. French privatization averaged over $7 billion annually during 1994–1998, almost twice the volume that took place in Germany during this period.

Spain, Portugal, and Italy undertook sizeable privatizations in the late 1990s. The Nordic countries and Greece, in contrast, lagged behind much of the rest of Europe. In terms of industries, the most intense European activity was in the telecommunications, financial services, transport, and public utilities sectors.

The EU share of global privatizations has increased steadily as commission directives have mandated market liberalization and reductions in subsidies, and as the budgetary targets have placed a premium on raising government revenues and limiting spending. During 1998 alone, for example, Italy undertook a public issue of Banca Nazionale del Lavoro shares for $4.6 billion, as well as the fourth tranche of ENI privatization begun in 1995. France did a $7 billion secondary offering of France Telecom shares, in addition to the sale of 2% to Deutsche Telecom to cement a strategic alliance between the two firms. There were also insurance and banking offerings such as CNP Assurances and GAN. Spain raised over $24 billion in privatization revenue in 1997 and 1998 through sales of telecoms shares, Argentaria Bank, Endesa power, and Tabacalera tobacco. Portugal did secondary offerings of EDP electricity, as well as the BRISA highway and Cimpor cement companies. Finland sold a 22.2% stake in Sonara telecoms and a 15% stake in Fortum electric power. Austria undertook its largest privatization in the form of a 25% share offer in Telekom Austria for $2.33 billion.

In contrast to Europe, where SOEs have traditionally played a much more important role, U.S. privatizations have been few and far between. In 1998 the government carried out a $3.1 billion IPO of U.S. Enrichment Corporation, which produces 75% of America's nuclear fuel. The previous privatization occurred 10 years previously with the sale of Conrail, which had resulted from a government merger and takeover of the bankrupt New York Central and Pennsylvania Railroads. Much U.S. privatization activity actually occurs at the state and local level through contracting-out of services in sectors ranging from garbage disposal to prison management. Large infrastructure holdings that have been prominently involved in privatizations in Europe and emerging markets today remain in public hands in the United States, both directly and through special public agencies. These include ports, airports, power generation, highways, and the postal system. Paradoxically, a country that prides itself on market orientation lags behind on privatization.

The Privatization Process

Successful privatization requires, first and foremost, a strong political commitment to carry the process through systematically, expeditiously, and fairly. This has to be based on some combination of political consensus and strong political leadership. In many cases, privatization will face opposition from entrenched members of the existing management concerned about losing their positions, from labor groups concerned about job losses in subsequent business restructuring, and from local interest groups and linked industries that might be adversely affected by a change in ownership. Formidable minefields are often thrown up individually and collectively by such opponents, and it takes perseverance and political commitment to overcome them. Political opponents are often eager to use the issues arising in the privatization debate for political advantage, and they are capable of raising legislative blockages to the process. Among the other retardant factors is often political preoccupation with the process of privatization rather than the outcome, excessive demands for second opinions, and timidity among public officials who may be held personally or politically accountable for any problems encountered.

Besides an underlying political commitment, established privatization guidelines and timetables are important. First, there has to be a solid legal basis for privatization that will stand up under possible court challenge. Then there should be a preannounced plan or high-level directive as the basis for a commitment to carry through the process on a fixed schedule to on-time completion that cannot easily be changed. Guidelines should be transparent and demonstrably fair, including objective selection criteria for possible private-sector buyers, investment bankers, consultants, tax advisers, accountants and auditors, and legal advisers who form the infrastructure or "facilitators" of the privatization process. All of this requires dedicated and motivated public officials and the commitment of substantial amounts of time and resources.

Important to the process is preparation of SOEs for privatization. A key issue is whether the business should be restructured first, while under public ownership, in order to maximize investor interest and to achieve the highest possible price for the government, or whether it should be sold to investors at a low price and let the new management do the restructuring. The arguments are complex. Prior restructuring while under state ownership is likely to run up against strong opposition by those affected, especially labor, and may therefore prove ineffective—if restructuring were easy to carry out, it might have been done earlier by the existing management. In contrast, an enterprise that is a basket case will command a very low price which, if it is far below book value, can raise political charges of a "giveaway." And there are possible long-tail liabilities involving environmental and health damage that the new owners may not want to take on and which may require some sort of governmental guarantees.

A good example of the complex nature of these problems is Air France, which went through massive government subsidies to the consternation of the airline's private-sector competitors and the EU competition authorities, as well as the earnest restructuring efforts of two teams of top managers, before it was deemed ready for partial privatization by the socialist Jospin government in 1999. Along the way, even the employees did not want shares of a business that seemed uncompetitive in a rapidly changing industry—and with a continued majority shareholding by the state—in return for wage concessions demanded by management. By the time an initial successful partial privatization IPO occurred in 1999, however, Air France had become a substantially more competitive airline and a major European and global player.

Evaluating the condition of an SOE is often complex and difficult. A set of books has to be built that means something in the real world, and the government has to accept a realistic "fair value" concept that reflects the economic value of the enterprise and may well be below book value. The value of disposal costs of peripheral activities has to be established, as does the competitive stand-alone viability of the enterprise. There are a number of valuation techniques that can be used, none of which may be precisely suited to the situation. Appropriate discount rates must be used, and a host of complex tax and other regulations must be considered, including the appropriate role of foreign direct and portfolio investors in the privatization process.

Post-privatization regulation in infrastructure activities and public utilities needs to tread a fine line between over- and underregulation and to avoid coopting of the regulators by the newly privatized enterprises. In some cases, regulatory forbearance, exclusivity, and protectionism have been incorporated into privatization programs in order to maximize the price to the government. Such "sweetheart" deals, of course, come at the expense of consumers who overpay in the future to underwrite current government revenues and ensure excess profits of the privatized firms. Sales to strategic buyers who are in a strong bargaining position tend to be especially vulnerable to such pressures. Proper regulation incorporates clear separation between regulatory and commercial functions, a high level of regulatory independence, commitment to phasing-in of competition where possible, coordination between competition authorities and industry-specific regulators and self-regulatory organizations, interregional coordination in federal states, appropriate modeling of rates of return and the use of price caps, possible universal service requirements, and the use of periodic reviews and regulatory sunset clauses

Also important is the state of development of the domestic capital market, its legal infrastructure, and the size of the SOE to be privatized. Capital market development and privatization are interdependent, with privatization often making major contributions to the breadth and depth of capital markets and the state of the markets, together with the appetite of retail and institutional investor pools determining the size and structuring of in-

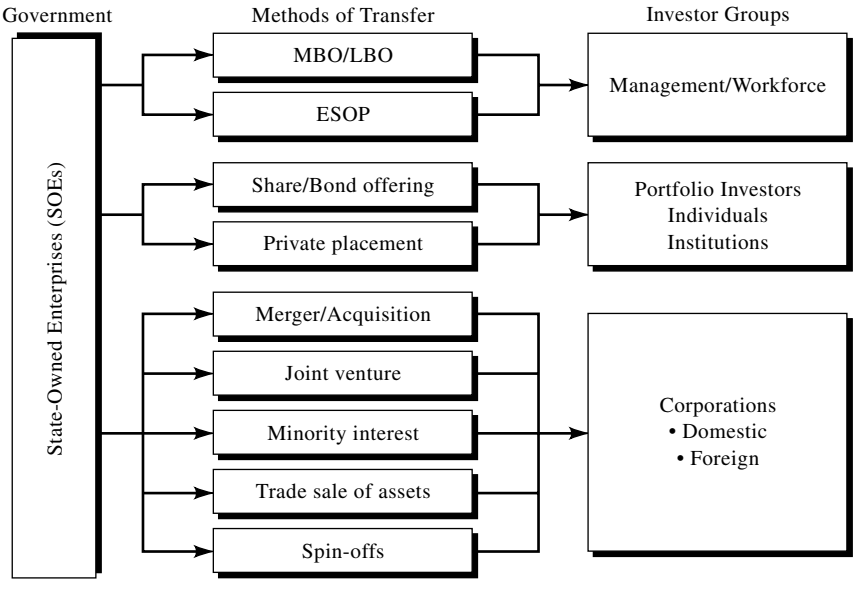

Figure 9-2. Alternative privatization method (Source: J.P. Morgan).

itial and secondary privatization offerings. A well-developed capital market makes an important contribution to the transparency and credibility of the privatization process.

Figure 9-2 shows the alternative approaches to privatization. The principal techniques are as follows.

Trade Sales

Trade sales of assets involves selling the SOE to a firm or group of investors who will manage the business after privatization. The buyer is usually a domestic or foreign private corporation with a strategic interest in the business to be privatized. Forms privatized through trade sales in many cases are small and unsuitable for privatizations via share offers.

Management and Leveraged Buyouts

An alternative to selling control of an SOE to a buyer already active in the business is to sell shares to an investment fund controlled by existing managers or by outsiders who see potential in the privatized company and are willing to put up capital to realize the values that they see, sometimes on a leveraged basis—MBO and LBOs. The advantage is that MBO or LBO investors have a strong personal interest in restructuring the SOE and maximizing its value over a relatively short time period, often with an exit strategy of selling the improved firm for a significantly higher price to an-

other buyer. They are therefore likely to want to get on with the job and to be intolerant of delays and blockages in the restructuring process. Governments, in contrast, may be suspicious of asset-stripping and liquidation motives among MBO or LBO investors and of the high political fallout that may result. Besides asset stripping, a domestic or foreign bidder in a trade sale might be interested only in the real estate involved or in closing the former SOE in order to reduce the degree of competition.

Initial and Secondary Public Offerings (IPOs and SEOs)

Shares may be offered to the general public in an IPO or an SEO. Among the government's decisions, with advice from an experienced investment bank, will be the appropriate price—one that will attract broad investor interest and is low enough so that the shares will trade strongly in the aftermarket. The extent to which a sizeable allotment of shares will be reserved for domestic retail investors has to be decided, as well as the terms on which the investors will be able to buy them. These decisions may have important political and financial consequences. In recent years, a large proportion of share sales have gone to retail investors in OECD countries, encouraged by a range of incentives such as discounts, bonus shares based on holding period, guarantees against stock price declines, and discounts of services provided by the newly privatized firms. There is also the issue of institutional distribution, including allotments to various investment banking intermediaries and the structure of the underwriting syndicate, and international tranches to be distributed to foreign institutional and retail portfolio investors. Because IPOs tend to be underpriced, these decisions have to be well justified, transparent, and fairly executed in the likely scramble among prospective investors.

Sale of Shares to Employees

The government may have as an objective the allocation of significant ownership stakes to employees of the SOE to be privatized. The justification may be that employees contributed materially to the value of the firm and therefore deserve a stake in the ownership, or that employees as owners may improve performance and make the privatized firm more attractive to outside investors. In some cases employee share ownership plans (ESOPs) are used to hold employee shares collectively instead of individual share allocations, and to prevent "flipping" by employees. On, employee shareholdings may increase the difficulty of restructuring the enterprise, much of which is likely to involve layoffs and personnel changes. In a comprehensive study of privatizations during 1977–1998, on average 8.5% of shares were reserved for employees in IPOs and 4.8% in SEOs.

Private Placements

In addition to, or in place of, initial public offerings, shares in privatized enterprises may be sold in large blocks to institutional investors such as insurance companies, pension funds, mutual funds, and other large pools of capital. The reason might be to focus ownership on fiduciaries who will maintain large, stable, and possibly strategic stakes in the company, thereby improving post-privatization corporate governance in comparison with absence of control implicit in widely dispersed and fragmented stakes, where management is accountable to no one. Among private-placement buyers might be a domestic or foreign firm with a strategic interest and capable of providing managerial and technical expertise, possibly with a view to increasing its stake later on.

Voucher Privatizations

In some cases, notably in some of the eastern European countries, vouchers that can be exchanged for shares in SOEs to be privatized have been given to citizens without charge or sold at a nominal price. These vouchers become "currency" for acquiring newly issued shares at ratios that depend on the perceived prospects of each privatized firm, or they can be sold beforehand in a secondary voucher market that usually develops very quickly and enables the initial voucher holders to cash out. The vouchers usually end up in the hands of large investors, who use them to acquire significant stakes in newly privatized firms. While voucher privatization has advantages—notably the formation of control groups that are capable of demanding management accountability and exercising effective corporate governance—in practice it has been largely discredited due to corruption, favoritism, and inefficiency involved in its implementation.

Leases, Asset Sales, and Management Contracts

Alternatives to shifting ownership to new investors include leasing and operating concessions. For example, a build-operate-transfer contract may involve sale to a private company as a concession to undertake an infrastructure project like a bridge or tunnel and to operate it on a commercial basis for perhaps 30 years, after which the project reverts to the government at no cost. Or a facility such as a resort or highway restaurant chain may be leased to a private operator for a fixed period against mutually agreeable performance requirements and financial terms. Or an SOE may be placed under a management contract by a private operator who has the necessary expertise. Such approaches may be useful where there is no legal basis for transfers to private ownership, or where such a transfer is politically difficult.

Selecting among the alternative privatization methods depends on (1) the economic and political objectives of the seller, (2) the types of buyers targeted, (3) the capabilities of the domestic financial market and access to external capital markets, (4) the capabilities of local investors and eligibility of foreign participants in the privatization process, (5) the condition of the SOE itself, (6) whether the legal entity is to be privatized or only the assets sold, as well as (7) political, legal, and tax implications.

Important decisions include share-allocation and the degree of underpricing, whether a tender offer, book-building, or fixed-price offer should be used, and, if the latter, at what point the offer price should be fixed. In fact, governments seem to rely almost exclusively on fixed-price offerings, even though a competitive tender offer could raise more revenue. And while governments typically tend to give up operating control in privatizations via share offers, they also tend to retain veto power through the corporate charter with regard to determination of the CEO, maximum allowable foreign shareholdings and retention of a "golden share" enabling blockage of certain corporate actions. In the case of trade sales, there have to be clear bidding rules and criteria for selecting winning bidders.

Initial and secondary public offerings seem to have dominated privatizations in the OECD countries during the 1990s, accounting for perhaps 60% of the cumulative total. This is indicative of the level of investor interest and the state of development of the domestic and international capital markets, broad-based investor interest in the properties to be privatized, and governments' interest in fostering broad and deep equity markets as an important factor in future economic growth. Second in importance are trade sales to domestic and foreign firms—with sales to the latter rising in importance as barriers to foreign direct investment have fallen.

All other types of privatizations such as MBOs, sales of shares to employees, asset sales, leases, and management contracts have been of minor importance among OECD countries, in contrast with their significance in some emerging market and transition economies. Whereas privatizations via share offerings dominate in the OECD countries, trade sales to strategic investors dominate elsewhere mainly because of the more limited development of the investor base in local capital markets.

Of the 48 largest share offerings in history until 2001, either through initial public offerings or seasoned equity offerings, 41 were privatization offerings, three were demutualizations (Halifax Building Society, Autoliv Sverige, and Norwich Union), and four were private issues (Conoco, Wellcome PLC, Alsthom, and Lucent Technologies).

Retail investors have participated actively in privatizations though public offerings but often "flip" their shares relatively soon after a public offering, and the shares have subsequently ended up in large institutional portfolios.

Another question is the extent to which foreign investors should be included as eligible buyers in privatizations. There are strong arguments against limits to foreign participation. The more eligible buyers there are,

the stronger the demand and the higher the share price and revenue to the government is likely to be. Foreign participation and its wider investor base encourage broader financial interest in the privatized company and may facilitate meeting its financial needs in the future. In the case of foreign strategic investors, foreign participation can provide managerial and technical expertise, deep financial pockets needed to undertake post-privatization restructuring, improved competitiveness, and better access to foreign markets.

An example of successful participation by a foreign strategic investor might be Volkswagen AG-Skoda in the Czech Republic, involving not only acquisition of a highly cost-effective manufacturing base but also leveraging the Skoda brand as part of Volkswagen's global portfolio. A less-effective example might be acquisition of a stake in Aerolineas Argentinas by Iberia of Spain, a venture that was beset by financial and operational problems from the start and ended in failure. Then there was the abortive strategic alliance in the automotive business between privately owned Volvo and state-owned Renault, which was represented by opponents as back-door nationalization of Volvo, which ultimately was acquired in 1998 by the Ford Motor Company.

Figure 9-3 presents a summary schematic depicting the key elements of the privatization process. At the center are the facilitators or intermediaries. These include investment banks that represent the government or potential buyers in negotiations by conducting valuations and coordinating due diligence, underwriting initial or secondary public equity offerings and distributing the securities to target investors, and arranging financing. They

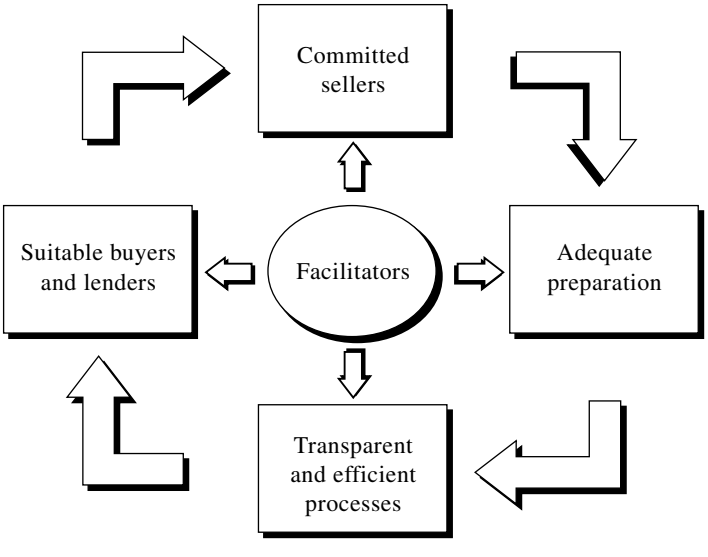

Figure 9-3. Key elements in the privatization process (Source: J.P. Morgan).

also include the accountants, lawyers, and tax specialists who are involved in the privatization process, as well as commercial bankers who arrange and provide any bank financing that may be required. In the end, successful privatization always involves a balance of multiple objectives. There must be tangible gains for both the government and for the private investors. The privatized firm has to be competitively viable and profitable on a stand-alone basis—that is, it has to be durable in the private sector without government subsidies, protectionism, or other competitive distortions.

Privatization and Investment Banking Competition

Few aspects of investment banking are more attractive than privatizations, with respect to both the available advisory assignments and the securities underwriting opportunities that may be involved in the sometimes massive initial and secondary public offerings. There are several more or less distinct roles that investment banks may play in the privatization process, which often shade into each other.

Government Advisory and Representation

For advisers to the government, important functions include building a positive image of the SOE to be privatized, preparing selling materials and road-shows, approaching prospective investors and prospective lenders, creating fall-back plans in case bids are inadequate, and educating prospective buyers on alternative acquisition structures. Advisers also have to maintain a constructive interface with potential buyers, including coordinated monitoring of contacts and avoidance of favoritism, with all inquiries referred to the adviser. Throughout, a high degree of confidentiality has to be maintained, and press coverage and the role of the media, which is often politicized, have to be carefully managed.

Based on a thorough understanding of the SEO's business, a review of current market data and the banker's own experience, the investment banking adviser to the government must conduct thorough due diligence in order to value the SOE and advise on the probable selling price range in either a trade sale, public offering or other share distribution. In discussions with privatization officials, the adviser must parley a strategy that optimizes the government's financial, economic, and other objectives, which may involve any of the alternatives discussed earlier. However, if privatization is to be undertaken, the following tasks must be undertaken:

- Prepare materials describing the company, based on information supplied by the SOE and developed during the due diligence process that emphasizes the points of value to a buyer, but is also in all respects fair and objective
- Control the process of distributing information to prospective buyers or

the market and providing opportunities for buyers or securities analysis and institutional investors to ask questions about the business and meet with management, and conduct their own due diligence.

The investment bank's expertise and track record in executing and financing privatizations is critical, as is the professional standing of its research team covering the affected industry. Specifically, in the case of a trade sale, the principal functions of the privatization adviser are the following:

- Analyze a list of possible buyers, including all names of possible buyers furnished by the government and existing SOE management—as well as LBO, MBO and/or employee investors, where appropriate and consistent with government objectives—to determine the most likely buyers and the ability of each to obtain financing for the transaction
- Explain how the identified buyers would go about making an evaluation of the company and what the effect of the privatization acquisition would be on the financial statements and stock price in the case of publicly traded private-sector buyers
- Contact potential buyers at decision-making levels and serve from that point forward as the exclusive contact for potential buyers
- Construct a bidding process to create an auction-like situation aimed at getting the highest price for the seller (or to maximize any other factors that may be important to the selling government)
- Advise on the financing structure of the transaction to get the maximum advantage for both sides
- Ensure that all-important nonfinancial terms are settled at an early stage, and see that post-privatization documentation flows smoothly.

This process is fairly straightforward. For larger-sized privatizations, a number of domestic and perhaps international names will be included on the list of prospective buyers, which will be up to the banker to contact at the appropriate level after a shortlist has been approved by the government. In all transactions, the banker's work is complemented by that of lawyers, accountants, tax experts, and other advisors selected by the government. It is the banker, however, who leads the team.

In the case of an IPO or SEO, the investment banking adviser to the government must be capable of the following:

- Design a distribution strategy that will maximize proceeds to the government and place shares strategically to ensure adequate market liquidity and research coverage in the future
- Broadly distributies sales materials to potential investors and assemble a syndicate capable of efficiently underwriting selling the securities to targeted groups of investors domestically and perhaps globally; here the investment bank's own research credibility and the placing power imbedded in its sales force is of central importance in winning mandates

- Carry through a pricing exercise through bookbuilding or a fixed-price offer that promises to achieve the governments pricing objectives and a successful share distribution
- Underwrite and distribute the securities and provide strong aftermarket liquidity support and research coverage.

Buyer Advisory and Representation

Buyer assignments in privatizations usually begin in one of two ways. The buyer may have already identified a prospective privatization and retains an investment banker to assist in executing the transaction or in confirming the valuation placed on the prospective purchase. Alternatively, the investment banker may bring an incipient privatization to a buyer and is retained to pursue it. Historically, some international corporations have disliked the idea of a competitive auction process in acquiring an SOE and preferred direct, off-market, one-on-one negotiations. But sellers and their bankers had a vested interest in promoting aggressive bidding. Inexperienced international buyers would sometimes balk at these procedures or bid too low to win. Usually, however, when an international company has been through the process unsuccessfully once or twice, it adapts and does much better the next time. When representing a buyer, a banker will perform the following tasks:

- Conduct a thorough review based of all publicly available information and see that information is made available by the privatization authorities about the SOE and its subsidiaries, if any
- Advise as to the probable price range necessary to acquire the SOE, bearing in mind the advice that would be given to the government by the privatization advisor
- Advise as to the likelihood of the government's receptiveness to an invitation to enter into discussions aimed at a purchase and how privatization officials will react when made aware of the client's interest, what it will consider to be its options, and what actions it is likely to take
- Advise on the initial approach to the government, the value to be suggested, and steps for following-up
- Evaluate tactical options and fallback position together with the client and play the "role" of the government's advisor in simulated negotiations, devising tactics accordingly
- Prepare recommendations on the financial structure of the transaction and how the buyer should best proceed to arrange financing
- Advise on the probable reaction of the stock market and rating agencies to the buyer's purchase of the privatized enterprise company if this is considered material
- Function as a continuous liaison between the client and the government and its bankers, looking for and heading off problems all the way to the

closing and advising on the changing tactical situation and responses to communications from the government or other bidders
- Assist in arranging long-term financing for the privatization purchase and in selling any assets that are not to be retained.

For investment bankers themselves, few sources of revenue are more attractive than the kinds of fees that can be earned in privatization transactions. They put the firm's skills and knowledge to work without necessarily committing the firm's capital, and the fees—commensurate with the value-added of the service—are usually considerable. Like the M&A business generally, privatization work has become globalized. The agents and brokers who are capable of providing advice and guidance to their government or buy-side clients and governments seeking to use the marketplace in privatization, IPOs and SEOs are the bankers with the infrastructure, the trained personnel, and the contacts with the worldwide corporate and financial market community.

Privatization continues to be an active business for investment bankers, although ultimately whatever can reasonably be transferred to the private sector will already have been done. Europe has been the scene of much privatization action because of the historically heavy role of SEOs in many countries. Some, such as the United Kingdom, are basically "sold out." Others such as Italy and France have a long way to go and will remain attractive arenas for privatization work for investment banks for some years to come.

Note

1. William L. Megginson and Jeffrey M. Netter, "From State to Market: A Survey of Empirical Studies on Privatization," NewYork Stock Exchange Privatizations Working Paper no. 98-05, December 1998.

10

Institutional Asset Management and Insurance

The institutional asset-management industry is likely to be one of the largest and most dynamic segments of the global financial services industry in the years ahead. As of January 2001, the global total of assets under management was estimated at close to $60 trillion, comprising some $13.2 trillion in pension fund assets, about $11.4 trillion in mutual fund assets, and $8.2 trillion in fiduciary assets controlled by insurance companies, as well as $17.0 trillion in onshore private client assets and perhaps $8.5 trillion in offshore assets of high net-worth clients. Not only will this already massive industry experience substantial growth in comparison with other parts of the financial services sector, but cross-border volume—both regional and global—is likely to take an increasing share of that activity.

Within this high-growth context, asset management attracts competitors from an extraordinarily broad range of strategic groups: commercial and universal banks, investment banks, trust companies, insurance companies, private banks, captive and independent pension fund managers, mutual fund companies, and various types of specialist firms. This rich array of contenders marked by very different starting points, competitive resources, and strategic objectives is likely to render the market for institutional asset management a highly competitive one, even under foreseeable conditions of large size and substantial growth.

The underlying drivers of the market for institutional asset management are well understood. They include the following:

1. A continued broad-based trend toward professional management of discretionary household assets in the form of mutual funds or unit trusts and other types of collective investment vehicles. This devel-

opment has perhaps run much of its course in some national financial systems, but it has only begun in others.
2. The recognition that most government-sponsored pension systems, many of which were created wholly or partially on a pay-as-you-go (PAYG) basis, have become fundamentally untenable under demographic projections that appear virtually certain to materialize, and must be progressively replaced by asset pools that will throw off the kinds of returns necessary to meet the needs of growing numbers of longer-living retirees.
3. Partial displacement of traditional defined-benefit public- and private-sector pension programs backed by assets contributed by employers and working individuals under the pressure of the evolving demographics, rising administrative costs, and shifts in risk allocation by a variety of defined-contribution schemes.
4. Reallocation of portfolios that have—for regulatory, tax, or institutional reasons—been overweight domestic financial instruments (notably fixed-income securities) toward a greater role for equities and nondomestic asset classes, which not only promise higher returns but also may reduce the beneficiaries' exposure to risk due to portfolio diversification across both asset classes and economic and financial environments that are less than perfectly correlated in terms of total investment returns.

The growth implied by the first three of these factors, combined with the asset-allocation shifts implied by the fourth factor, will tend to drive the dynamics and competitive structure of the global institutional asset-management industry in the years ahead.This chapter assesses the two principal sectors of the global institutional asset-management industry: pension funds, mutual funds, and private clients; foundations, endowments, central bank reserves, and other large financial pools requiring institutional asset-management services. Private asset management for private clients is covered in chapter 11. We include a discussion of the competitive structure, conduct and performance of the asset-management industry, and an impact assessment of institutional asset management on global capital markets.

Asset Management in a Financial Intermediation Framework

The asset management services that are the focus of this chapter are depicted in figure 10-1, as follows:

1. Pension funds take two principal forms; those guaranteeing a level of benefits, and those aimed at building beneficiary assets from which a pension will be drawn (see below). Defined-benefit pension funds can buy securities directly in the market or place funds with banks, trust companies, or other types of asset managers, often

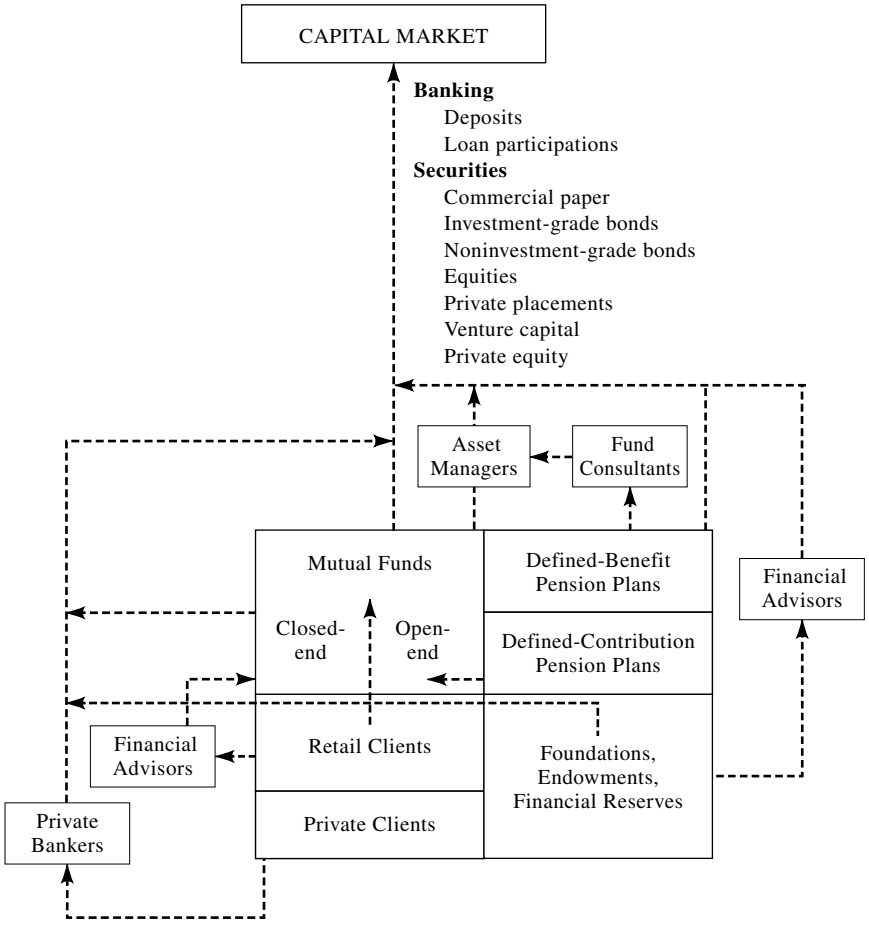

Figure 10-1. Organization of institutional asset-management functions.

aided by fund consultants who advise pension trustees on performance and asset-allocation styles. Defined-contribution pension programs may operate in a similar way if they are managed in-house, creating proprietary asset pools, and in addition (or alternatively) provide participants with the option to purchase shares in publicly available mutual funds.

2. Foundations, endowments, and financial reserves held by nonfinancial companies, institutions, and governments can rely on in-house investment expertise to purchase securities directly from the institutional sales desks of banks or securities broker-dealers. They can use financial advisers to help them build efficient portfolios or place funds with open-end or closed-end mutual funds.
3. Retail clients have the option of placing funds directly with financial

institutions such as banks or by purchasing securities from retail sales forces of broker-dealers, possibly with the help of fee-based financial advisers. Alternatively, retail investors can have their funds professionally managed by buying shares in mutual funds or unit trusts (again possibly with the help of advisers), which, in turn, buy securities from the institutional sales desks of broker-dealers (and from time to time maintain balances with banks).

4. Private clients are broken out as a separate segment of the asset-management market in Figure 10-1. They are usually serviced by private bankers who bundle asset management with various other services such as tax planning, estates, and trusts. They place assets directly into financial instruments, commingled managed-asset pools, or sometimes publicly available mutual funds and unit trusts.

Each of these segments of global asset management will be discussed in turn, with the last, private banking, reserved for the next chapter.

Mutual Funds

The mutual fund industry has enjoyed rapid growth in the past several decades, although there are wide differences among national financial markets in its pace of development, in the composition of the assets under management, and in the nature of mutual fund marketing and distribution. At the end of 2001, the United States had more than 6,000 mutual funds (and over 4,500 equity mutual funds) available to the public—more than the number of stocks listed on the New York Stock Exchange—with average annual growth in excess of 17% between 1975 and 2001, comprising more assets than life insurance companies and assets about equal to those of commercial banks. Much of the growth is also attributable to the use of mutual funds for retirement savings. Similar overall dynamics are expected in Europe and Japan, but with a number of significant differences.

Figure 10-2 shows the distribution of mutual fund assets in terms of

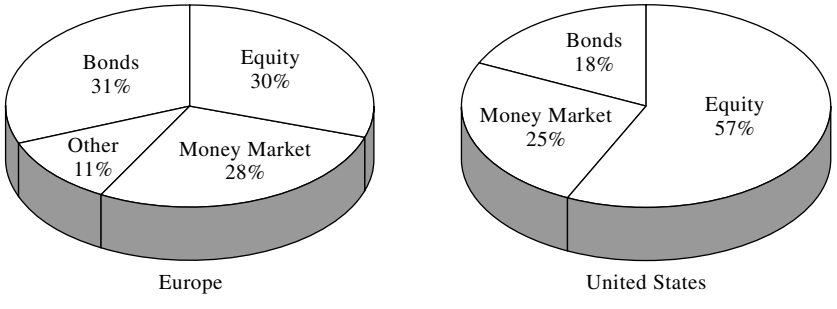

Figure 10-2. Comparative mutual fund assets by investment type, 2001 (US$ billion). (Source: EFID: Lipper Analytical Services International; Goldman Sachs).

market capitalization and asset allocation at the end of 2001 in Europe, Japan, and the United States. The United States accounts for slightly over half the assets under management.

In the United States, mutual funds have traditionally been invested mainly in equities. In 1975, over 82% of the fund assets under management were allocated to equities, and a mere 10% and 8% to bonds and money market instruments, respectively. By 1985 this picture had changed completely, with the equity component declining to 24% and money market funds capturing 49%, due both to poor stock market performance in the 1970s and early 1980s and to the substitution of money market mutual funds for bank savings products by households searching for higher yields. This occurred at a time when banks continued to be limited by interest rate regulation on deposits. By 2001 the U.S. pattern of mutual fund investments had shifted yet again, with equities accounting for 57% of the total, money market funds 25%, and bond funds 18%. In 2000, in Europe, 30% of mutual fund assets were allocated to equities, 31% to bonds, and 28% to money market instruments.

Mutual Fund Distribution

There are also wide differences among countries in how mutual funds are distributed, which, in turn, is linked to comparative mutual fund growth and structure. European mutual fund distribution through bank branches has dominated in countries such as Germany (80%), France (70%), and Spain (61%), with U.K. distribution concentrated among independent advisers and Italian distribution roughly split between bank branches and independent sales forces. The dominance of universal banks, savings banks, and cooperative banks as financial intermediaries in most of the continental European countries explains the high concentration of mutual fund distribution via branch networks. In the United States—large independent mutual fund companies compete with investment banks, insurance companies, discount brokers, and commercial banks in distributing mutual funds.

Full-service U.S. broker-dealers maintain large retail sales forces capable of penetrating the household sector. In recent years, discount brokers have made substantial inroads in mutual fund distribution, compensating for reduced sales effort and limited investment advice by lower fees and expenses. Insurance agents account for a substantial share of U.S. mutual fund distribution, focusing on mutual funds with an insurance wrapper such as fixed and variable annuities and guaranteed investment contracts (GICs). Bank branches have traditionally played a limited role in the United States due to the legacy of regulatory constraints, accounting for the relatively small distribution share.

Mutual fund distribution has undergone dramatic change. Distribution without advice is clearly most efficient over the Internet or other on-line interfaces with the retail client. This means that transactions services can be separated from investment advice, both functionally and in terms of

pricing. Advice can be delivered only in part in disembodied form, with value-added depending partly on interpretive information on investments and partly on personal counseling that the client must be willing to pay for. With this advice increasingly likely to come from independent financial planners in many markets, traditional distributors of mutual funds are encroached on from both sides and have had to react to maintain market share.

Mutual Fund Competition

Competition among mutual funds can be among the most intense anywhere in the financial system, and this competition is heightened by analytical services that track performance of funds in terms of risk and return against indexes over different holding periods and assign ratings based on fund performance. These fund-rating services are important because the vast majority of new investments tend to flow into highly rated funds. For example, in the United States during the period 1993–2000, about 85% of all new money was allocated to funds rated 4- or 5-star by Morningstar, Inc. These same highly rated funds captured roughly three-quarters of all mutual fund assets. In addition, widely read business publications publish regular "scoreboards" among publicly available mutual funds based on such ratings and, together with specialized investment publications and information distributed over the Internet, have made mutual funds one of the most transparent parts of the retail financial services sector.

Despite clear warnings that past performance is no assurance of future results, a rise in the performance rankings often brings in a flood of new investments and management-company revenues, with the individual asset manager compensated commensurately and sometimes moving on to manage larger and more prestigious funds. Conversely, serious performance slippage causes investors to withdraw funds, taking with them a good part of the manager's bonus and maybe his or her job, given that the mutual fund company's revenues are vitally dependent on new investments and total assets under management. A gradual decline in the average sophistication of the investor in many markets—as mutual funds become increasingly mass-market retail-oriented and interlinked with pension schemes—means that performance ratings, name recognition, and "branding" appear to be progressively more important in defining competitive performance in the industry.

Historically, at least in the United States, there has been little evidence of increasing market concentration in the mutual fund industry. The largest and smallest long-term funds have gradually eroded the market share of mid-size funds. Factors that seem to argue *for* greater industry concentration in the future are economies of scale and brand-name concentration among progressively less sophisticated investors in taxable funds and mutual funds that are part of retirement accounts battling for attention among the enormous number of funds vying for their business. Arguments *against*

further concentration include shifts in performance track records and the role of mutual fund supermarkets in distribution, which increase the relative marketing advantage of smaller funds.

In addition to promoting their performance (when favorable), mutual fund companies and securities broker-dealers have aggressively added banking-type services such as checking and cash-management accounts, credit cards, and overdraft lines. They provide user-friendly, integrated account statements and tax reporting. Client contact is based on easy access by telephone, mail, and the Internet. Securities firms have likewise increased their mutual fund activity, presumably with the view that this part of the securities industry is more capable of supporting significant, sustained returns than is wholesale investment banking where competition has become cutthroat, capital-intensive, and subject to a high degree of earnings instability. Insurance companies have also considered the mutual fund business to be a strong candidate for strategic development, especially in the face of competition in their traditional annuities business and the cross-links that have emerged in some countries between the pension fund and mutual fund industries. Banks have likewise pushed aggressively into the mutual fund business.

Competition in the mutual funds business thus covers a rich array of players, ranging from commercial banks and securities broker-dealers to specialized mutual fund companies, discount brokerages, insurance companies, and nonfinancial firms. Such incursions of strategic groups, each approaching the business from a different direction, tends to make markets hypercompetitive. This is the likely future competitive structure of the mutual fund industry, particularly in large, integrated markets such as the United States, Japan, and the euro-zone.

Comparative Regulation and Taxation of Mutual Funds

In the United States, mutual fund regulations require strict fit-and-proper criteria for management companies of mutual funds sold to the public, as well as extensive disclosure of pertinent information. The National Securities Markets Improvement Act of 1996 makes the Securities and Exchange Commission (SEC) responsible for overseeing investment advisers with over $25 million under management, with state regulators alone responsible for investment advisers with smaller amounts under management advisers who had previously been co-regulated together with the SEC. The large investment advisers falling under SEC jurisdiction account for about 95% of U.S. assets under management, although the vast majority of abusive practices and enforcement problems occur among the smaller firms.

Threat of regulatory action and civil liability lawsuits keep the pressure on U.S. mutual fund boards to take their obligations to investors seriously and to ensure that the fund objectives are faithfully carried out. Some fund management companies, however, nominate individuals to serve as directors of numerous—sometimes a very large number—of funds from among

those managed by the firm, perhaps raising questions whether such directors can fulfill all of their responsibilities to their investors. Still, if they are thought not to be doing so, they can expect to be the object of legal action brought by lawyers representing the investors as a class. All of this information is in the public domain, accompanied by a high degree of transparency with respect to fund performance and ample media coverage and vigorous competition among funds and fund managers. This means that investors today face a generally fair and efficient market in which to make their asset choices, so that the mutual fund business in a number of countries is probably a good example of how regulation and competition can come together to well serve the retail investor.

In contrast to the United States, the rules governing the operation and distribution of mutual funds in Europe have traditionally been highly fragmented—fragmentation that will gradually come to an end in the years ahead. As of the mid-1980s, definitions of mutual funds varied from country to country, as did legal status and regulatory provisions. Door-to-door selling was forbidden in Belgium and Luxembourg, for example, and strictly regulated in Germany. In Britain, however, direct marketing was the norm. Market access to clients varied between the extremes of high levels of impenetrability to virtually complete openness.

The EU directive governing the operation and sale of mutual funds—undertakings for the Collective Investment of Transferable Securities (UCITS)—came into force on October 1, 1989, after 15 years of negotiation. It specifies general rules for the kinds of investments that are appropriate for mutual funds and how they are to be sold. The regulatory requirements for fund management and certification are left to the home country of the fund management firm, while specific rules governing the adequacy of disclosure and selling practices are left to the respective host countries.

Consequently, mutual funds duly established and monitored in any EU member country such as Luxembourg—and which are in compliance with UCITS—can be sold without restriction to investors in national financial markets EU-wide; they can be promoted and advertised through local marketing networks and via direct-mail, as long as selling requirements applicable in each country are met. Permissible investment vehicles include conventional equity and fixed-income securities, as well as high-performance "synthetic" funds based on futures and options not previously permitted in some financial centers such as London. Under UCITS, 90% of mutual fund assets must be invested in publicly traded companies, no more than 5% of the outstanding stock of any company may be owned by a mutual fund, and there are limits on investment funds' borrowing rights. Real estate funds, commodity funds, and money market funds are specifically excluded from UCITS.

U.S. mutual funds have operated in a comparatively coherent tax environment. There is a uniform federal income tax code, which requires mutual fund companies to report all income and capital gains to the Internal Revenue Service (IRS)—normally there is no withholding at source—

and requires individuals to self-report the same information in annual tax returns, with data reconciliation undertaken by the IRS. Taxable fund income is subject to regular federal income tax rates, while capital gains and losses are recorded as they are incurred in mutual fund trading and net gains attributed to the mutual fund investor and are taxed at the federal capital gains rates. Tax fraud, including the use of offshore accounts to evade tax, is a criminal offense. States and sometimes municipalities likewise tend to tax mutual fund income and capital gains (and sometimes assets) at substantially lower rates. Under the U.S. Constitution, the states and the federal government cannot tax each other. So there is a broad range of mutual funds that invest in securities issued by state and local governments with income exempt from federal tax, as well as (usually) exempt from tax on the income from the state's own securities contained in the portfolio. Similarly, the states do not tax income derived from federal government securities. The U.S. tax environment, while complex, provides the mutual fund industry with opportunities for product development such as tax-efficient funds (e.g., investing in municipals and capital gains–oriented equities) and imposes compliance costs in terms of the required tax reporting both to the IRS and to the investor client.

The European tax environment has been far more heterogeneous by comparison, with the power of tax authorities stopping at the national border and—in the presence in many EU countries of very high tax rates on capital income—widespread tax avoidance and evasion on the part of investors. In the light of intra-EU capital mobility, the euro, and the UCITS initiative, narrowing or eliminating intra-EU differentials in taxation of capital income and assets and the establishment of a coherent tax environment that is considered equitable and resistant to evasion has been of continuing interest.

There seems little doubt that, in the end, a financially integrated Europe can no more afford a haven for tax evaders than the U.S. federal government can afford permitting one of the states to declare itself a tax haven. In 1998 the debate resumed with an EU Commission proposal for a 15% withholding tax at source for interest and dividend payments or, alternatively, reporting by the paying entity of any capital income payments to the fiscal authorities of the member state in which the recipient is resident. This proposal moved the EU closer to the U.S. model of a more uniform tax environment for the financial markets and managed-asset pools.

Pension Funds

The pension fund market has proven to be one of the most rapidly growing sectors of the global financial system, and promises to be comparably dynamic in the years ahead. As a result, pension assets have been in the forefront of strategic targeting by all types of financial institutions, including banks, trust companies, broker-dealers, insurance companies, mutual

fund companies, and independent asset-management firms. Pension assets in 2001 were estimated to amount to about $14.2 trillion worldwide.

The basis for rapid projected growth is the demographics of gradually aging populations, colliding with existing structures for retirement support which, in many countries carry heavy political baggage. They are politically exceedingly difficult to bring up to the standards required for the future, yet eventually doing so is inevitable. With a population of some 261 million people at the beginning of 2001, the United States at that time had accumulated pension pools equal to 84% of GDP. Western Europe, with a population almost twice as large, had accumulated pension assets of only 12% of GDP. Japan's pension accumulations at that time amounted to about 36% of GDP in 2001.

The demographics of the pension fund problem are very straightforward. Figure 10-3 depicts data for the so-called support ratio (roughly, people of retirement age as a percentage of people of working age) in the OECD countries. Unless there are major unforeseen changes in birth rates, death dates, or migration rates, for Japan, the United States, and EU the support ratio will have doubled between 1990 and 2040, with the highest support ratios being attained in Italy, Germany, and the Netherlands and the lowest in Ireland. While the demographics underlying these projections may be quite reliable, support ratios remain subject to shifts in working-age start and end-points. Obviously, the longer people remain out of the active labor force (e.g., for purposes of education), the higher the level of sustained unemployment, and the earlier the average retirement age, the higher will be the support ratio. In recent years all three of these factors

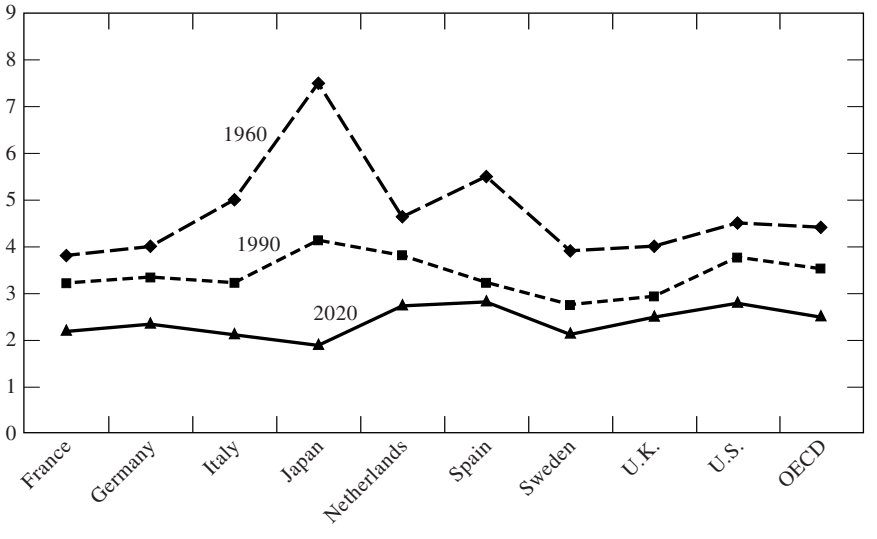

Figure 10-3. Support ratios of OECD countries: number of people aged 25–59 for each person aged 65+ (Source: Goldman Sachs).

have contributed to raising support ratios in Europe and Japan relative to those in the United States.

Alternative Approaches to Old-Age Support

There are basically three ways to provide support for the post-retirement segment of the population:

Pay-as-you-go (PAYG) programs. Pension benefits under this approach are committed by the state based on various formulas—number of years worked and income subject to social charges, for example. They are funded by current mandatory contributions of those employed (taxes and social charges), contributions which may or may not be specifically earmarked to cover current pension payouts. Under PAYG systems, current pension contributions may exceed or fall short of current disbursements. In the first case, a "trust fund" may be set up, which, as in the case of U.S. Social Security, may be invested in government securities. In the second case, the deficit will tend to be covered out of general tax revenues, government borrowing, or the liquidation of previously accumulated trust fund assets.

Defined-benefit programs. Based on actuarial benefit formulas that are part of the employment contract, employers commit pension benefits under defined-benefit programs to their employees. Defined-benefit pension payouts may be linked to the cost of living, adjusted for survivorship, and so on, and the funds set aside to support future claims may be contributed solely by the employer or with some level of employee contribution. The pool of assets may be invested in a portfolio of debt and equity securities (possibly including the company's own shares) that are managed in-house or by external fund managers. Depending on the level of contributions and benefit claims, as well as investment performance, defined-benefit plans may be overfunded or underfunded. They may thus be tapped by the employer from time to time for general corporate purposes, or they may have to be topped-up from the employer's own resources. Defined-benefit plans may be insured (e.g., against corporate bankruptcy) either in the private market or by government agencies, and they are usually subject to strict regulation.

Defined-contribution programs. Under defined-contribution pension plans, pension fund contributions are made by the employer, the employee, or both into a fund that will ultimately form the basis for pension benefits. The employee's share in the fund tends to vest after a number of years of employment and may be managed by the employer or placed with various asset managers under portfolio constraints that are intended to serve the best interests of the beneficiaries. The employee's responsibility for asset allocation can vary from

none at all to virtually full discretion. For example employees may be allowed to select from among a range of approved investment vehicles, notably mutual funds, and based on individual risk-return preferences.

Most countries have several types of pension arrangement operating simultaneously—for example, a base-level PAYG system supplemented by state-sponsored or privately sponsored defined-benefit plans and defined-contribution plans sponsored by employers or mandated by the state. As of the end of 2000, at least 54 countries had defined-contribution pension systems of some kind, ranging from nationwide compulsory schemes to funds intended to supplement state-guaranteed pensions. The collision of the aforementioned demographics and heavy reliance on the part of many countries on PAYG approaches is at the heart of the global pension problem and forms the basis for future opportunities in this part of national and global financial systems.

The percentage of the labor force in various countries who are covered by occupational pension schemes differs greatly among nations. Countries such as Italy, Belgium, and Spain are highly dependent on PAYG state-run pension systems and have little in the way of dedicated asset accumulations. Countries like the Netherlands, Denmark, and the United Kingdom, in contrast, have long traditions of defined-benefit pension schemes backed by large asset pools. The French system involves a virtually universal state-directed defined-benefit scheme which, given the demographics, is heavily underfunded. This is reflected in pension assets per capita and pension assets as a percentage of GDP. By contrast, Denmark, the Netherlands, and the United Kingdom appear to be in reasonably good shape. German companies have traditionally run defined-benefit plans, with pension reserves booked within the balance sheets of the employers themselves as opposed to externally managed asset pools, backstopped by a government-mandated pension fund guarantee scheme. Today's conventional wisdom is that the pension problems that are centered in European countries with heavy PAYG obligations will have to be resolved in the foreseeable future, and that there are only a limited number of options in dealing with the issue:

- Raise taxes on employees and employers to cover increasing pension obligations under PAYG systems. It is unlikely that any degree of uniformity can be achieved in this regard, given the aforementioned large inter-country differences in pension schemes and their financing. The competitive effects of the required major increases in employer burdens, especially in a unified market with a common currency, are unlikely to make this a feasible alternative. No more palatable is saddling employees with additional social security taxes in what are already some of the most heavily taxed environments in the world.
- Make major reductions in retirement benefits, cutting dramatically into benefit levels. This is unlikely to be any more feasible politically than the

first option, especially considering the way many PAYG systems have been positioned—as "contributions" (not taxes), to assure a comfortable old age. Taking away something people feel has already been "paid for" is far more difficult politically than denying them something they never had in the first place. The sensitivity of fiscal reforms to social welfare is illustrated by the fact that if the growth in pension expenditures were limited to just the projected rate of economic growth from 2015 onward, that alone would reduce income-replacement rates from 45% to 30% over a period of 15 years—leaving those among the elderly without adequate personal resources in relative poverty.

- Significantly increase the retirement age at which individuals are eligible for full PAYG-financed pensions—perhaps to age 70 for those not incapacitated by ill health. This is unlikely to be any more palatable than the previous options, especially in many countries where there has been active pressure to go the other way—to reduce the age of eligibility for PAYG retirement benefits to 60 or even 55.
- Provide major increases in general taxation levels or government borrowing to top up eroding trust funds or finance PAYG benefits on a continuing basis. Again, this is an unlikely alternative due to the economic and competitive consequences of further increases in tax rates, major political resistance, and fiscal constraints.
- Adopt major pension reforms to progressively move away from PAYG systems toward defined-contribution and defined-benefit schemes such as those widely used in the United States, Chile, Singapore, Malaysia, the United Kingdom, the Netherlands, Denmark, and certain other EU countries. Each of these differs in detail, but all involve the creation of large asset pools that are reasonably actuarially sound. Where such asset pools already exist, more attention will have to be focused on investment performance, with a shift away from government bonds toward higher-yielding assets in order to help maintain benefit levels.

Given the relatively bleak outlook for the first several of these alternatives, it seems inevitable that increasing reliance will be placed on the last of these options. The fact is that future generations can no longer count on a "free ride"—the present value of benefits exceeding the present value of contributions and social charges—as the demographics inevitably turn against them and their governments face fiscal constraints. This requires fundamental rethinking of pension arrangements in most OECD countries.

Asset Allocation and Cross-Links with Mutual Funds

Wide differences among countries in their reliance on PAYG pension systems (and in the degree of demographic and financial pressure to build actuarially viable dedicated-asset pools) are paralleled by equally wide differences in how those assets have been allocated.

The United States (not including the Social Security Trust Fund) and the United Kingdom have relied quite heavily on domestic equities. The largest 15 pension fund managers in 2001 had about 50% of equity assets invested in passive funds versus about 57% in mutual funds. The share of asset-allocation to domestic bonds is highest in Germany and Denmark, followed by Portugal, Switzerland, and the Netherlands. Foreign equity holdings are proportionately highest in Ireland, the Netherlands, and Belgium (each with small domestic stock markets). Foreign bond holdings play a major role only in the case of Belgium.

With the introduction of the euro in 1999, regulations that require pension funds to match the currency of their assets with the currency of their liabilities drop away within the single-currency zone, which greatly broadens the equity allocation opportunities open to fund trustees. In some cases, currency-exposure restrictions have forced pension fund equity allocations to be overweight in certain industries, due to the importance of a few major companies in national equity market capitalization—in which case, the euro will permit significantly improved sectoral asset allocation in pension portfolios.

Taxation remains a major problem in the creation of efficient pension asset allocations via international portfolio diversification. The reason is that governments often do not provide reciprocal tax exemption for pension assets invested abroad. For example, many countries exempt employee and employer pension contributions and pension fund earnings from tax, and these are later taxed at prevailing personal income tax rates when it is distributed upon retirement. Some countries tax retirement income at concessionary rates, as well. If part of a retirement fund is invested abroad, however, the host country often treats the assets the same as all other financial assets and levies taxes on interest, dividends, or capital gains at regular withholding rates. Such differential tax treatment obviously biases asset allocation toward domestic investments and can significantly affect portfolio optimization.

The growing role of defined-contribution plans in the United States has led to strong linkages between pension funds and mutual funds. Numerous mutual funds—notably in the equities sector—are strongly influenced by pension inflows. At the end of 2001, over one third of mutual fund assets represented retirement accounts of various types in the United States. Some 40% of total retirement assets were invested in mutual funds, up from about 1% in 1980. A similar development is likely in the EU, Japan, and in other countries, as well.

Competitive Restructuring of the Institutional Asset-Management Industry

We have noted that various kinds of financial firms have emerged to perform asset-management functions. These include commercial banks, sav-

ings banks, postal savings institutions, savings cooperatives, credit unions, securities firms (full-service firms and various kinds of specialists), insurance companies, finance companies, finance subsidiaries of industrial companies, mutual fund companies, financial advisers, and various others. Members of each strategic group compete with each other, as well as with members of other strategic groups. There are two questions. First, what determines competitive advantage in operating distribution gateways to the end-investor? Second, what determines competitive advantage in the asset-management process itself?

One supposition is that distribution of asset-management services is both scope-driven and technology-driven. That is, it can be distributed jointly with other types of financial services and thereby benefit from both cost economies of scope, and demand economies of scope (cross-selling). This would tend to give retail-oriented financial services firms like commercial and universal banks, life insurance companies, and savings institutions a competitive advantage in distribution. At the same time, more specialized firms may establish cost-effective distribution of asset-management services by using proprietary remote-marketing techniques like the postal service, telephone selling, or the Internet or by "renting" distribution through the established infrastructures of other financial intermediaries like banks, insurance companies, and mutual fund supermarkets. They may also gain access through fund-management consultants and financial advisers.

Asset management itself depends heavily on portfolio-management skills, as well as economies of scale, capital investment, and technologies involved in back-office functions, some of which can be outsourced. Since fiduciary activities must be kept separate from other financial services operations that involve potential conflicts of interest, through either organizational separation or Chinese walls, there are constraints on what can be gained in the way of economies of scope.

Intersectoral competition, alongside already vigorous intrasectoral competition, is what will make asset management one of the most competitive areas of finance, even in the presence of rapid growth in the size of the market for asset-management services. Certainly the dynamics of competition for the growing pools of defined-benefit and defined-contribution pension assets in various parts of the world, and its cross-linkage to the mutual fund business, has led to various strategic initiatives among fund managers. These include mergers, acquisitions, and strategic alliances among fund managers, as well as between fund managers, commercial and universal banks, securities broker-dealers, and insurance companies. This is reflected in table 10-1, which presents the volume and number of mergers and acquisitions involving asset managers, both in total and managers of open-end mutual funds only, covering the 16-year period from 1985 through 2000. Note that British asset managers represented the largest single target group. The predominant buyers were continental European institutions, mainly banks and insurance companies. These data suggest

Table 10-1 *Merger and Acquisitions Activity in the Asset Management Industry, 1985–2000, millions of U.S.$ (number of transactions)*

Total	Total Asset Managers	Open-end Mutual Fund Managers
Global target	$71,252 (1,719)	$15,082 (364)
European target	37,715 (736)	6,030(186)
U.S. target	18,431 (569)	5,118 (114)
Other target	15,106 (414)	3,934 (64)

	Total	European Acquirer	U.S. Acquirer
Total Asset Managers			
U.S. target	$18,431 (569)	$5,743 (36)	$12,038 (508)
U.K. target	26,367 (350)	23,285 (304)	1,974 (23)
Cont. Eur. target	11,348 (386)	10,573 (353)	9 (10)
Open-end Mutual Fund Managers			
U.S. target	$5,118 (105)	$1,849 (7)	$3,225 (104)
U.K. target	2,291 (33)	2,204 (28)	52 (3)
Cont. Eur. target	3,739 (153)	3,579 (137)	9 (2)

Data: Thomson Financial Securities data, Author calculations.

that M&A market action and strategic repositioning substantially reflects the economic drivers of the asset-management industry's restructuring. Much of that action, both with respect to pension funds and mutual funds, is in western Europe. Market valuations of asset-management companies have been quite high in comparison with other types of firms in the financial services industry, reflecting the high quality of earnings in this industry.

Besides gaining access to distribution and fund-management expertise, the underlying economics of the M&A deal-flow in asset management presumably have to do with the realization of economies of scale and economies of scope. These can facilitate cost reductions and cross-selling of multiple types of funds, banking and insurance services, investment advice, and high-quality research in a one-stop-shopping interface for investors.

Nevertheless, there is a good deal of evidence that investors are quite happy to shop on their own with low-cost fund managers. Empirical evidence of either economies of scale or economies of scope in this sector is lacking, although the plausibility of scale economies exceeds that for scope economies. In any event, there has been little evidence so far that M&A activity in this sector has led to lower fees and charges to retail investors.

Finally, table 10-2 provides some indication of the relative size of the world's top asset managers. Overall, countries with traditional reliance on funded pension schemes and mutual funds marketed to retail investors—the United States, Japan and the United Kingdom—were home to most of the top asset managers, although this is changing as PAYG pension programs increasingly give way to dedicated asset pools and as financial market integration stimulates a competitive battle among different types of financial institutions for asset-management services.

Table 10-2 World's 20 Largest Asset Managers, 2001

Firm	$ Billion
UBS AG	1,438
Kampo	1,230
Deutsche Bank AG	1,079
Fidelity Investments	886
Crédit Suisse	837
AXA	802
Barclays Global Inv.	801
State Street	724
Allianz AG	641
J.P. Morgan Fleming	638
Merrill Lynch	557
Capital Group	556
Mellon	510
Morgan Stanley	472
Citigroup	464
Vanguard	389
Invesco	384
Putnam	370
Amvescap	333
Northern Trust	323

Source: *Institutional Investor*, July 2001 (U.S. data) and November 2001 (non-U.S. data).

The Global Insurance Industry

Alongside mutual fund companies and pension funds, the third major player in asset management worldwide is the insurance industry. This industry manages assets both for its own account (reserves against life and non-life insurance claims) and off the balance sheet in the form of fiduciary assets managed on behalf of retail clients, usually in the form of annuities and other savings and retirement products that incorporate insurance features.

Industry Economics and Segments

The principal activities of insurance companies consist of non-life insurance, life insurance, and asset management, although the differences between the last two areas have become increasingly blurred. Non-life insurance includes property, casualty, and health-related programs. Reinsurance adds a global activity that provides liability coverage for insurers themselves. Life insurance comprises whole life (live insurance that incorporates a savings or cash-value feature) and term life (pure life insurance) policies, and increasingly savings and pension products that are based on annuities.

The two traditional sources of insurance company income are earnings on policies—known as "technical profits and losses"—and earnings on in-

vested premiums from policyholders. Technical profits and losses refers to the difference between policy premiums earned and claims or benefits paid. In some countries, insurers are required to invest the majority of their premiums in government bonds, but most countries allow a range of high-quality, conservative assets, together with establishing a "technical reserve" liability on their balance sheet. The technical reserve reflects the estimated cost of claims and benefit payments that the insurer would be ultimately required to make. In asset management, a relatively new business for the industry, income usually consists of either a fee when assets are managed for third-party investors or an investment return when assets are on the insurance company's balance sheet.

Non-Life Insurance. By the early 2000s, the insurance industry had to contend with a rapidly changing and more difficult market environment. Non-life business weakened due to falling premiums and stagnant growth, while both non-life and life segments were adversely affected by lower interest rates, resulting in reduced investment income. However, there are profit-sharing agreements on most of the fixed business, while new production is heavily unit-linked, which has limited the damage to the companies. So did active asset and liability management.

Across most geographic markets, non-life insurance premiums had been falling since the mid-1990s, a situation due to a general slack in demand and excess capacity that drove prices down. Starting in about 1994, premium levels had come down in the United States by 17%, even though the value of new policies increased significantly. By 1999, some risks underwritten in the London market only commanded half of the premiums of a few years earlier. In most industrialized countries, the market growth for personal non-life insurance had been sluggish, growing since the mid-1990s at a slower rate than the GDP.

Commercial lines of insurance hardly fared better. Multinational companies, which had been large buyers of insurance in the past, were now buying less coverage and in some cases managed their global risks internally through self-insurance. A growing number of companies felt that insurance was no longer an absolute necessity. Some had discovered that premiums significantly exceeded their actual losses over time. Meantime, insurers themselves were buoyed by the strong equity markets of the late 1990s until the equity market peak in 2000, which swelled the value of their investments and resulted in the industry's highest net-asset values ever.

European insurers tended to invest shareholder or surplus funds in equities as well as property for a variety of reasons. These types of assets were seen as a hedge against inflation, which many of these companies had experienced in the past. There were also no regulatory restrictions on the investment of surplus capital as there were for technical reserves. And equities represented a tax-advantageous way for capital formation since capital gains were usually not taxed until realization or sale. The approach to equity investing of European-based insurers was largely passive, focused on

buying and holding blue-chip stocks over the long-term. German insurers such as Munich Re and Allianz were famed for their large cross-holdings, which formed a major share of their equity portfolios.

Regulators were pleased with this excess capital, since it meant that insurance companies had become safer for policyholders. But for the industry's competitive performance, an oversupply of capital was a sign of illness rather than good health. Since capital determines underwriting capacity, the surplus capital created overcapacity in the industry. Excess capacity led to intensified underwriting activity in both Europe and the United States, triggering price wars, which made it difficult for weaker companies to survive.

Declining investment returns due to lower interest rates compounded the problem of falling premium revenues and profitability. Non-life insurance liabilities were backed largely by government bonds. However, bond yields had fallen sharply by the late 1990s, hovering near their post–World War II lows. Falling interest rates had the effect of raising the value of outstanding bonds but squeezed the returns of insurers that were forced to reinvest maturing bond principal and new premiums at lower rates. It was estimated that the net effect of a drop in bond yields from 8% to 5% in the United States was to halve insurance industry profits even without any deterioration in underwriting income. By 2000, a growing number of insurers were incurring underwriting losses—claims and expenses exceeding premiums—for their non-life business, and they were reportedly propping up earnings by releasing excess claims reserves from the balance sheet or cashing in capital gains on sales of equity investments.

Life Insurance. Opportunities in life insurance have been more attractive due to the strong market growth since the early 1990s in retirement savings and pensions. In industrialized countries, the pensions business benefits from an aging population and threatened cutbacks in social security benefits, discussed earlier. However, life insurance has also been affected by a "yield pinch," especially in continental Europe. Historically, the investments for life policyholders in Europe—with a major exception in the United Kingdom—were allocated to fixed-income securities, mostly government bonds. With these traditional life products, insurers guaranteed their clients a fixed rate of return that was usually set by regulators. This guaranteed return ranged from 2.5% to 4% in most European countries. However, the spread between the insurer's investment yield and its guarantee to policyholders had dramatically narrowed due to lower interest rates.

This situation seriously damaged the profitability of both old and new business. The life of outstanding liabilities to policyholders often exceeded that of the underlying bond assets, which periodically matured and had to be rolled over at successively lower yields. For new policies, insurers could only invest new premiums at rates that were either close to or below those guaranteed to policyholders. By 1998, some continental European insurers

had started to reduce their guarantees to better match lower interest rates. Nonetheless, some of the larger continental European life insurers such as Fortis and ING had made significant provisions against yield risk, adjusted for profit-sharing agreements with clients and shifts to unit-linked products.

Although life insurers in some countries also suffered from policyholder guarantees, they have fared better through the adoption of unit-linked products with variable returns for new life policies. Unit-linked products, also known as "separate asset account" policies, are usually tied to the performance of equity investments. Unlike traditional life products bearing a guaranteed return, the investment risk under a unit-linked product is borne by the policyholder. Under this business model, income is earned from asset-management fees rather than from participating in investment returns. The unit-linked product provides an important benefit by requiring lower capital reserves than traditional policies—sometimes as much as 25% of traditional products' capital requirements—since clients assume the risks directly.

In the early 2000s, life insurance was thus in the process of reinventing itself into an increasingly asset-management-based business. Indeed, some of the larger insurers adopted a strategy of asset management as a "core" business by leveraging their investment expertise. These companies offer separate asset-management products to satisfy demand from both retail and institutional clients and to compete with banks that had made inroads into life insurance with annuity-linked products. Aside from AXA, which had become a leading asset manager, Allianz in 1999 announced the creation of Allianz Asset Management and acquired a major portfolio manager (PIMCO) in the U.S., while Generali was developing its own asset-management business. Table 10-2 shows how prominent insurance companies have become in the asset-management industry.

Demutualization and Consolidation

Many insurers traditionally operated as mutuals, in which ownership was vested in policyholders, not shareholders. Without shareholder pressure, mutual insurance companies are often less efficient than their shareholder-owned competitors. The mutual form of ownership also hinders consolidation through mergers and acquisitions, since a mutual is first required to demutualize after obtaining consent from its policyholders to become a stock company in order to use its shares as acquisition currency. By the late 1990s, the trend toward demutualization was industry-wide, especially in the United States and Japan. Some of the largest U.S. life insurance companies—including Metropolitan Life, John Hancock, and Prudential—were undergoing demutualization, while in Europe demutualization was well under way in the United Kingdom, including Old Mutual, the dominant South African insurer which issued its shares in London. Table 10-3 shows the world's largest insurance companies according to their forms of organization in 2001. Note that most of the mutuals were in the life sector, while

Table 10-3 Insurance Rankings, 2001

Ranking	Company	Country	Revenues ($mil.)	Profits ($mil.)	Type
Life Insurance Companies Ranked by Revenue					
1	AXA	France	92,782	3,608	Stock
2	ING Group	Netherlands	71,196	11,075	Stock
3	Nippon Life	Japan	68,055	2,704	Mutual
4	CGNU	Britain	61,499	(2,597)	Stock
5	Assicurazioni Generali	Italy	53,333	1,313	Stock
6	DAI-ICHI Mutual Life	Japan	46,436	336	Mutual
7	Prudential	Britain	43,126	1,043	Stock
8	TIAA-CREF	U.S.	38,064	1,222	Mutual
9	Sumitomo Life	Japan	37,536	1,099	Mutual
10	Metlife	U.S.	31,947	953	Stock
11	Meiji Life	Japan	29,777	871	Mutual
12	Aegon	Netherlands	28,423	1,909	Stock
13	Prudential of America	U.S.	26,544	398	Mutual
14	CNP Assurances	France	22,586	431	Stock
15	New York Life	U.S.	21,450	1,205	Mutual
Nonlife Insurance Companies Ranked by Revenue					
1	Allianz	Germany	71,022	3,198	Stock
2	State Farm Insurance	U.S.	47,863	408	Mutual
3	American Intl. Group	U.S.	45,972	5,636	Stock
4	Munich Re	Germany	40,672	1,617	Stock
5	Zurich Finan. Services	Switzerland	37,431	2,328	Stock
6	Berkshire Hathaway	U.S.	33,976	3,328	Stock
7	Allstate	U.S.	29,134	2,211	Stock
8	Royal & Sun Alliance	Britain	25,570	(21)	Stock
9	Loews	U.S.	20,670	1,877	Stock
10	Swiss Reinsurance	Switzerland	18,688	1,757	Stock
11	Tokio Marine & Fire	Japan	17,762	378	Stock
12	Liberty Mutual Group	U.S.	16,438	287	Mutual
13	Groupama	France	14,851	37	Mutual
14	Nationwide Ins. Entrprs.	U.S.	14,762	411	Mutual
15	Hartford Finan. Services	U.S.	14,703	974	Stock

most of the non-life insurers were public companies or insurance units if financial conglomerates.

The insurance industry had become increasingly consolidated both across and within national markets, and this trend is not likely to fade anytime soon. Because of lower margins from intense competition, insurers feel increasingly pressured to diversify outside of their home markets to spread volatility risks and gain access to new business. Greater size advantage is perceived to provide economies of scale and tighter control of expenses through improved technology. Cost-cutting seems clearly more advantageous at the national level between domestic rivals than between companies based in different countries, or in financial sectors with few overlapping operations.

Consolidation is also viewed by many as a way to reduce industry

overcapacity in non-life business, although others find such benefits to be somewhat illusory since size does not seem to provide greater market power and control over prices. The late 1990s were notable for some of the largest mergers within the industry. In the United States, AIG acquired Sun America in 1998. In Europe, Allianz bought AGF in 1997, one of the largest French insurers that recently had been privatized. In 1998, the Zurich Group merged with the financial services arm of BAT Industries to form Allied Zurich Financial Services. There were also deals between the insurance and banking sectors to form "bancassurance" groups that would gain from a potential for product cross-selling. In 1998, the respective takeovers by Crédit-Suisse of the Wintherthur Insurance Group in Switzerland by Fortis of Generale de Banque in Belgium typified this approach, and the U.S. merger in 1998 of Citigroup and Travelers, valued at $83 billion, was the largest on record at the time.

In Europe, the move toward insurance industry consolidation in the European single market proceeded in fits and starts. Critics argued that regional differences between European insurance markets were still too great for any real cross-border synergies. For example, there remained a lack of economic and legal harmonization to sell life and pension products across borders. Customers in some European Union countries could only claim tax benefits on life policies that they had bought from local suppliers. Indeed, currency unification among the initial 11 countries of the euro-zone probably brought more immediate benefits to the industry than a single market. National legislation usually required that insurers back their liabilities largely with assets denominated in the same currency. With the introduction of the euro, this restriction was effectively removed for insurers operating in the euro-zone's participating countries. The disappearance of currency risks also encouraged the growth in equity investments by insurers, with a shift away from a country-based investment approach to a pan-European sector-based approach. Finally, a single currency provided much greater access to the European bond market through its larger size and greater diversity of products. This allowed insurers to achieve a better matching of assets and liabilities by buying longer-term bonds across borders. For example, a Spanish insurer could add to its portfolio German government bonds of a longer maturity than were available locally.

In short, over the past decade the insurance industry, traditionally perhaps the least exciting of the four major financial services sectors—commercial banking, investment banking, asset management, and insurance—has become one of the most dynamic. Not only has the industry become increasingly global with major penetration of foreign players in national markets, but also it has penetrated banking just as banking has penetrated insurance, such as the 1998 Citigroup merger and the 2001 Allianz–Dresdner Bank merger. In the future, no doubt, insurance will continue to be provided by both specialist and generalist insurers, as well as by financial conglomerates, as the industry continues to sort out the best way to manufacture and distribute life and non-life insurance products.

Institutional Asset Pools and Capital Market Development

The effect of the euro on global financial markets in the context of a growing role of performance-driven asset managers is likely to run the gamut from the composition of financial assets and the scope available for portfolio diversification to competition among financial centers and corporate governance.

The rise to prominence of global institutional asset managers will do a great deal to enhance financial market liquidity. Mutual funds—whether part of defined contribution pension schemes or mass-marketed as savings vehicles to the general public—and other types of money managers are "noise traders" who must buy and sell assets whenever there are net fund purchases or redemptions, in addition to discretionary trades to adjust portfolios. They therefore tend to make a disproportionate contribution to capital market liquidity.

Professional fund managers attempt to optimize asset allocation in line with modern investment concepts by taking advantage of the potential for domestic and international portfolio diversification inherent across the range of financial instruments being offered, as well as by using the most efficient (friction-free) available securities markets and infrastructure services. They persistently seek sources of diversification across less than perfectly correlated exchange rates and interest rates. There is also likely to be increased correlations across equity markets covered by the dollar, the euro, and the yen, representing a continuation of the gradual increases in intermarket correlations that already have been observed. This will force portfolio managers to focus relatively more heavily on diversification strategies involving industrial sectors. Even in the case of market equities, the traditionally lower correlations between emerging market stock returns and the major market indexes seem to be rising.

Asset Managers, Shareholder Value, and Corporate Governance

Clearly, the capital markets will increasingly be the major source of external financing for corporations worldwide in the future—as against the traditional reliance (in many countries) on bank finance for debt and on bank and corporate long-term shareholdings for equity. Fiduciary asset pools managed against performance benchmarks by mutual funds and pension funds will create increasingly fluid sources of capital for industry, along with a fundamental shift in the accountability of management and monitoring of corporate performance in Europe.

In such a system, industrial restructuring will increasingly be triggered by the emergence of a control premium in the market—that is, between the existing share price of a corporation and the value that an unaffiliated acquirer feels could be unlocked by changes in management strategies or

policies. Based on such a perception of corporate underperformance, an investor may purchase a significant block of shares and signal his or her unhappiness with the company's performance, or perhaps initiate a full takeover bid for the target firm (which is now "in play"). Institutional asset managers can assume a critical role in such a scenario. They may agree that a control premium does indeed exist and may begin purchasing shares, thereby placing still greater pressure on management of the target company.

Even in the absence of a potential acquirer putting the company in play, major institutional asset managers who (because of their size or portfolio constraints) find it difficult to dispose of their ownership interest in a poorly performing company can request a meeting with management about the firm's strategy, financial performance, and realization of shareholder value. And they may speak out at annual general meetings. Concerns about unwanted takeover efforts and institutional investor dissatisfaction may trigger other management responses—including a self-restructuring, the search for an acceptable merger partner ("white knight"), pay-outs of special dividends or share repurchases, or finding other ways to enhance shareholder value and efficiency in the use of capital to preclude the emergence of a control premium and hostile action.

Such a transition is an important consequence of the growing role of professionally managed institutional asset pools. The potential benefits of such developments involve reduced cost-of-capital through higher share prices and improved access to global financial markets, as well as a greater capacity for economic restructuring in response to changes in technology, market competition, and other fundamentals.

Investor-driven, market-based systems will require much higher levels of transparency in corporate accounting and disclosure than has been the norm in most of the world, together with greater reliance on public information provided by management and systemic surveillance by research analysts working aggressively on behalf of investors. It implies arm's-length financing on commercially viable terms by banks and financial markets, with financial institutions active in giving strategic and financial advice and sometimes taking transitional, nonpermanent equity positions in (and occasionally control of) corporations in the process of restructuring.

Summary

There are at least six principal conclusions that can be drawn from the discussion presented in this chapter.

First, the asset-management industry is likely to grow substantially in the years ahead. Institutionalization and professional management of household discretionary assets through mutual funds has begun to take hold in many countries that have traditionally been dominated by bank assets. At the same time, demographic and structural pressures in pension systems will require strong growth in dedicated financial asset pools as pay-

as-you-go systems become increasingly unsupportable fiscally and as alternative means of addressing the problem show themselves to be politically difficult or impossible to implement. There are, substantial differences of view as to the timing of these developments within national environments however, since pension reform is politically difficult to carry out and the political willingness to do so is difficult to predict.

Proliferation of asset-management products, which is already exceedingly high in the United States and the United Kingdom, will no doubt be equally impressive elsewhere in the world as financial markets become more fully integrated. There will be a great deal of jockeying for position and higher levels of concentration, especially in the pension fund sector, that will begin to permeate the mutual fund business through defined-contribution plans, given the importance of economies of scale and the role of pension fund consultants. However, as in the United States, the roles of fund supermarkets; low-cost distribution via the Internet; and the very large contingent of universal banks, insurance companies, and specialized fund management companies—all are likely to prevent market structure from becoming monopolistic to any significant degree.

Fund performance will become a commodity, with few differences among the major players and the majority of actively managed funds underperforming the indexes. This implies a competitive playing field that will be heavily conditioned by branding, advertising, and distribution channels, which, in turn, are likely to gradually move away from the traditional dominance of banks in some national markets. All of this implies that asset-management fees will come under pressure as competition heats up, to the benefit of the individual investors and participants in funded pension plans.

Second, despite the prospects for rapid growth, the structure of the asset-management industry is likely to reflect a high degree of contestability. In addition to normal commercial rivalry among established players in national markets for asset-management services, foreign suppliers, notably the United Kingdom, Switzerland, and the United States, are aggressively targeting these same markets. Moreover, asset management (including private banking) is being marked for expansion by virtually every strategic group in the financial services sector—commercial and universal banks, private banks, securities firms, insurance companies, mutual fund companies, financial conglomerates, and financial advisers of various types.

Normally, the addition of new vendors in a given market would be expected to reduce market concentration, increase the degree of competition, lead to an erosion of margins, and trigger a more rapid pace of financial innovation. If the new vendors were from the same basic strategic groups as existing players, the expected outcome would be along conventional lines of intensified intraindustry competition. But if, as in this case, expansion-minded players come from very different strategic groups, the outcome may involve a substantially greater increase in the degree of competition. This is because of potential diversification benefits, possibilities for cross-subsidization and staying power, and incremental horizontal or ver-

tical integration gains that the player from "foreign" strategic groups may be able to capture. And natural barriers to entry in the asset-management industry—which include the need for capital investment in infrastructure (especially in distribution and back-office functions), human resources (especially in portfolio management), technology, and the realization of economies of scale and scope—are not excessively difficult for newcomers to surmount. So the degree of internal, external, and intersectoral competition in this industry is likely to promote market efficiency for the benefit of the end users in managing discretionary household asserts, pension funds, the wealth of high net worth individuals, and other types of asset pools in Europe.

Third, the rapid evolution of the institutional asset management industry will have a major effect on financial markets. The needs of performance-oriented institutional investors will accelerate the triage among competing debt and equity markets in favor of those that can best meet their evolving requirements for liquidity, execution efficiency, transparency, and efficient regulation. In turn, this will influence where firms and public entities choose to issue and trade securities in their search for cost-effective financing and execution. At the same time, the growing presence of institutional investors in local and regional capital markets will greatly increase the degree of liquidity due to their active trading patterns and create a ready market for new classes of public-sector securities that will progressively emerge. And it will intensify competitive pressure and enhance opportunities for the sales and trading activities of banks and securities firms, and for the role of product development and research in providing useful investment ideas.

Fourth, cross-border asset allocation will grow disproportionately as a product of institutional investors' search for efficient portfolios through international diversification, although such gains will disappear among increasingly integrated financial markets and will be replaced by sectoral and asset-class diversification.

Fifth, the development of deeper and broader global capital markets, spurred by the development of the institutional asset-management industry, will fundamentally change the market for corporate control into a much more fluid one focused on financial performance and shareholder value. This turn has the potential of triggering more intensive economic restructuring and creating trimmer, more competitive firms. Markets need to deny capital to uncompetitive firms and at the same time promote leading-edge firms though venture capital and other forms of start-up financing.

Sixth, developments in institutional asset management will pose strategic challenges for the management of banks and other traditional financial institutions. They need to extract maximum competitive advantage from this high-growth sector. They also need to structure and motivate their organizations and to manage the conflicts of interest and professional conduct problems that can arise in asset management—and that can easily cause major problems for the value of an institution's competitive franchise.

The fact that institutional asset management requires a global perspective, on both the buy side and the sell side, reinforces the need to achieve a correspondingly global market positioning. Nevertheless, technology and the changing economics of distribution virtually assures the survival of a healthy cohort of asset-management boutiques and specialists.

11

Private Banking

Individual wealth can take a variety of forms, encompassing financial assets (currency, bank balances, stocks, bonds, etc.) and real assets—commodities, precious stones, objets d'art, real estate, and other assets that have some sort of actual or potential market value. They range across the entire liquidity, risk, and return spectrum from cash to participations in private equity investments. The ability to measure wealth at any point in time depends on the existence of a market for each asset (hence the importance of liquidity) and the ability to "mark to market."

Like other investors, wealthy individuals base asset-allocation choices on their relative preferences for risk and return. The market value of a portfolio of assets is driven by the risk-return attributes of the various assets contained in the portfolio—the risk associated with an individual asset being based on the variance of its expected future returns. The risk embedded in an entire asset portfolio, in turn, is a product of correlations among the returns of all the assets contained in it. Consequently, there is value in diversification across individual assets, asset classes, political-economic environments, and other "buckets" (asset allocation categories) that are believed to be less than perfectly correlated. The lower the correlations across asset buckets, the greater the power of diversification.

Like everyone else, wealthy people are explicitly or implicitly looking for "efficient" portfolios that minimize risk for a given target rate of return or maximize total returns for a given level of portfolio risk. They are different from ordinary people in that they have a lot to preserve, so that they often tend toward relatively conservative asset-allocation approaches. They are also sensitive to confidentiality, trust, and service quality. Wealthy people usually don't have to deal with people they dislike or distrust, and usually they don't.

Defined in such general terms, wealth is a purely economic measure. It does not necessarily equate to an individual's own assessment of his or her

personal worth in a broader context, which is affected by many other factors. People differ in the satisfaction they derive from higher levels of wealth and how this may affect family members and other eventual beneficiaries. They are influenced by prevailing social, political, religious, and philosophical attitudes toward wealth. And they differ in the time and resources they want to spend on wealth management. This complex of issues tends to color their vision of the true "value" of what they have and needs to be intuitively understood by the private banker. Achieving this understanding is not easy and usually is very personal in nature. Successful private bankers thus require a unique combination of skills in applying a broad "value chain" of services and advice.

Sources of Personal Wealth

Wealth is usually the product of past or present returns in the provision of goods or services, together with capital income (interest, dividends, capital gains) earned on the accumulated assets through time. As such, it can normally be considered evidence of significant economic contributions in a market-oriented system. On the other hand, wealth can also be amassed *at the expense* of the rest of society through the unchecked exercise of monopoly power, extortion, racketeering, corruption, insider trading, drug trafficking, and the like. Nobody likes to talk about such things, but they nevertheless exist. Wealth is wealth. Classifying wealth in terms of its origins can provide a useful basis for the assessment of client attitudes, market segmentation, and private banking requirements.

Family (inherited) wealth involves the transfer of assets from one generation to another. This form of wealth tends to be sensitive to redistribution-oriented national fiscal and economic policies, especially taxation. It can arise from any of the other sources of wealth specified below. Heavy concentrations of family wealth are found in western Europe, the home of "classic" private banking, in North America, and in parts of Asia.

Corporate wealth is typically generated through service as a management employee of a corporation in the form of salaries, bonuses, stock options, and severance payments. The greatest concentration of this form of wealth is found in the United States due to exceedingly high levels of executive compensation (usually though stock option grants) compared to anywhere else in the world.

Entrepreneurial wealth tends to be accumulated over an individual's lifetime either as sole or co-owner of a business enterprise. The key word is "owner," not "employee." Entrepreneurial wealth may remain "paper" wealth for extended periods of time and is realized only when the enterprise is sold or goes public. Traditional concentrations of such wealth are found in Europe and Asia (often in family-owned and controlled businesses), but vastly more is found

in the United States, with massive new wealth concentrations resulting from start-ups in leading-edge economic sectors.

Political wealth may represent "gifts" from constituents or the proceeds of corruption in political office at varying levels within national or regional governing administrations, and private businesses benefiting from official corruption. Sources include misappropriation of public funds, bribery, extortion, political contributions, kickbacks, and financial holdings linked to government contracts. Public servants are rarely highly compensated, but there are some very wealthy ex-public servants who did not start out that way. The incentives underlying ill-gotten gains are ubiquitous. They are typically leveraged into serious wealth in environments where there are poorly developed markets and a lack of transparent, rule-based democratic politics, legal systems, and administrative infrastructures. As such, political wealth has tended to arise disproportionately in some of the emerging-market and transition economies of Africa, Asia, and eastern Europe.

Criminal wealth comprises assets traced to organized crime, extortion, theft of public and private property, financial fraud, arms trafficking, the drug trade, and other illegal activities, usually laundered into standard asset classes and invested in various ways. Criminal activities exist in all parts of the world, but it is likely that they give rise to more wealth where there are less open and transparent markets, combined with poor law enforcement.

Private banking targets the first three sources of wealth, which may represent some 85% to 90% of the total assets under management. Dealing with the last two categories of wealth presents some unique problems. Contamination of a private banking franchise as a result of a major corruption or criminal investigation can seriously injure a bank's reputation or, at the very least, require a great deal of explaining to clients. Nobody who values reputation and privacy enjoys being a client of a bank undergoing intense scrutiny and criminal investigation. In this trust- and service-based business, knowing what clients to avoid can be just as important as what clients to attract.

The Facts: Global Distribution of Wealth

What determines where wealth is distributed by source-region (held both onshore and offshore) around the world? Figure 11-1 provides estimates of the geographic wealth patterns for 1998–2000 and estimated for 2005.[1] The pattern tends to change relatively slowly based on a number of fundamentals:

Per capita income. Wealth is a "stock" measure, and income is a "flow" measure. Macroeconomic policies can greatly affect wealth

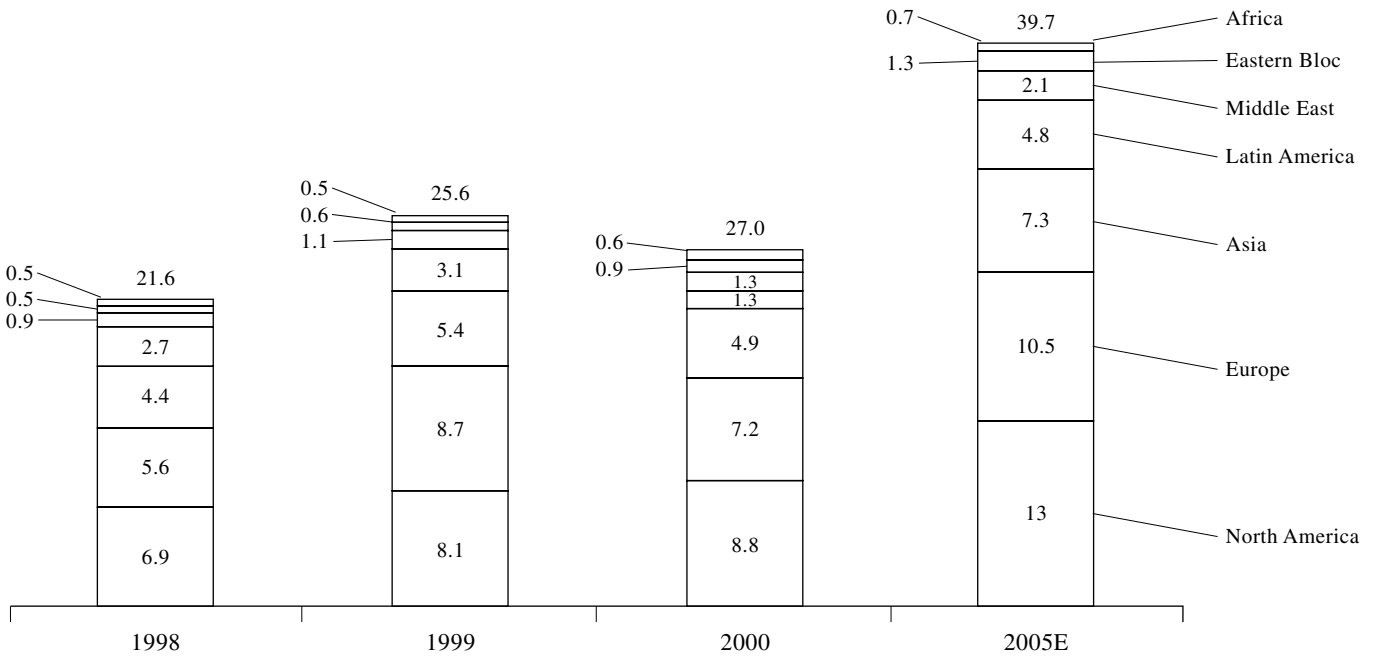

Figure 11-1. High Net Worth Individual wealth by region, 1998–2005 ($ trillion, adjusted for foreign HNWI ownership of securities) (Source: Cap Gemini Ernst & Young Lorenz curve analysis; base data from multiple sources, including MSCI).

levels, as evidenced by a decade of economic growth in the United States during the 1990s versus a comparable period of stagnation in Japan, or by the periodic booms and busts seen in some of the emerging-market countries. Higher-income countries and regions naturally tend to harbor greater wealth concentrations than lower-income ones.

Market distribution mechanisms. The distribution of capital ownership and property rights, as well as education levels and other sources of earning power, differ significantly among countries and regions. Market processes may generate wide differences in the distribution of wealth among countries around the world, even when economic size and per capita income are comparable.

Government policies. How governments treat the accumulation of wealth tends to result from a confluence of historical, cultural, and sociological factors that generate a political concept of a "fair" distribution. There have always been societies where wealth is regarded as evidence of exploitation and economic parasitism. This political overlay drives national policy with respect to taxation, expropriation, and other policy measures affecting the wealthy and is often based on the politics of envy. Policy changes related to wealth can be gradual or abrupt, and those who have assets to conserve tend to be highly sensitive to them.

Taken together, these three factors probably explain much of the geographic global distribution of wealth—not only where wealth can be found but also where it is individually held rather than institutionalized. There are plenty of "rich" societies where seriously wealthy individuals are few and far between, while others have them in abundance. If wealth accumulation is heavily taxed or heavily institutionalized (for example in the form of pension funds or assets controlled by the state, labor unions, or cooperatives), there is little of interest for private banking. It is where markets have been allowed to determine individual income and wealth levels that wealthy individuals and families tend to emerge and where private banking services are of greatest interest.

Private Banking Client Objectives

The objectives of private clients tend to be more idiosyncratic than many other financial services segments, such as mass-market retail and business customers. They reflect an amalgam of needs, among which capital preservation and yield, tax efficiency, confidentiality, and service level are critical.

Capital preservation versus total return. The traditional private banking client tends to be focused on wealth preservation in the face of

uncertain political and economic conditions, changeable government policies, and fickle markets. They demand the utmost in discretion from private bankers, with whom they often maintain lifelong relationships initiated by personal contacts. Such clients continue to be important but have gradually yielded to a more active and sophisticated group—clients who are increasingly aware of opportunity costs associated with poor investment performance and often focus on total returns calibrated against benchmarks. They may prefer gains to accrue in capital appreciation rather than interest or dividend income, and often they demand a much more active investment approach in which they themselves want to be involved.

Security. Until September 11, 2001, the world had arguably been a more stable place than ever before. The probability of revolution, war, and gross confiscatory taxation had declined just about everywhere. Still, many wealthy clients remained highly security conscious and therefore prepared to trade off yield for stability and safety. The events of September 11, turmoil in the Middle East and West Asia and stock market disasters in the West may have justified such concerns.

Tax efficiency. Many private clients are exposed to high average or marginal tax rates. Nobody likes to pay taxes, but the wealthy are under more pressure than anyone else—estimates for the United States, for example, are that the highest-income 5% of taxpayers generate over half of the country's income tax revenue. Where fiscal burdens can be avoided using the tax code, this is a valuable service to the private client. And in some environments the same is true of tax evasion, which occurs in violation of the applicable tax code and which financial institutions in a number of countries facilitate.

Discretion. Confidentiality is a key attribute of private banking. It means keeping sensitive information away from others in the knowledge that disclosure causes damage—in whatever form—to the individual concerned. One would expect the rich to have more reasons to keep secrets than the not so rich. So the watchword of the private banking profession is "discretion, discretion, discretion."

Service level. Personal services provided to private banking clients can be exceptional, and are considered critical in cementing relationships and client loyalty to a particular financial institution. Extraordinary personal services may save time, reduce anxiety, increase efficiency, and make the whole wealth management process more convenient and pleasant. They allow banks in very individual ways to show their commitment to, and understanding of, clients who are accustomed to high levels of personal services in their daily lives.

Perhaps more than other parts of the financial services industry, the essence of private banking is to accurately identify each client's unique char-

acteristics and objectives, and bring to bear the flexibility and expertise to satisfy them in a highly competitive marketplace.

In the 1990s, eroding lending margins and regulatory tightening of capital adequacy standards forced banks to carefully review their on-balance-sheet activity, with many deciding to emphasize fee-generating services. Simultaneously, there was a general effort to reduce dependence on commodity-like financial activities. In this context, the private banking client base offered a number of notable attractions. In terms of competitive analysis, it appeared underserved, especially in view of the increasing demographic importance of the wealthy in the main industrialized countries. The baby boomers of the 1960s were well into the prime-saving 40 to 60 age group, a time when their income level and wealth base tends to increase significantly. Notwithstanding the rapid rise in the number of banks targeting this segment of the market, it was generally considered to have continued attractive business potential. "Asset gathering" became the watchword, and private banking became a key part of the strategy.

The range of private banking services was quite broad, the essential factor being to offer a truly personal service focusing on the asset and sometimes the liability side of the client's balance sheet: lending to rich people. Moreover, due to the highly personal nature of private banking, clients generally preferred to "stay with" a particular bank, if possible, resulting in a lower price and performance sensitivity, facilitating product cross-selling, and enabling institutions to compete on qualitative variables instead of pricing alone. The business seemed to be characterized by favorable cost-to-income ratios and capable of realizing significant economies of scale in transactions processing and portfolio-management activities.

Onshore Private Banking

Onshore, or domestic private banking, consists of a value chain of financial and advisory services provided within the country of residence of wealthy clients. It can be viewed as an extension of the concept of "personal banking" or a broadening of the concept of "trust banking." A key difference among competing financial institutions is the wealth cut-off point for private banking clients. One bank may require a minimum of $5 million placed in investment management accounts. Another may be more flexible—a minimum requirement of $1 million in assets under management, for example, or a lower limit that may be dropped if a client appears to have significant future potential. Or there may be a $5 million individual net worth rule, but exceptions may be made for the "right" client. Alternatively, a bank may require that each private banking client generate a certain amount of annual fees.

Some financial institutions positioned themselves at the lower end of the wealth spectrum, especially regional banks, broker-dealers, and inde-

pendent asset managers such as Fidelity Group and Vanguard. Given the performance of the stock markets in many of the major industrial countries, even relatively modest equity holdings at the beginning of the 1990s put many "retail" clients into the high net worth class by the end of the decade, especially when the value of pension investments are included.

The principal private banking client segments thus encompass the following:

- Traditional high net worth individuals and families, with substantial inherited wealth requiring comprehensive advice on portfolio structures, proper inheritance planning, and long-term investment strategies, in addition to having possible interest in global investing and trading opportunities.
- Entrepreneurs/*Mittelstand*—owners and partners of small and medium-size businesses, as well as family-controlled industrial groups, a sector representing the driving of wealth creation in most countries and offering an opportunity for integrated advice on both business finance and personal finance.
- Professionals and executives, comprising self-employed individuals, partners in professional firms, financiers, traders, and highly paid executives, notably those with stock options. Such clients usually have complex and tax-driven compensation and asset-holding patterns, sometimes including multicountry requirements. The traditional private banking focus in this segment has been on personal assets, although it can be argued that an integrated focus on both employment-related income generation and wealth accumulation is more productive.
- Entertainers and artists, often highly paid, who are accustomed to agents in their professional activities but whose level of financial sophistication is often limited—yet with ample scope for innovation, including royalty and endorsement income management, value-extraction from intellectual property, and residuals.
- Sports professionals in an industry that has increasingly produced seriously wealthy individuals but with a highly uneven track record for wealth preservation and asset management.
- Family offices, maintained by the very wealthy and staffed by professionals who are capable of handling most matters related to wealth management and dealing with lawyers, accountants, and bankers to achieve family goals. Sometimes family offices will also take on wealth management assignments of close friends of the family.
- Intermediaries and external asset managers, constituting a substantial and growing array of small private banks, independent financial advisers, accounting and legal firms. These specialists market their services as being based on independent, objective advice in combination with outsourcing a good deal of the private banking value chain.

Key Private Banking Services

By the late 1990s many banks had made efforts to become one-stop financial supermarkets for the wealthy, offering a broad range of financial services:

Cash management services. A proliferation of deposit and payments services are available to wealthy individuals—checking accounts, cash management accounts, money market accounts, savings accounts, CDs, commercial paper, bankers acceptances, Treasury bills, and a variety of taxable and nontaxable mutual funds. Most are generic services available to retail clients but provided to private clients as well with a "platinum" level of service.

Brokerage and trust services. Traditional private client services include custodian accounts and advice on the establishment of estates, trusts, and corporations, as well as conventional stockbrokerage services, albeit with a high level of service quality. Tax advice is another key private banking function, since changes in tax structures, as well as altered client circumstances, may mean that the appropriate structure of an individual's balance sheet should change.

Investment management. Services provided for private clients vary between and within institutions, depending on the type of client served and the assets size of funds available for investment. Smaller accounts are normally pooled, with many banks offering a variety of funds across a broad range of investments. Larger accounts may be managed either on a discretionary basis or on an active advisory basis with clients involved in each transaction. The scope of investments may include real estate, limited partnerships investing in start-up businesses or special situations, precious metals, currencies, emerging-market equities, commodities, and works of art, in addition to conventional asset selections.

In terms of the asset-management function, private clients run the gamut from passive to active. Passive investors tend to be risk-averse individuals whose predominant use of financial resources may be for lifestyle maintenance and intergenerational wealth transfer. Active investors tend to be more risk oriented and financially sophisticated, and they generally use their financial assets to try to increase wealth. Banks compete aggressively for both markets but tend to be particularly attracted to active investors, where they perceive greater scope for value-added. They like to focus on individuals in the wealth-building phase of their lives. By helping them in the early stages of wealth accumulation, the argument goes, a bank may keep them later on.

Credit extension and personal lending. The need to borrow is particularly prevalent among entrepreneurial wealthy individuals. Such cli-

ents tend to be in the wealth-creating phase and illiquid. They may rely on the private banker to find a way to structure a deal around an existing personal asset base, for example. Other lending may involve real estate purchases or temporary (bridge) credits pending a sale of assets.

Business finance. The overlap between the personal and business needs of wealthy clients is particularly interesting for some of the larger banks with strong private banking units. It allows them to penetrate more deeply into the individual's finances and provide a range of corporate banking activities, in addition to personal financial services. These include banker's acceptances, letters of credit, revolving lines of credit, and term loans on the commercial banking side, and initial and secondary public offerings, merger and acquisitions services, and corporate finance advisory services on the investment banking side. IPOs have made many people rich, and that wealth needs to be managed. Wealthy individuals are often interested in private equity participations and other "alternative" asset classes. Due to the links between the corporate and personal finance, familiarity with the individual's attitudes to risk, currency, maturity, and liquidity requirements gives a significant advantage to an institution already servicing clients' commercial or investment banking needs.

Personal services. In a business where quality of service is of paramount importance and where the fiduciary nature of the relationship is critical, private bankers provide personal services atypical to mainstream banking. These can include personal introductions to the "great and the good"—prestigious individuals—admission to exclusive schools for children or grandchildren, invitations to sports and entertainment events, and many others—all provided with a good deal of style and discretion.

In many cases banks try to supply so-called 360-degree private client services comprising active customer solicitation and retention based on a high level of intimacy and trust as a deterrent to opportunism and achieving maximum "share of wallet." These services include asset allocation (passive, discretionary, and active fund management), brokerage (including Internet access options), real estate, art banking (authenticity, pricing, financing), access to IPOs and private equity participations, M&A services where appropriate, research, credit, structured products such as hedge funds and funds of funds, tax advice, estates and trusts, and a supporting range of personal services.

It is in the nature of private banking that clients tend to be more loyal than other financial services sectors. Given the high switching costs that private clients feel they face, clients tend to be lost mainly as a result of consistently poor investment performance, personal disagreements, or serious administrative snafus. Conversely, they are difficult to poach. Client acquisition in private banking thus depends on distinctive value-

propositions that can be put forward in a credible way, hopefully attracting a part of the individual's business that can later be expanded, based on satisfactory service and portfolio performance. In larger institutions it also depends on the ability to identify future wealthy clients early in the asset-accumulation process in order to retain the relationship later on. There are perhaps two alternative approaches to delivering the private banking value-chain to clients.

The first approach involves client segmentation based on product requirements, with maximum delivery of proprietary services. The argument is that this approach can leverage multiple in-house capabilities, sharpen application of specific expertise, help capitalize on global capabilities, and improve operating economics.

The second approach focuses on the private client as a single continuous "advisory project" using targeted teams that emphasize best-in-class products or services, whether in-house or external, to facilitate client intimacy, maximize objectivity in fulfilling client needs, and broaden the product range. The argument is that clients need to be made aware of best products, regardless of source, on an objective basis (as against favoring in-house proprietary services) and that this will maximize returns over the long term. It presupposes a much more fluid, capable, demanding, and diverse client base in the future, with much greater transparency in both performance and costs—and a decisive shift from product-linked fees (with advice provided virtually free) to advisory fees (with some products and transactions provided virtually free). The approach is to offer private clients what they want, drawn from an open array of benchmarked vendors through a highly capable client officer.

Many private banks attempt to focus on "event windows" in the life of clients, which coincide with both opportunities for client acquisition and vulnerability to client erosion. For affluent individuals or families, event windows include receipt of a major inheritance, opening the way for proposing asset-holding structures in light of family and lifestyle preferences, as well as providing an opportunity to market the entire private banking value-chain. For entrepreneurs, an event window might be flotation or sale of a business, creating the need for investment banking advice and IPO origination, tax issues, ownership and control questions, dealing with non-compete agreements, as well as a comprehensive and well thought-out wealth-management strategy. Executive event windows might include compensation-plan implementation or large-scale vesting, requiring ESOP life-cycle management and integration with other sources of wealth. And for athletes and entertainers, there might be a major career breakthrough or contract renewal with higher compensation or change in location, triggering the need for advice on contract structure, endorsements, sponsorships, and a proper lifetime investment strategy given a short career. Implementing an event-window approach requires identification of a compelling value-proposition for each client segment, drawing on the expertise of each private banking function, assessment of local market poten-

tial, definition of specific event-windows, and identification of generic private banking service-profile, including life-cycle dimensions.

Bundling of private banking services makes it difficult to evaluate the value/cost relationship of each component, potentially allowing the bank to extract higher fees. It is also likely that the client is less price-sensitive with respect to the purchase of bundled services than with respect to each of the services separately. While other parts of banking have been subject to a general unbundling of services as a result of a proliferation of new financial products and techniques, private banking remains an area where bundling may retain value for some time to come. And due to the existence of economies of scope, a bank can often provide several services more economically than providing a single service. This represents an important rationale for cross-selling of banking products. Since the fiduciary nature of the private banking relationship gives the bank access to a rich vein of client-specific information, it may retain an advantage in servicing the private client that competitors find difficult to penetrate.

Critical factors in executing an effective onshore private banking strategy include achieving intergenerational lock-in of clients by using financial and succession planning and wealth management, legal and tax-effective structures, discretionary asset management and custody. Performing these services well should create barriers to client exit and financial promiscuity, thereby retaining assets during life-cycle changes and achieving client retention over several generations. Also important are high-quality specialist services such as art banking and real estate advisory services. And substandard service in any of an array of back-office functions can easily contaminate a private banking relationship.

Offshore Private Banking

In offshore banking, assets are normally managed on behalf of nonresidents in the major functional financial centers such as London, Luxembourg, New York, Hong Kong, Switzerland, and Singapore—as well as in "secrecy havens" such as Antigua and Barbuda, Anguilla, Barbados, the British Virgin Islands, Cayman Islands, Dominica, Granada, Guernsey, Isle of Man, Jersey, Montserrat, Liechtenstein, Netherlands Antilles, St. Kitts and Nevis, St. Lucia, St. Vincent, the Grenadines, Turks and Caicos Islands, and Vanuatu, among others.

People want assets held outside their countries of residence for various reasons, which include portfolio diversification, risks pervading the home environment, tax evasion and avoidance, escape from domestic legal and enforcement actions, and confidentiality. The core client base for offshore private banking demands both security and confidentiality for the wealthy individuals and families who wish to hold funds in a tax-friendly environment offshore and in a form that will maintain its value, but which is

protected from exposure and disclosure. In addition, such clients have standard portfolio diversification objectives and lifestyle requirements.

Confidentiality

Financial confidentiality—involving nondisclosure of financial information concerning individuals, firms, financial institutions and governments—represents an integral part of the market for all banking and financial services, fiduciary relationships, and regulatory structures. It also constitutes a "product" that has intrinsic value, and that can be bought and sold separately or in conjunction with other financial services.

Demand for Financial Confidentiality. The demand for financial confidentiality can be defined as assured nondisclosure of financial information that people are willing to pay for:

- *Personal financial confidentiality* usually remains in substantial compliance with applicable laws and regulations, and in many countries has been well served by long-standing traditions of banking confidentiality. Indeed, financial privacy is often regarded as a cornerstone of individual liberty.
- *Business financial confidentiality* involves withholding financial information from competitors, suppliers, employees, creditors, and customers. Release of such information is undertaken only in a tightly controlled manner and, where possible, in a way that benefits the enterprise. Financial information is proprietary. It is capitalized in the value of a business to its shareholders.
- *Tax evasion* (as distinct from *tax avoidance*) is a classic source of demand for financial confidentiality. Some people are exposed to high levels of income taxation. Others are hit by confiscatory wealth taxes or death taxes. Still others feel forced by high indirect taxes or quasi taxes to escape into the underground economy. And there are those for whom the only "fair" tax is zero. Tax evasion requires varying degrees of financial confidentiality to work.
- *Capital flight* normally refers to an unfavorable change in the risk-return profile associated with a portfolio of assets held in a particular country, as compared with a portfolio held in other national jurisdictions, sufficient to warrant active redeployment of assets. It usually involves significant conflict between the objectives of asset holders and their governments. It may or may not violate the law. It is always considered by the authorities to be dysfunctional.
- *Criminals*, such as drug traffickers, not only accumulate large amounts of cash but also regularly deal in a variety of financial instruments and foreign currencies. All require ways to launder funds and eliminate paper trails that can be taken as evidence of criminal activity:

their money needs to disappear and stay that way. Bribery and corruption require financial confidentiality no less.

No matter what the motivation, the value of confidentiality depends on what may happen if disclosure occurs and on the probability of that happening. Damage can range from familial conflict and social ostracism to confiscation of assets, incremental taxes, fines, imprisonment, and worse. Avoidance of damage is what the confidentiality-seeker is after. Since damage is usually a matter of probabilities, the individual's attitude toward the risk of exposure is a critical factor in how this benefit is valued.

Supply of Financial Confidentiality. As with the demand for confidentiality, the supply of confidentiality-oriented financial services encompasses a complex patchwork of intermediaries, conduits, and assets that provide varying degrees of safety from unwanted disclosure. Supply dimensions can be classified into onshore financial assets, offshore financial assets, and physical assets held either onshore or offshore.

Traditional banking practice in most countries provides for adequate confidentiality with respect to unauthorized inquiries, which gives reasonable shielding for "personal" and "business" needs for privacy. Once the law gets involved, however—either in civil, tax, or criminal matters—much of this protection is lost. Under applicable legal procedures, the state can also force disclosure in the event of divorce proceedings, creditor suits, inheritance matters, and tax cases, not to mention criminal actions. Assets held abroad may offer a good deal more confidentiality since national sovereignty halts at the border, and extraterritorial investigation normally requires disclosure terms carefully and often reciprocally negotiated between governments. Bank deposits or assets in fiduciary accounts may be held abroad in jurisdictions (which often are also tax-friendly for nonresidents) that safeguard confidentiality through credible nondisclosure laws and blocking statutes. Bearer certificates, beneficial ownership structures, and shell companies may provide added protection and increase the complexity of any future paper chase. All suppliers of financial confidentiality—whether individuals, financial institutions, or countries—have an important stake in doing their best to limit disclosure as far as possible in order to avoid damaging the value of what they have to sell.

A broad array of offshore confidentiality-oriented services and vendors thus exists, competing with one another. A few offer confidentiality-oriented services with no good substitutes, so that fees and other costs may be quite high. Some traditional sources of confidentiality are easily available in some places but less so elsewhere. Others have been built up over the generations as secure repositories and can command high premiums. Arguably, higher levels of confidentiality involve successively greater degrees of monopoly power in the competitive structure and organization of the market for financial confidentiality.

Market Dynamics. Together with conventional motivations related to risk and return, investor behavior thus may also be driven by confidentiality regarding the nature, location, and composition of financial or other assets that comprise a portfolio. If confidentiality is not a free good, it must be "purchased" by putting together a portfolio of assets (or a single asset class) that yields the desired level of nondisclosure. One "cost" of confidentiality to the asset holder is thus the difference between the expected yield on a confidentiality-oriented portfolio and the yield on a "benchmark portfolio" put together for the same individual when confidentiality is not a consideration.

Part of the total return differential attributable to the need for confidentiality simply reflects charges levied by financial intermediaries. Banking fees may be higher for asset holders driven by the need for confidentiality. Transactions may have to be routed in clandestine ways, through narrow markets with wider spreads or via inefficient payment conduits, adding to transactions costs in the process. Foreign exchange transactions, perhaps repeated several times or involving parallel (black) markets, may add further costs. Third parties, beneficial owners, lawyers, and shell companies may have to be used to enhance confidentiality, all of which involve costs. And in some cases people may have to be bribed. Since many of the intermediaries know the name of the game well, they may not be shy about pricing their services.

Besides the confidentiality-related differential in the expected total return on assets, there is also the matter of differential risk. It seems likely that portfolios of assets containing greater degrees of financial confidentiality can be more risky. For example, assets may have to be held directly or indirectly in offshore jurisdictions, resulting in increased foreign exchange risk or country risk. Or the portfolio may be forced into a configuration that is susceptible to increased interest rate risk, and various ways of diversifying or hedging risk may not be available to portfolios incorporating a high degree of confidentiality.

The Agency Problem. There can also be so-called agency problems that confront those substantial needs for confidentiality. An "agency" relationship exists whenever an asset holder delegates decision-making authority to the manager of a portfolio. Interpretation of investor objectives is often not easy under the best of circumstances. Investor objectives may change, with the fiduciary being uninformed or poorly advised. Or the investor may psychologically reposition his or her objectives after the fact if the portfolio has underperformed in some way, with undeserved blame assigned to the asset manager. In addition, serious agency problems arise if, for example, the asset manager abuses his or her mandate by "churning" the portfolio to bolster commission income or by "stuffing" the portfolio with questionable assets. Usually, well-defined contracts between principals and agents, together with redress incorporated in banking and securities laws, provide

adequate incentives for agents to make decisions that are in the interests of asset holders.

Financial confidentiality raises some unique agency issues. If confidentiality is added to the fiduciary's mandate, the job becomes very much more complex. Violation of the fiduciary's role, at least in the eyes of the client, includes violation of the confidentiality mandate—even if this is itself in violation of applicable laws or regulations. Ordinarily, disputes between clients and their asset managers can be taken into court in civil suits or other means of dispute resolution But how can the asset holder take the agent to court when a foreign legal jurisdiction is involved, when that jurisdiction is unclear, or when any such an action would itself compromise the confidentiality that is being sought? So the agent acquires certain immunity from the kind of redress usually available to asset holders who might be confronted by agent misconduct.

The question is whether such quasi immunity influences the behavior of the fiduciary to the detriment of the asset holder. Perhaps those seeking high levels of confidentiality are prepared to pay some agency costs, as long as there are no large unaccountable losses. Perhaps competition in the asset-management business, as well as traditions of prudence and competence, tend to impose constraints on abusive behavior. Still, this problem puts a real premium on selection of the offshore private banker, who must be depended on to carry out fiduciary responsibilities with great care and sensitivity to client desires without succumbing to the temptations that derive from his or her potential leverage as a "secret agent."

Supply and demand thus interacts in the (predominantly offshore) market for financial confidentiality, just as they do in any other market. A hierarchy of differentiated products exists, each with its own characteristics. The greater the demand, the higher the price. The more intense the competition among vendors, and the easier the substitutability of confidentiality products, the lower the price. The rational offshore client will presumably shop around, insofar as his or her position is not jeopardized thereby, to acquire an optimum mix of products at a cost (including agency costs) that makes the whole exercise worthwhile. The acquisition of offshore assets in the presence of confidentiality can thus be thought of as a rational process—one that balances a number of costs against benefits and in which the confidentiality factor is likely to alter behavior in rather predictable ways. And if confidentiality-seeking asset holders are risk-averse, they may prefer rather conservative portfolios, since they are seriously exposed to risk in other ways.

Regulatory and Tax Pressures on Offshore Private Banking

There are indications that the value of confidentiality may be on a gradual decline as a competitive driver in global private banking. This is based on changing attitudes toward financial secrecy and the kinds of pressure that

national tax and criminal authorities can bring to bear on foreign jurisdictions.

National authorities seem determined to use their influence to combat criminal uses of secrecy as well as tax evasion—and more willing to share information—so it may be increasingly difficult to guarantee customary levels of secrecy in some cases. A driving force is governments' appreciation that financial secrecy facilitates criminal activities and that one of the best ways to attack these is to increase the cost and reduce the opportunities to launder money. At the same time, fiscal constraints such as the Maastricht criteria in the euro-zone, budgetary compacts in the United States, and IMF-imposed fiscal austerity in many emerging market countries tends to reinforce government determination to collect taxes that are due.

According to one OECD report, secrecy laws and other factors made the use of Swiss bank accounts in particular "attractive to nonresidents" seeking to evade taxes and avoid detection in their home country:

> Switzerland is the world's biggest offshore banking sector for wealthy individuals, with about a third of the global market. It has always been suspected [that] Switzerland's dominant market share in private banking was partly dependent on its long tradition of banking secrecy, which protected customers who wanted to evade tax in their own country. But until now the OECD's annual country reports on Switzerland have not dealt with the subject. Switzerland and the OECD have, however, clashed once before on the question of tax evasion and bank secrecy. In April 1998 Switzerland, along with Luxembourg, refused to endorse the OECD's guidelines on harmful tax competition. The move was part of an attempt by the OECD to combat unfair fiscal practices. Swiss banks argued that their big market share is primarily due to Switzerland's long tradition of neutrality, political stability, a strong currency and professional banking services. Switzerland has long provided a home for extremely wealthy foreign individuals who want to minimize their tax bills. . . . The vast bulk of Swiss bank customers rarely step inside the country and rely on banks there to handle their affairs. The OECD said access to information was essential for effective tax enforcement and that, as globalization and technology continue to advance, it would become increasingly important.[2]

In November 1999, congressional hearings on private banking in the United States were held in response to allegations of massive diversion of foreign aid funds, official corruption, organized crime, the drug trade, and money laundering. Several high-profile cases once again trained the spotlight on the role of offshore private banking and the quality of due diligence and appropriate conduct on the part of private banking organizations and their employees.

In general, there seems to be a growing disparity between the degree of financial secrecy offered in the high-quality offshore banking centers like Switzerland and those of lesser standing. This is probably because the high-quality financial centers have more to lose from being "tainted" and, at the

same time, are more vulnerable to outside pressure due to their own banks' large presence in global markets.

Those concerned with the future of offshore private banking usually focus on (1) tax coordination, cooperation, and alignment among countries of residence of offshore clients; (2) tighter notification and reporting requirements imposed on banks dealing with suspect or underregulated banks and countries; (3) international agreements to expand account investigation related to money laundering, including a more intense focus on accountants and lawyers; and (4) the use of *cordons sanitaires* in the case of noncooperating institutions and countries. These things don't change overnight, but the pressures are sufficiently visible to raise concerns about offshore private banking as a major source of future earnings growth for financial services firms engaged in private banking.

Economics and Competitive Structure

Private banking is an unusually attractive business within the global financial services industry. The services involved are not particularly capital-intensive in comparison to commercial or investment banking activities. And generally they can be carried out at cost-to-income ratios on the order of 45% to 60%. The revenues are relatively stable as well, including resistance to major losses attributable to market risks and credit risks.

Within the private banking domain, offshore private banking is more profitable than onshore private banking, given the offshore client's need for confidentiality and, consequently, his or her willingness to pay higher fees or tolerate a lower level of portfolio performance. In addition, the competitive pressure on pricing may be considerably less intense in offshore than in onshore private banking.

The size, growth prospects, and profitability of the private banking market in general has resulted in fierce competition. Virtually every strategic group in the financial services sector has targeted private banking and asset management for the wealthy as a key area for development. This includes the classic specialists such as Lombard Oder, and Darrien Hentsch (which merged in 2002), Pictet, Julius Bar, Coutts & Co., Schroders, and (a unit of Charles Schwab) U.S. Trust Company, as well as megabanks like J. P. Morgan Chase, Citigroup, Deutsche Bank AG, UBS AG and the Crédit Suisse Group. Insurance companies like AXA and the Zurich Group have targeted their insurance and asset-gathering units catering to wealthy clients as well. American Express focuses on "platinum" and "black" travel and entertainment cardholders in efforts to cross-sell private banking services. Broker-dealers like Merrill Lynch and Goldman Sachs have initiated major efforts to become important players in private banking. And fund-management companies like Fidelity Group and Vanguard have had intensive efforts under way to target affluent clients as well. Everyone is in on the act, each coming from different strategic directions and competing in ways that can be traced to their origins, ranging from retail-like approaches

Table 11-1 World's Largest Private Banks, 2002

	Assets Under Management ($ bil.)	Market Share (%)
UBS AG	428	1.8
J. P. Morgan Chase	320	1.4
Crédit Suisse	293	1.2
Goldman Sachs	293	1.2
Deutsche Bank AG	200	0.8
Citibank	153	0.6
Merrill Lynch	140	0.6
Bank of America	129	0.5
HSBC Holdings	115	0.5
ABN Amro	114	0.5
BNP Paribas	99	0.4
All Others	21,126	90.5
Total	23,410	100.0

Data: Financial Times, June 26, 2002.

such as advertising campaigns and toll-free numbers to sophisticated personal marketing pitches and efforts to enlist intermediaries such as attorneys, accountants, and independent financial advisers. For some of the larger and broader firms, referrals from other units within the organization can be valuable. Whatever the "surface" tactics for attracting clients, the key to profitable private banking is the relationship with a client. Table 11-1 presents the world's largest private banks in 2002 and shows how highly fragmented the business is.

In order to perform effectively, especially the large institutions in private banking markets have to engage in considerable market segmentation, based on sophisticated analysis that incorporates a range of characteristics, needs, and financial sourcing habits of specific client groups. This can help a large banking organization focus its resources more accurately in order to target its product line, its distribution system, and its promotional efforts to particular market segments. Smaller, specialized private banking institutions, in contrast, can rely on a broad, generalist approach. In either case, sophisticated marketing is vital to attract clients who who have become newly wealthy or who have been clients of competitors, and to persuade customers to remain even when their wealth levels and portfolio requirements change.

The most important component of any private banking effort remains the quality of the bankers. It is not easy for a private client to share confidences with his or her banker, so a low staff turnover is particularly important. At the same time, the changing nature of wealth and the demands of the wealthy suggest that tomorrow's private banking will have to be quite different from that of the past. Classic private banking qualities will be combined with a strong understanding of modern financial markets and instruments and how they can be used to the client's advantage—as well

as personal acquaintance with individuals in the organization who are the relevant specialists and can be brought to bear on the client at the right place and the right time. Good ideas, combined with good execution and a strong relationship, are what tend to determine competitive performance in global private banking.

Notes

1. Merrill Lynch, *World Wealth Report 2001* (New York: Merrill Lynch, 2001). Prepared in cooperation with Gemini Consulting and Ernst & Young.

2. William Hall, "OECD Warns Swiss over Tax Evaders," *Financial Times*, August 7, 1999.

III

COMPETITIVE STRATEGIES

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12

Assessing and Managing Cross-Border Risks

Various types of risk are faced by commercial and investment banks in their global operations. Credit risks in lending or investing in foreign entities, several types of risks associated with project financing, operational risks, compliance risks, risks in dealing foreign exchange, and funding risks related to balance-sheet management and off-balance-sheet exposures are a few examples. By definition, global banking activities cross the political frontiers of sovereign national states and give rise to yet another source of risk in international banking—country risk.

The Nature of Country Risk

Suppose a New York bank makes a dollar loan to a Venezuelan company with satisfactory local credit standing. When the time comes to repay the loan, however, the company finds it is unable to convert bolivares into dollars because its government has imposed exchange controls as part of a general declaration of economic emergency—a case in which the borrower is willing and able to meet its contractual obligations, yet country conditions effectively prevent it from doing so. In retrospect, credit risk was not a problem but transfer risk (a form of country risk) was.

Or suppose a Japanese insurance company buys 10-year Eurobonds issued by the government of Vietnam, with the proceeds used for infrastructure financing purposes. In effect, the insurance company is lending against the full faith and credit of the government of Vietnam; therefore, it is exposed to sovereign risk, since future circumstances may be such that the government may be unable or unwilling to provide debt service. This is another form of country risk.

All cross-border lending or investment activities by international commercial or investment banks and their clients thus involve country risk, which is associated with the possibility that the future flow of returns from these activities may be impaired by economic or political events.

Credit risks associated with each borrower represent unsystematic risk. A bank or investor can reduce the overall level of risk to which it is exposed in a given country by carefully building a diversified portfolio of exposures and ultimately drive the level of unsystematic risk close to zero. But because all exposures in a single country are linked by economic and political events, the lender or investor is stuck with a form of systematic risk that also falls into the general category of country risk. A government may pursue fiscal, monetary, foreign exchange, or other policies that impair debt service on the part of multiple borrowers by affecting their profitability, by undertaking nationalization or expropriation, and by impeding access to foreign exchange, or it may enact a host of other adverse policy measures. Systematic (country) risk thus limits the ability of a bank or investor to diversify away from unsystematic risk in the management of its portfolio in a particular country.

We have used two examples of country risk in the preceding hypothetical cases:

Transfer risk involves the possibility that the borrower may not be able to convert domestic currency into foreign currency.

Sovereign risk involves loans or securities of governments, their agencies, or nongovernmental entities under government guarantee that eliminates local credit risk—and yet the government itself may be unable or unwilling to service its foreign obligations.

Foreign exchange risk does not confront the lender or investor directly if the obligation is denominated in non-local currency. Yet exchange-rate movements can influence the creditworthiness of borrowers and issuers, and factors affecting exchange rates are often closely allied to those that affect country conditions in general.

Besides cross-border loans and securities holdings, a bank or investor may also have certain direct investments in a particular country. These may take the form of equity holdings in local companies, bank branches, joint ventures, or other types of ownership interests, all of which are subject to foreign direct investment risk (FDI), which can be quite different from the other country risk categories. Clearly, a country may be economically and politically sound, yet the government may decide to nationalize all foreign ownership interests in a certain sector as a matter of national policy. Country risk may be low, yet risk associated with FDI may be high under such circumstances. In cases where government places a very high priority on direct foreign participation in a given sector—such as development of a nation's financial system—the reverse may also be true.

Finally, a bank or investor that has a well-diversified portfolio of assets

in a particular nation and yet remains troubled by its exposure to (systematic) country risk always has the option to diversify still further and distribute its holdings across a variety of different countries. This way, country risk becomes unsystematic as far as its overall portfolio is concerned, and this allows cross-country diversification strategies to reduce overall exposure to risk still further. Under international portfolio diversification (IPD), the bank or investor simply puts its eggs in different country baskets, in the hope that the chances of one basket getting dropped has little to do with what happens to others.

But are country futures indeed independent? Unfortunately, changes in oil prices, conditions on international financial markets, business cycles, protectionism, and global or regional political events turn out to affect many countries at the same time, often in the same direction. Brazil's economic conditions may be quite independent of South Korea's, but both may simultaneously be affected by a major change in global interest rates or a financial crisis in Russia. The risk associated with changes that transcend national political frontiers can be called *contagion* risk and is systematic and inherent in the global environment. For practical purposes, contagion risk sets a limit on the extent to which IPD can succeed in reducing overall exposure to risk. The only way to reduce risk still further is to move into other asset classes that have traditionally served as hedges in periods of global unease, such as gold or real estate, or to buy risk insurance. Unfortunately, neither is entirely free from contagion risk, and both can be rather costly alternatives.

We have defined seven types of risk in three broad categories, all of which have to be considered in international portfolio management:

- *Credit* risk and *foreign direct investment* risk at the narrowest, unsystematic level, both relatively easily subject to diversification
- *Country* risk, of which *transfer* risk, *sovereign* risk and *exchange* risk are components; it is systematic as far as individual cross-border loans and investments are concerned, but can be made unsystematic through international portfolio diversification
- *Contagion* risk, which is generally systematic, transcends national frontiers, and thus effectively limits risk reduction via IPD

Problems associated with country exposures have proven to be hardy perennials.[1] As table 12-1 shows, during the nineteenth century most international borrowing was associated with issuance of sovereign bonds. A good part of these proceeds was used for military purposes, with the losers of wars often ending up in default during the first great episode of cross-border credit difficulties in the 1820s. During the 1870s another period of sovereign bond defaults combined this reason with the unwise use of proceeds and political pressure by home governments on investors as part of foreign policies being pursued at the time. Bond defaults in the 1930s were mostly associated with the Great Depression, as country after country was

unable to meet its commitments and private borrowers cascaded into bankruptcy. The postwar period was mainly closed to bond issuers outside the OECD countries, and bond investors were replaced by syndicated bank lending to countries that eventually ended up in major difficulties during the debt crisis of the 1980s. As table 12-1 suggests, in the 1990s systemic contagion factors were increasingly associated with short-term capital flows. The bottom line is that country problems are not at all unusual, nor are they unconnected from each other. This suggests that both careful country assessment and the adoption of a careful portfolio approach to cross-border exposures are in order. In the 2000s, as emerging market debt and equity issues once again become significant, and cross-border bank loans reappear, the lessons of the past should not be forgotten.

Country Exposure: Definition and Measurement

A basic prerequisite for effective global asset management is exposure tracking. Banks and institutional investors need to know their global exposure to risk along a variety of dimensions. For example, it is important for a bank to track its claims on all of its clients in a particular industry (such as petroleum, copper, or air transportation) since worldwide, regional, or national developments at the industry level may affect multiple clients simultaneously. Groups of borrowers sensitive to certain economic or political conditions (such as energy-intensive companies) also require exposure measurement at the national, regional, or global level.

The difference between measurement of a bank's exposure to risk associated with particular firms or industries and its exposure to country risk is that the latter deals with cross-border financial flows, while the former is concerned with total claims and other exposures, whether cross-border or not. For instance, a loan by a European bank's branch in Buenos Aires to a local company, funded by Argentine peso deposits, incurs firm and industry risk but not country risk (although the bank's local branch does involve FDI exposure), yet the same loan originated by the bank's Paris office involves all three types of risk.

Figure 12-1 indicates, as a three-dimensional display, the kind of information that is useful in keeping track of a bank's global exposure. With respect to exposure to country risk, the first category is lending exposure. Every cross-border loan, whether originated by the bank's head office or by offices anywhere else in the world, must be promptly reported and captured in the system. To double-check, it is useful to have each cross-border loan reported both by the originating office and by the office directly responsible for the country concerned. Exposures by country should then be broken down into appropriate maturity buckets, loan commitments, and drawdowns or disbursements. It is also useful to know the extent to which the country has claims on the bank. These should not be netted against lending exposure, but it is important to be aware of them. In extreme cases,

Table 12-1 Comparison of the Five Major International Debt Crises

	1820s	1870s	1930s	1980s	1990s
Countries of major private creditors	Britain	Britain, France, Germany	USA, Britain, Netherlands, Switzerland	USA, Europe, Japan, Canada	USA, Europe, Japan, Global Portfolio Investor Base
Major defaulters	Latin America, Greece	Egypt, Turkey, Spain, Latin America	Germany, Eastern Europe, Latin America	Latin America, Eastern Europe, Africa	Russia, Thailand, Indonesia, Korea, Philippines, Malaysia, Mexico
Systemic factors	Lending to belligerents Lack of lending experience and information	Lending to belligerents or profligate rulers Strong political influence	Worldwide depression Trade wars	Oil and interest rate shocks Worldwide recession Poor economic management	Financial contagion investment vehicles Structural problems in domestic financial systems, leverage, unhedged foreign debt Lack of transparency Cronyism Corruption

such claims may be used under the "right of set-off" (retaining assets of the obligor to compensate the bank for defaulted liabilities).

Not only is keeping track of lending activity by country an important function of exposure-tracking systems, but also it serves portfolio purposes as well. Figure 12-1 may also indicate subtotals by regions, wherein specific country groups may be captured as needed—for example, Central America, Southeast Asia, or sub-Saharan Africa. At the same time, such a system can track (in its B-dimension) lending by borrower type: banks, industries,

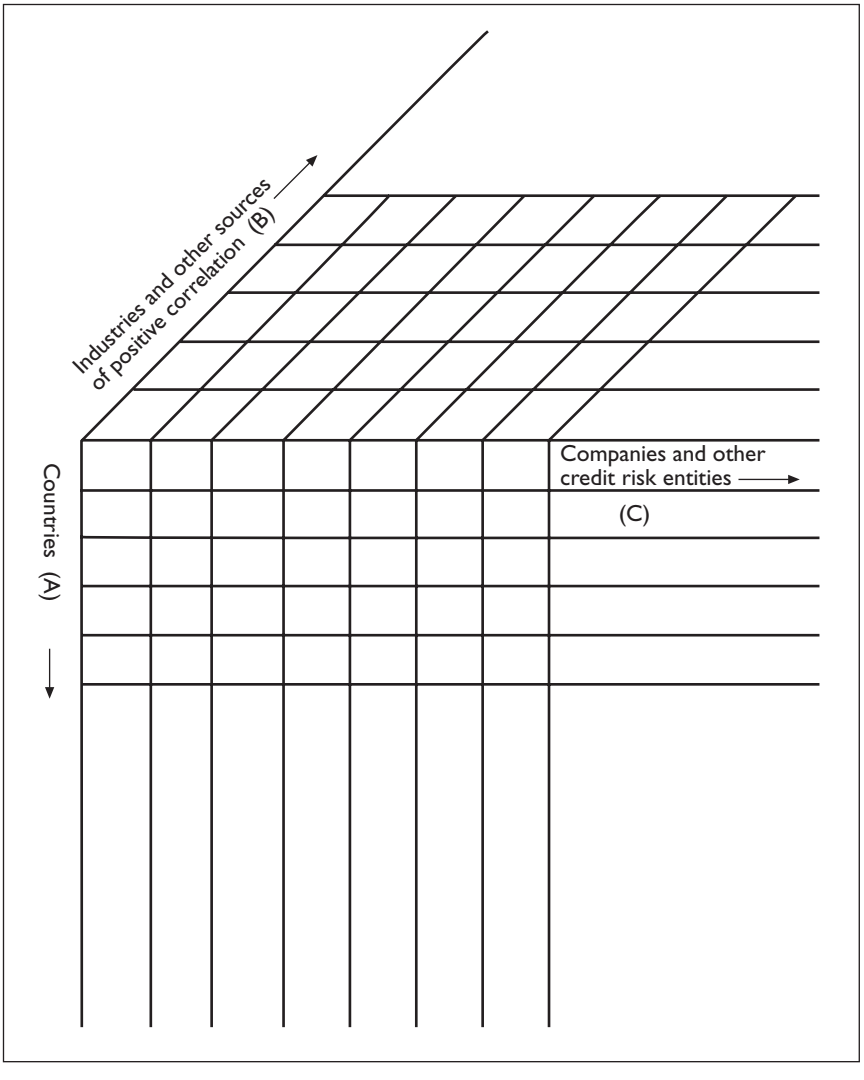

Figure 12-1. Three dimensions of global exposure tracking.

public-sector and private-sector companies, energy-intensive companies, or other classifications of special interest. It may also include (in its C-dimension) exposure to corporate "families"—such as Daimler Chrysler worldwide—as well. While only cross-border exposure is of interest with respect to country risk, total exposure is relevant for portfolio purposes and management of noncountry risk exposures.

The A-dimension of figure 12-1 focuses on direct cross-border exposure. But suppose a bank loan to the Thai subsidiary of an American company is guaranteed by its parent. In that case, the "country of lending" and the "country of risk" are different: one is Thailand (country of lending) and the other is the United States (country of risk). Guarantees serve to transfer country exposure. "Comfort letters" or "keepwells," provided by corporate parents, for example, do not transfer country exposure. Exposure transfers via guarantees are reflected in the A-dimension of figure 12-1. Quite often, as in shipping loans, considerable judgment is required to determine the appropriate allocation of country exposure.

In making judgments about a country and its lending or investment opportunities, a bank or institutional investor will want to set limits on country exposure that should not be exceeded, usually in the form of overall country limits and sublimits for different maturities. Limits applied to individual borrowers, industries, or regions can also be incorporated here. All are driven by returns, as well as risk factors.

Nonlending exposure—in the form of off-balance-sheet transactions, foreign exchange and derivatives exposures, equity interests in foreign firms, bank affiliates, branches, consortium arrangements, and portfolio investments—may also be recorded in an exposure information system, generally under the A-dimension in figure 12-1, although risk transfer may also be possible under home-country guarantees of parent companies, government agencies, or international organizations. Periodic exposure reports must be made available in regular intervals to bank officers, either in printed form or in computer displays.

Valuation of Country Exposure

A bank or investor in debt instruments is naturally interested in the economic value of its exposure in a particular country. It is also interested in maximizing the economic value of its global asset portfolio, spread among a variety of different countries. Both decisions involve expected returns and possible future variance of those returns, as reflected in the degree of risk associated with them. We can express this in the form of a conventional present-value equation, such as the following:

$$\mathrm{NPV}_j = \sum_{t=0}^{n} \frac{E(F_t) - E(C_t)}{(1 + i_t + \alpha_t)^t}$$

where NPV_j is the net present value of the future stream of expected returns to the bank or investor related to exposure in a particular country j, $E(F_t)$ and $E(C_t)$ denote the expected value of the stream of future returns and the associated collection costs at time t, respectively, i_t is the risk-free discount factor representing the bank's cost of funds (or some other risk-free rate), and α_t represents a country-risk premium, which depends on the variance in returns on the bank's exposure in country j, relative to the variance in returns on an overall asset portfolio and on management's attitude toward risk. Prospective future developments in countries involving cross-border exposures will be reflected in the means as well as the variances of the probability distributions associated with these returns, and hence will influence both $E(F_t) - E(C)_t$ and α_t.

It is important, to develop an accurate picture of the net expected returns, namely, $E(F_t) - E(C_t)$. A first component of returns is the repayment of principal. A second component covers the stream of interest payments, which usually involves either a fixed rate or the spread over LIBOR, the U.S. prime rate, or a similar floating base rate of interest. A third component is a share of commitment, participation, and management fees agreed on with the borrower. As noted in chapter 5, these may be quite substantial, especially for those involved in organizing and managing syndicated loans. And banks often lend to a particular borrower on fine terms in order to develop or maintain a "relationship." This involves existing and past banking ties and focuses on the expectation of future earnings from a variety of activities, foreign exchange transactions, deposit balances, advisory services, custody business, and the like.

There is ample evidence of the importance of the "relationship" factor in international banking behavior, with regular scrambles by firms to get "close to" the client, and in the tendency for losers of mandates to participate in deals anyway, simply to maintain a relationship with the client. Similarly, borrowers can sometimes "encourage" banks to participate in loans that would not otherwise be attractive by suggesting that failure to do so may lead to loss of other business or put pressure on their operations in host countries, thereby requiring the addition to apparent returns, in effect, of an insurance premium against possible future earnings losses elsewhere in the relationship. Particularly where a relationship with a specific government has been highly profitable in the past, and promises to be so in the future, such anticipated "indirect" or "soft" returns can be an important issue.

A bank's financing of a particular borrower may also generate future returns with third parties, which would otherwise be lost. For example, a particular loan to a company or government abroad may create opportunities for future business with home or third-country suppliers, or a well-structured loan could strengthen a relationship with a particular domestic or foreign client in a way that promises additional future earnings.

Finally, there are collection costs. Loans that are delinquent or "nonperforming" because of conditions in countries where the exposure is

lodged often involve sizeable travel, as well as legal and other expenses. Particularly for bankers who take relatively small participations in major loans, collection costs can loom large in relation to expected losses in the event of problems. And fixed-income investors may recover only a small fraction of the face amount of bonds in default situations.

It is clear, therefore, that expected returns of principal interest, fees, and the remaining less-tangible earnings components generated by country exposure, as well as expected collection costs, form a multi-sided, probabilistic picture. Each element has its own time profile and expected value, so that $E(F_t) - E(C_t)$ in our formula is itself a highly complex composite. In addition, each element has its own measure of variability, so that the associated risk premium α_t is similarly complex. There are often trade-offs, as when the terms of financing agreements are relaxed at the borrower's insistence in exchange for higher expected returns in some other earnings components. Partly for such reasons, profit attribution in international banking tends to be extraordinarily difficult, and the returns facing individual banks that participate in syndicated transactions may well differ substantially from one to the other.

In measuring interest rate risk, banks differentiate between floating-rate and fixed-rate loans. In floating-rate (e.g., LIBOR-based) loans or floating-rate bonds, a change in interest rates would show up as a change in both i_t and $E(R_t)$ and would have a minimal effect on interest rate risk. In fixed-rate loans or bonds, $E(R_t)$ remains constant while i_t changes, causing a corresponding change in NPV. But even with floating-rate instruments, since spreads are fixed either for the life of the contract or for specific periods, there exists some residual interest rate risk.

Apart from changes in interest rates, there are a number of other contingencies:

- The borrowing country may ultimately be unwilling or unable to fully pay back its debt. Nonperformance results in realized accounting losses of principal or of accrued interest that must be booked against earnings, capital, and reserves after recovering what can be recovered. The consequences of nonperformance for the borrower's access to international financial markets and normal channels of credit are such that this event today tends to be triggered under relatively rare circumstances, as in bond or loan defaults.
- The borrowing country may be unable to meet its external debt obligations and be forced to renegotiate the loan. By definition, the necessary refinancing or rescheduling under such circumstances cannot be accomplished *at market terms*. Since it occurs under duress, the original lenders are forced to extend further credit with the hope of avoiding accounting losses in the end. This may involve an extension of maturities, a new grace period, negotiation of new facilities, an adjustment in interest spreads or other modifications. Even if this ultimately results in increased accounting returns, the lender nonetheless incurs an economic loss, since

it would have used its assets—which are now tied up in the troubled portfolio—for other purposes with better risk-return profiles.

- The borrowing country may be willing and able to service external debt and avoid default and problems leading to reschedulings or forced refinancings, but something may happen that raises the perceived risk associated with the exposed assets from the lender's perspective. For example, an assassination of the head of state may have an unpredictable effect on debt service. Even though neither of the first two types of losses has been incurred by the lender, it has suffered a decline in the value of assets, since it cannot immediately reallocate them according to new perceptions of relative risks and returns. Such reallocation may be possible at the margin by running down exposures beginning with very short maturities. But this is usually far from the type of instantaneous adjustment that is needed to avoid long-run downward adjustment in the value of the portfolio.

A number of country-related events may thus reduce NPV. Prospective defaults can be viewed as a reduction in $E(F_t)$ and an increase in $E(C_t)$. Anticipated rescheduling or refinancing losses are analogous to the forced introduction of higher-valued t's that are less than compensated for by negotiated increases in $E(F_t)$, net of $E(C_t)$. Finally, losses from risk-class shifts reflect an increase in α_t if, as a result, the country is viewed by the market itself as being more risky. Examples related to the difference between the book value of bank-country exposures and its respective economic value emerged in the latter phases of the less-developed country debt crisis of the 1980s, and again in the Mexican debt crisis of 1994–1995 and the Asian debt crisis of 1997–1998.

Factors Affecting Country Risk

The country risk problem that international banks or investors face is one of forecasting the future prospects of countries in which they have assets. It represents a strikingly complex task, requiring the construction of a social, political, psychological, historical, and economic composite assessment of risk that may arise out of structural (supply-side) economic elements, demand-side macroeconomic and monetary elements, and external economic and political developments, along with the quality of the national economic management team and the domestic political constraints facing decision-makers.

A simple view of the problem could begin with an equation such as the following:

$$Y + M = A + X$$

representing real flows of goods and services in an economy, where Y is output, M is imports, A is domestic absorption (consumption, investment

and public-sector spending), and X is exports, all in real terms. Clearly, supply-side changes in Y will (with unchanged demand) require shifts in imports or exports. Reduced production capabilities at the national level, for example, may mean increased imports or a more limited capacity to export. In a similar way, demand-side shifts such as increased government spending for example, will, have to be met by expanded imports or by diverting export production to meet domestic needs. Monetary variables can affect the picture as well: unless it is offset by changes in exchange rates, growth in the domestic money supply will tend to raise A relative to Y and therefore either increase M or decrease X or both.

To bring the money side into the picture more explicitly, we can develop an equally simple equation to describe international financial flows:

$$VX - VM - DS + FDI + U - K = DR - NBR$$

Here, VX and VM represent the money value of exports and imports, respectively, DS represents debt-service payments to foreigners (usually part of VM in conventional balance of payments accounting), FDI is the net flow of private-and public-sector grants such as foreign aid, U is gifts and grants received from abroad, K is net capital flows undertaken by residents, DR is the change in owned international reserves of the country in question, and NBR is its net borrowing requirement. An overall negative balance on the left-hand side of the equation clearly means that the country will have to increase its foreign borrowing or use up some of its international reserves. Increases in foreign borrowing brings about an increase in DS in future time periods.

Tying the two equations together are typical "country scenarios." Consider a government that comes under political pressure to increase spending for domestic social purposes. It does so by running a fiscal deficit, which it finances by issuing government bonds. Most of these bonds may end up in the asset portfolio of the central bank, which, in turn, pays for them by increasing the money supply (central bank liabilities), representing monetization of debt. This tends to put upward pressure on the general price level of the economy and downward pressure on expected real interest rates, a result the government is reluctant to see reflected as a depreciation of its currency. The currency becomes "overvalued," made possible by the imposition of exchange controls or central bank intervention in foreign exchange markets. The whole process is likely to show up as an increase in A offset by an increase in M and/or a decrease in X in our first equation. The financial flows appearing in the second equation as a net reduction in the trade balance ($VX - VM$) are financed by a reduction in reserve holdings DR (the central bank's external liabilities).

Many such scenarios can be sketched out, focusing on a wide variety of internal and external shocks that eventually lead to increased foreign borrowing, which, if sufficiently large and sustained, can lead to debt-serving difficulties and economic losses for banks or investors. The problem

is to evaluate the effect of these scenarios on the different variables as they evolve over time, and in particular, *DS* and *NBR*. Together with the underlying political scenarios, this is the essence of getting a handle on the expected value and variance of exposure to country risk in any given case.

In view of the complexity of the problem, "well-rounded" individuals," whose knowledge spans a variety of different fields, such as economics, political science, sociology, and psychology, are very valuable to effectively assess country risk. Low-quality estimates of $E(F_t) - E(C_t)$ and α_t yield low-quality portfolio decisions and, ultimately, second-rate performance of a bank in the competitive marketplace.

National Economic Management

How do developments in the internal workings of a national economy, on both the supply and demand sides, threaten a country's ability to service its external debt obligations? Of interest are the linkages between the supply side's ability to produce exports along with import-competing and nontraded goods and in the quantitative and qualitative dimensions of the labor force, the capital stock, the natural resource base, the technology, and the entrepreneurship—which are all combined to drive this capability. At the same time, also of interest are the contributions of real capital inflows to these supply capabilities: those made possible by foreign borrowings, foreign direct investment, and other types of financial transfers.

Historical measures of supply-side economic performance are labor force growth and participation rates, unemployment rates, migration and labor force distributional trends, savings and investment trends, productivity trends, natural resource availability, and the like. The quality, timeliness, and comparability of the relevant data vary widely, but the real problem lies in evaluating how good a predictor the past is for the future. Here, a great deal of judgment is required to identify and project various types of quantitative or qualitative labor-supply ceilings, possible market disruptions, social and economic infrastructure bottlenecks, capital availability problems, and natural resource constraints.

Of prime importance is the evaluation of government policies that will influence domestic savings and investment, capital flight and foreign direct investment, risk taking in entrepreneurial activity, supply conditions in labor markets, adequacy of economic and social infrastructure, exploitation and value-added processing of natural resources, and the entire underlying structure of incentives and disincentives that is built into the nation's fiscal and regulatory system.

In many cases, such policies are anchored in government planning documents, where the evaluation of the degree of realism embodied in these plans is quite important. Government attempts to force the supply side of the economy into a mold that does not fit, but to which a political commitment has been made, can lead to severe domestic and international dis-

tortions in the real sector and inflate the external borrowings that ultimately lead to debt service problems.

On the demand-side of the national economy, country analysts are interested in factors that affect taxes, government expenditures, transfer payments, and the overall fiscal soundness of the public sector, as well as in prospective demand patterns for goods and services from the private and export sectors. Once again, historical data series covering consumption, government taxation and expenditures, gross national product or gross domestic product, and other conventional economic indicators are usually available on a reasonably timely basis to permit an evaluation of the demand picture over a number of years past. But forecasts largely depend on the ability to predict government demand management and income distribution policies, as well as demand-side shocks that may be stemming from the foreign sector.

In attempting to develop a prognosis of the structural aspects of country futures, the analyst should start by acquiring the most accurate information possible on both the historical and the current performance record of the economy in question, and then try to project both the demand-side and supply-side dimensions. This may not be a particularly difficult problem in the short term, where the policy elements are relatively fixed. However, the error sources multiply as the forecasting period is extended, and very few or none of the important determinants of economic performance can then be considered as constants. What will happen to taxes, fiscal transfers, government regulations, the use of subsidies and other market distortions, consumption and savings patterns, investment incentives, treatment of foreign-owned firms, and similar factors after five or ten years? Everything is up for grabs, and forecasting has to rely largely on the basic competence of the nation's policymakers, their receptiveness to formal or informal outside advice, and the pattern of social and political constraints under which they operate. Assuming that a country's economic management team remains more or less the same, past experience in domestic policymaking and reactions to outside shocks may not be a bad guide for the future—an assumption that nevertheless is often open to question.

A part of the task of projecting future economic management scenarios—maybe the most important one—lies in the monetary sector. Whereas most good country analyses contain extensive descriptions of the national financial system, the critical factors obviously relate to domestic prices and exchange rates. Useful indicators are the domestic monetary base, the money supply, net domestic credit, and available price indices, together with net foreign official assets and net foreign debt. Monetary disturbances may originate in the domestic economy or internationally, including contagion effects. Apart from their inflationary and exchange-rate aspects, such disturbances may also have real-sector influences on consumption and savings, capital formation, income distribution, and expectations about the future.

Once again, whereas the mechanisms relating monetary developments to external debt service and transfer problems are well understood, and the requisite data usually are readily available, short-term assessments are much easier to make than a full-fledged, long-range outlook. After all, it is possible to evaluate the relationship of the existing exchange rate to some hypothetical market-determined rate based on a calculated purchasing power parity index, for example, and to project any deviation based on relative inflation trends. For instance, the larger the degree of projected currency overvaluation, in general, the greater will be the need for increased external borrowing, as well as the likelihood of reserve losses or the prospects for a tightening of controls on international trade and payments.

Much more difficult is the task of forecasting government responses to problem situations in the monetary sphere—devaluation, liberalization of exchange controls, and domestic monetary stringency—particularly the timing of such measures. In the long term, the problem, once again, comes down to the competence of the monetary policymakers and the political pressures that they face.

The domestic economic management issues involved in country analysis by international banks are summarized in figure 12-2. Complex as it is, this is still only part of the picture.

External Economic Aspects

Because foreign exchange availability is important for projecting a country's debt-service capabilities, country analysts must also pay attention to outside factors that affect its balance of payments and external finance. On the export side, this requires evaluation of both long-term trends and short-term instabilities. Increasing product and market diversification might be a sign of greater export stability and reduced vulnerability to shifting economic and political conditions, or they could signal protectionist trends in the country's major markets. Shifts in the ratio of exports to gross national product may portend changing future debt-service capabilities, and an analysis of demand and supply elasticities for major export products may indicate possible sources of future instability in export receipts. Domestic export-supply constraints and export-competing demand elements link back into the analysis of structural problems, discussed earlier. Export policies pursued by national governments, along with exchange rate policies, may also be very important. In general, we are interested in (1) alignment of a country's exports with its international competitive advantage, (2) diversification of export risk, and (3) home and third-country policies that might pose a threat to future export earnings.

On the import side as well, focus should be placed on both long-term trends and short-term instabilities. For example, the ratio of imports to

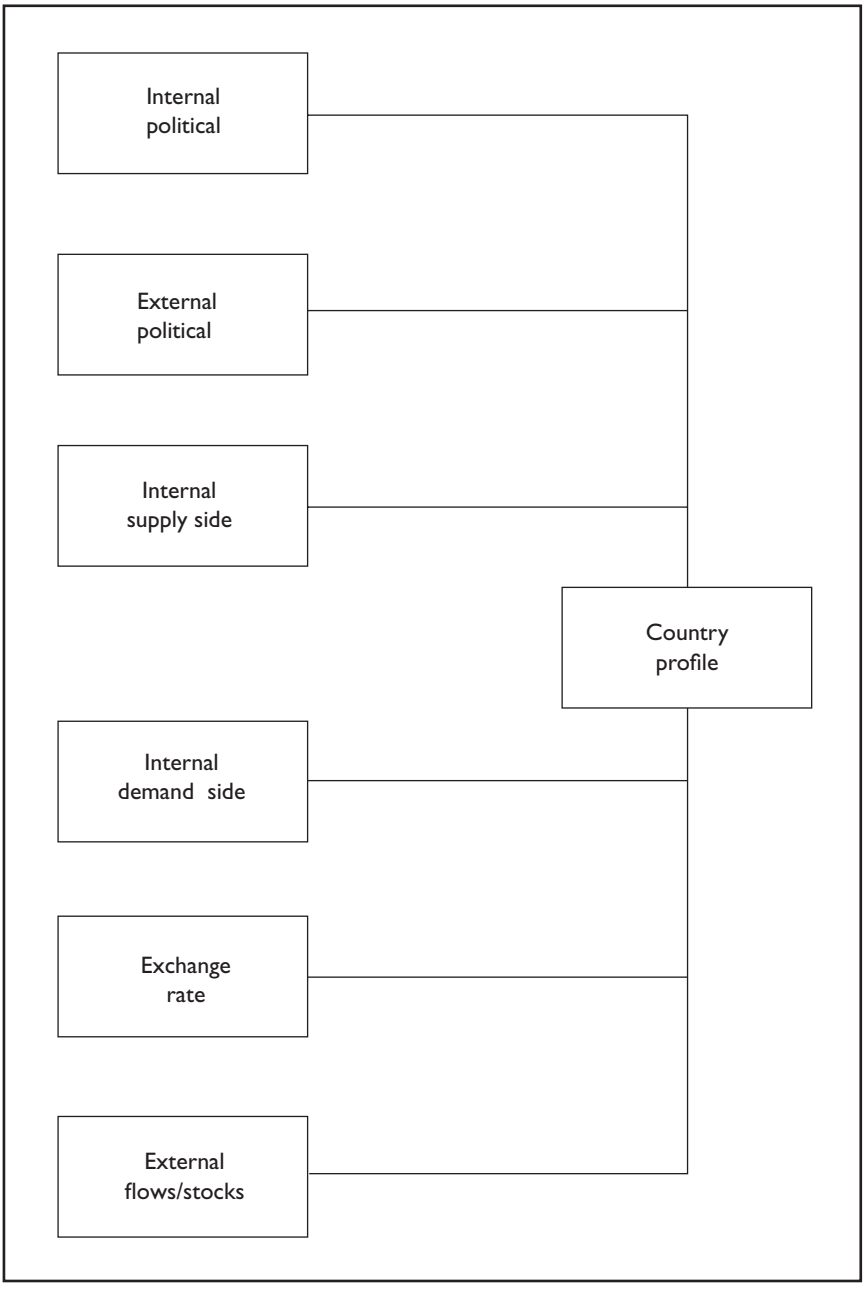

Figure 12-2. Summary of domestic economic management issues involved in country evaluations.

gross national product indicates very little, per se, but abrupt and significant shifts in this ratio may be important. The ability of the government to compress imports in times of balance of payments trouble may be indicated by measures such as the ratio of food and fuel imports to total imports. Import price volatility, supplier concentration among trading partners, and trends in import-replacement production are among the other measures that can help identify possible problems originating in the import side. Here, as in the case of exports, the analyst should also be interested in the policy context—the structure of effective tariff and nontariff protection and the effect of domestic resource allocation and efficiency on production.

The importance of foreign direct investment for the supply side of a national economy has already been mentioned—in terms of its contribution to aggregate and sectoral capital formation, technology transfer, development of human resources, management and entrepreneurial activity, access to markets and access to supplies—the traditional multinational corporate "bundle" of services. Besides the balance of payments gains associated with FDI, induced exports and import-replacement production, outflows may occur via induced imports of goods and services and profit remittances. Each foreign investment project evidences a more or less unique balance of payments profile, in magnitudes as well as in timing. Policies that affect foreign direct investment (e.g., taxation, restrictions on earnings remittances, privatization, nationalization, and expropriation) may alter this profile and thereby influence a country's prospects as perceived by international lenders and bondholders as well. Multinational companies are often extraordinarily sensitive to changes in national policies. Since such changes can trigger changes in the overall creditworthiness of countries as a whole, shifts in FDI patterns deserve careful attention. Moreover, capital outflows on the part of residents (which are frequently highly sensitive to the domestic outlook) and private lending by foreigners to domestic residents can also have a substantial effect on a country's overall creditworthiness.

Finally, it may be important to analyze the magnitude and types of grants and concessionary (foreign aid) loans that a country receives from abroad, and the prospective future development of these flows. Domestic conditions in the donor countries, donor-recipient relationships, and the economic and political attractiveness of the recipient countries are very important. And countries that are of strategic or economic importance are obviously prime candidates for future intergovernmental "rescues," which may to some extent backstop private investment or bank lending exposure in severe problem situations and increase the interest of major financial powers in successfully concluding "workout" situations. Examples from recent history include Mexico, Brazil, Thailand, Indonesia, Korea, and Turkey, among others.

Figure 12-3 summarizes financial flows and their relationships to the domestic economic picture.

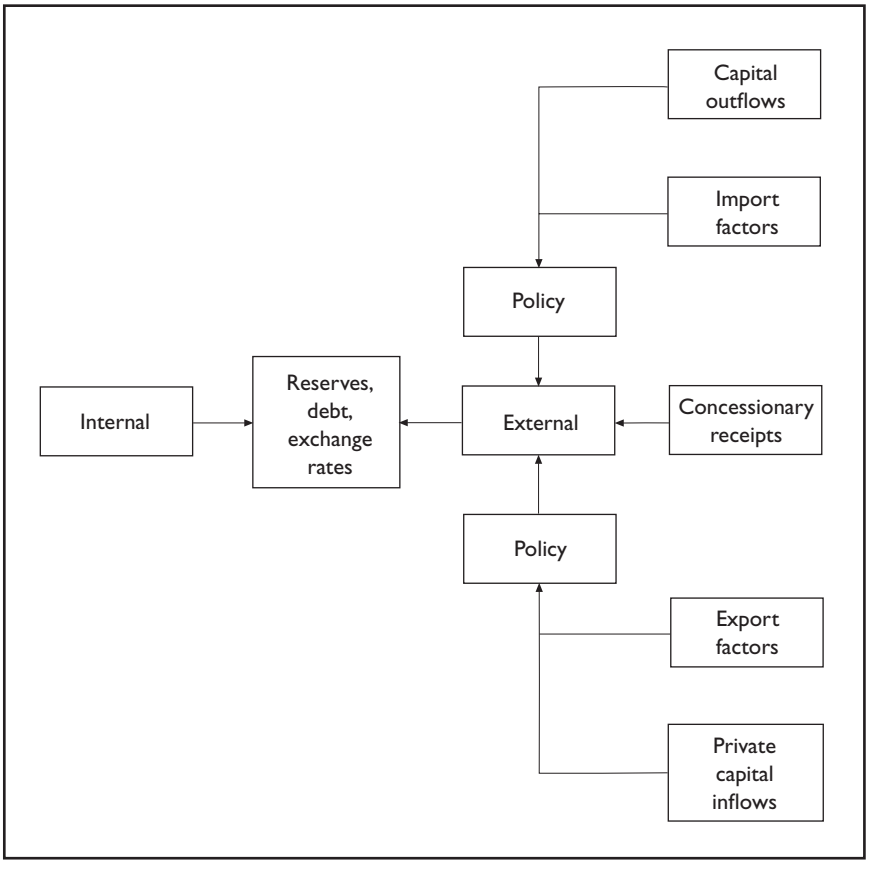

Figure 12-3. Relationship of external financial flows to the domestic economic situation.

Liquidity and Debt Aspects

The aforementioned issues usually involve medium- and long-range forecasts of such measures as the balance of trade, the current account, and various other measures of "flow." These aggregates will ultimately be reflected in a country's international reserve position and in its access to international financial markets for external financing needs. Near-term "liquidity" assessments generally focus on such measures as changes in a country's owned reserves and IMF position, and on ratios such as reserves to monthly imports, which are intended to indicate in some sense the degree of "cushioning" provided by reserve holdings. The ability to borrow additional sums abroad or to refinance existing debt depends on the projected state of financial markets and the assessment of country creditworthiness by international banks and official institutions at the time of need.

Analysis of the size and structure of country external indebtedness and debt service patterns is equally important in this regard. Ratios such as (1) total debt to exports or to gross national product and (2) long-term public debt to exports or to gross national product are used in virtually all country analyses. So are the amounts and trends in overall external indebtedness and current versus longer-term debt.

The "debt service ratio"—debt service payments to exports or "normal" exports—is perhaps the most commonly used ratio. However, by using only exports in the denominator, the debt service ratio ignores the potentially equivalent contributions of import savings to a country's debt service capabilities. Consequently, for different countries, a particular debt service ratio (say 0.3) may mean entirely different things about their relative creditworthiness.

Another commonly used indicator is the so-called cash flow index (CFI), calculated as follows:

$$\text{CFI} = \frac{R + A + LC + T}{DS}$$

where R represents gross foreign exchange reserves held by the country's central bank; A denotes net foreign assets held by the commercial banks; LC represents undrawn loan facilities committed to the country, including interbank lines; T is the expected current-account balance; and DS represents debt service obligations for the year ahead. A CFI value of less than 1 indicates that additional borrowing will be required during the year to meet debt service obligations. Also commonly used are the following ratios:

- Foreign capital inflows to debt service payments
- Exports plus capital inflows and aid receipts to current debt
- Vital imports plus debt service payments to exports plus capital inflows and aid receipts ("compressibility ratio")
- The reciprocal of the average maturity of external debt ("rollover ratio)

All such ratios must be interpreted with caution. Ratios have different meanings for different countries and for the same country at different times and stages of development. There are no good, universal rules of thumb. Wise usage of ratios lies in their interpretation, in their changes over time, and in their specific context in a particular country situation. However, even if a good analyst recognizes the limitations of some of these indicators, he or she may nevertheless make use of them to understand and forecast how *other* banks or investors perceive the situation when a country comes to the international debt market. So it is usually very useful for banks to monitor ratios carefully.

Figure 12-4 depicts the linkage between internal and external "flow"

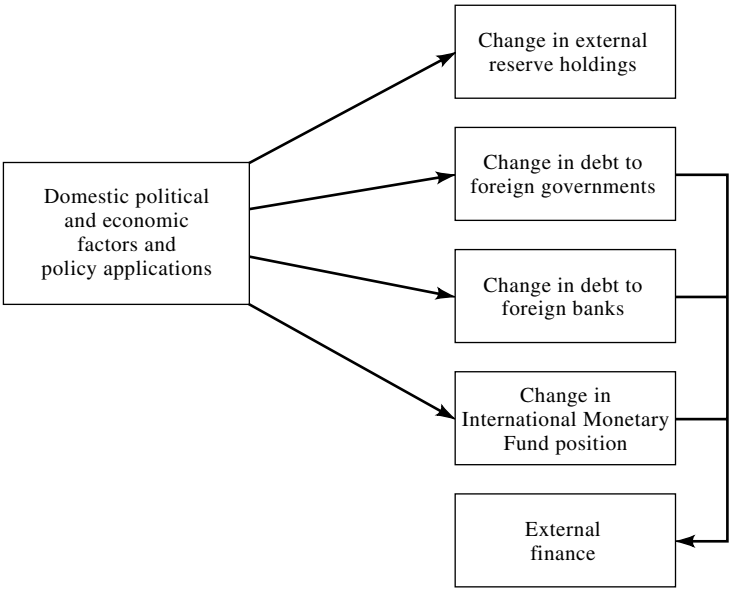

Figure 12-4. Internal and external linkages.

factors, and the associated policies, and a country's external "stocks" of external reserves and debt. Domestic real or monetary changes may trigger trade or payments shifts, or vice versa, and both may affect external borrowing and reserves. Once a country borrows, the creditor takes a natural interest in the goings-on. As the external debt builds up, there is more extensive monitoring and advice on the part of lenders, in both the public and the private sectors.

Political Aspects

Besides domestic structural and monetary variables and external stock and flow factors, country analysis related to term exposure always requires astute political forecasting. Most closely related to the economic variables just discussed is the "competence" or "wisdom" of national economic managers. Small changes in the cast of characters can cause enormous changes in the quality of the play. There is also the question whether the technocrats have a full political mandate to "do what's necessary" from a debt-service point of view—and, ultimately, whether the government itself is firm and has the political will to carry out the necessary but often unpopular programs. The need for evaluating and forecasting the political "overlay" of national economic policymaking—the degree of resolve, the power base, and the tools available for implementing sound policy decisions—cannot be overemphasized. Banks that are leaders in country analysis generally

place a great deal of stress on this particular dimension. It requires an entirely different sort of forecasting and information base than some of the more mechanical approaches to country risk assessment.

Of particular importance is the extent to which policymakers are receptive to outside advice. Politicians often find "business as usual" the best way to go, even when it is becoming clear that serious debt service problems are in the air. They certainly know that whatever needs to be done is probably going to have a substantial political cost (i.e., tax increases, monetary restraint, exchange rate changes), and they fervently hope that "something will turn up." Often nothing does turn up, at least in the short run, and foreign lenders (notably the IMF) offer advice as the country's debt grows. When the advice is well received, the country can make its way out of the impending problematic situation well before it becomes critical, despite the political costs involved. Sometimes the country engages outside advisors to help formulate sound economic plans and policies, improve its image in international financial markets, and perhaps take some of the domestic political heat. But in severe cases, outside advice is often ignored until any additional borrowing becomes considerably more expensive or not available at all, and a crisis looms.

At some point in this scenario—for domestic politicians later rather than sooner—the country will have to negotiate borrowing facilities with the International Monetary Fund. IMF involvement gives a certain degree of comfort to private banks and investors, and often their own extension of further credit is conditioned on the IMF stamp of approval on a country's economic stabilization plans. At the same time, the IMF may provide domestic policymakers with the necessary backbone to undertake unpopular yet necessary economic measures. Problems arise when even this external pressure fails to rectify the issue. In some cases the IMF can play a pivotal role in gradually rescuing countries from financial distress, but not always in a timely fashion so as to save lenders or investors from economic losses. And sometimes IMF bailouts save lenders and investors from their own excesses, thereby encouraging excesses in the future.

In addition, there are also some, rather fundamental political developments that need to be sorted out, monitored, and forecast as well.

Internal political change in a country may range from gradual to abrupt, systemic to nonsystemic, and cataclysmic to trivial in terms of its importance to international lenders. For example, political drift to the right or to the left may be very important in terms of the internal and external operationality or soundness of the national economy and the quality of economic management. The symptoms can be clearly observed in domestic fiscal and monetary policies, in relations with foreign countries, in imposition of financial controls, and the like. This may result in soaring imports, reduced capacity to export, drying up of FDI, capital flight, aid cutoffs, and increasing problems of access to international financial markets. It is therefore necessary to look into the direction, magnitude, and timing of

any political drift before one considers various future macroeconomic scenarios.

A more dramatic version relates to violent internal political conflict, which may ultimately produce the type of political "drift" just discussed and which is doomed to have serious direct economic consequences. Strikes, terrorism, sabotage, and popular insurrection seriously disrupt the operationality of the national economy, with potentially dramatic consequences for a country's balance of payments. Export industries, (i.e., tourism) are particularly sensitive to these kinds of problems. The direct and indirect import requirements of government anti-insurgency efforts can be significant as well. It is clearly important to assess the strength of both the insurgency movement and the government in order to forecast the duration and outcome of such conflict. If the conflict results in systemic political change, the external debt may be repudiated.

External political conflict can likewise take a variety of forms, ranging from invasion and foreign-inspired or supported insurgency to border tension and perceived external threats. Threats from abroad often require far-reaching domestic resource reallocation in the form of an inflated defense establishment, which can cause adverse trade shifts and involve direct foreign exchange costs. In an economic sense, military hardware, human resources, and infrastructure generally have low or negative productivity in terms of the domestic economy and international payments, and therefore they contribute nothing to future debt service. Such distortions alone may have a serious bearing on the risk profile of a country as perceived by foreign banks and investors.

These problems reside in both potential and actual external conflict. The latter simply magnifies the various distortions to which must be added the supply-side effects of physical and human-resource destruction and dislocation, obsolescence, and reconstruction costs—unless they are partly offset by reparations or aid receipts. Even when external political conflict is over, there may be further internal political upheavals and possibly sizeable costs of occupation or continued internal resistance and reparations obligations, all of which can have a debilitating effect on the home economy. All such assessments have to be undertaken in probabilistic terms since they are of special interest in cross-border lending.

Shifting political alliances, regional political developments, and bilateral relations over such issues as human rights and nuclear proliferation can provide additional sources of political conflict. They are heavily influenced by global, regional, and national political events.

Political forecasting is an art which, despite its central role in plotting the future creditworthiness of countries, remains highly imperfect. Indices of political stability developed by political scientists say little that is very reliable about the future or about the ultimate implications for debt service. The more sophisticated projections of possible sources of internal and external political conflict, while useful and necessary, usually leave the critical

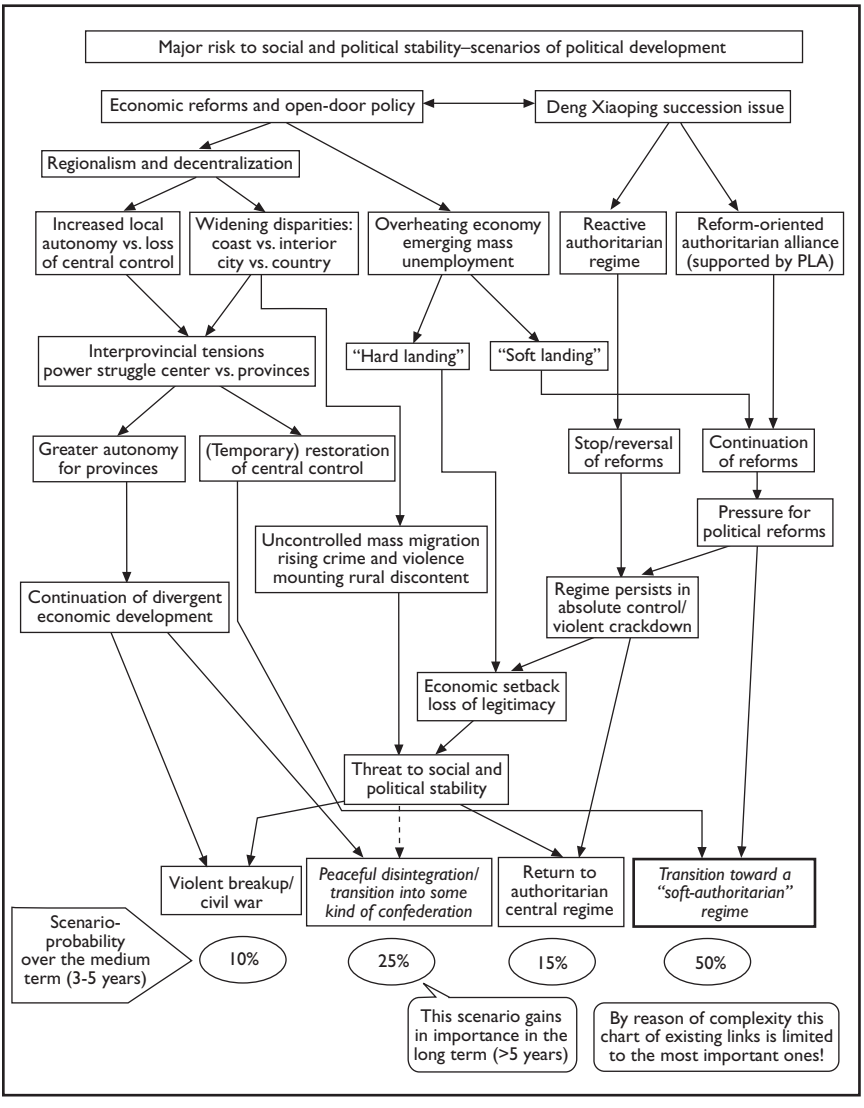

Figure 12-5. Example of political assessment of the People's Republic of China in 1994.

judgments largely up to the user of the information. And there are problems related to the completeness and timeliness of political information. Figure 12-5 shows the political factors considered in one major bank's risk assessment of the People's Republic of China in the mid-1990s.

To summarize, country analysis is a process that requires careful assessment and weighing of internal economic and financial elements, external trade and monetary flows, and the effect of each on external debt and reserves—all in a political context that is itself often highly complex

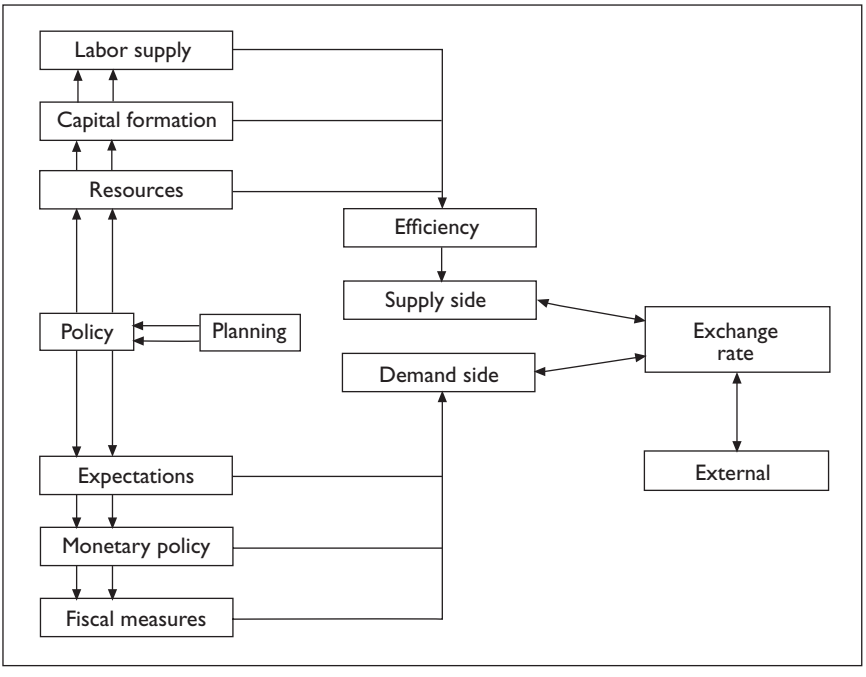

Figure 12-6. Domestic economic management issues involved in country analysis.

and difficult to gauge. As figure 12-6 shows, each element in the analysis is linked to all of the others, and the task is to forecast the national politico-economic future with specific reference to the *ability* and *willingness* to service external debt.

Banks and other foreign debt holders are principally concerned with base-level country scenarios, which permit evaluation of the net present value of country lending exposure. The problem often becomes much more complex if the task is to evaluate project-specific country scenarios related to equity investments, possibly including the bank's own operations in the country in reference.

Approaches to Country Risk Assessment

Given the complexity of the factors that affect the creditworthiness of countries, how should international banks or institutional investors organize and evaluate the necessary flow of information within their own organizations' structures—and its assembly—in a form that is useful for decision-making?

A truly definitive portrayal of a country's economic and political future and its implications for creditworthiness could require writing a book, maybe several books, about each action. Such a review should be updated

every six months or so, or whenever there is a significant change in lender/investor interest or country circumstances. Encyclopedic analyses of this sort tend to be useless from a decision-making point of view, even though they would probably give the only correct and comprehensive overview of all of the critical variables (each highly country-specific) and the various interrelationships among them. In other words, the "ifs" and "buts" that constitute an inevitable part of any exercise in politico-economic forecasting all need to be increased. But banks and investors operate under pressure of time, as well as of fiscal and human-resource constraints. Given these realities, the following approaches to country analysis attempt to achieve a balance between completeness and accuracy, usability and feasibility.

Qualitative Assessments

Closest to the custom-tailored, in-depth qualitative country analyses are largely "descriptive" country studies, which try to cover all of the political and economic underpinnings. They tend to be largely retrospective and subjective, and they use no standardized format to avoid straightjacketing the discussion. This approach is particularly conducive to political risk evaluation, which inevitably tends to be "soft." Cross-country comparability suffers, however, from the exclusive focus on specific country attributes and prospects. Updating can be relatively difficult because of the nature of the qualitative analysis and the level of detail since there are great difficulties in distilling the essence of unstructured descriptive studies for use in exposure-setting decisions.

Structured Country Reviews

Using a standard, relatively short format for all countries under consideration, structured reviews severely cut back on the narrative and rely more heavily on the use of data analysis, standard ratios, and formalistic trend assessments. Qualitative elements are retained in an abbreviated format. An effort is usually made to retain country-specific qualitative elements in the analysis and to enhance usability by means of carefully formatted and tightly worded summaries. Besides conventional sources of country data, periodic country visits and information from representatives in the field are supposed to update country files and improve the quality of the analysis. The standard format used in this approach is intended to facilitate cross-country comparisons without loss of significant qualitative country-specific information. Nevertheless, there is sometimes a tendency to deemphasize political risk and to adopt an excessively retrospective focus.

Country Ratings

So-called checklist country rating systems employ the same information base just discussed and are often backed up by a formal narrative country

study, in an attempt to assign "grades" to both quantitative and qualitative variables. Each grade is then assigned a weight, and one or several weighted summary scores are computed. These weighted summaries are supposed to capture not only the historical evidence but also the future outlook as reflected in the score-assignment and weighting process. This approach is basically an effort to facilitate country monitoring, cross-country comparisons, and performance auditing of the country assessment system. Besides weighted country scores, some approaches try to generate composite measures of debt service capacity, political stability, adaptability to external shocks, and the like, with weighted input measures used to generate "composite" indicators, which are then displayed in grid or matrix format.

Despite their advantages in country comparisons and their usability in lending decisions, all such scoring systems have disadvantages. Selection of indicators tends to be subjective, and it is often not based on coherent underlying models of politics or economics. Grading of indicators likewise tends to be subjective, as is the assignment of weights. Usually, the same indicators and weights are used for all countries examined, which makes little sense. Nonquantifiable information is often ignored, which may throw out some country-specific elements that could eventually have a strong bearing on risk. Political-risk grading systems, as developed in financial institutions and available from advisory services, are even more tricky. Perhaps the greatest potential problem lies in overreliance on and abuse of such systems in exposure decisions. In an area where the use of forecasting in decision-making (especially in the long term) is akin to grasping at straws, this technique in the wrong hands may be particularly dangerous.

Country Evaluation Filters

Filtering involves the use of "multiple discriminate analysis" to differentiate between countries that have encountered external debt problems in the past and those that have not. The objective is to avoid type I errors (predicting that a country will get into trouble when, in fact, it does not) and type II errors (predicting that a country will stay clear of problems when, in fact, it ends up in trouble). In the first case, a bank or investor may stay away when it should have become involved, while in the second case it will go ahead when it should have passed it up. If selected indicators like the debt service ratio or the liquidity ratio have been found to successfully discriminate between "trouble" and "no-trouble" countries in the past, then they may be used for this purpose in a forecasting context.

Despite their methodological sophistication, neatness and usability of "yes/no" results, such filters have a number of limitations. They provide only partial coverage of the dependent variable of concern—namely, the possibility of a decline in the real economic value of exposure in a particular country. Empirically, they focus almost exclusively on past debt defaults or reschedulings. The wide economic differences among the countries in which banks or investors have exposed assets, together with often rapid shifts in

these countries over time, raise doubts about excessive reliance on such filters—or any limited set of indicators—even if past statistical performance is reasonably good. However, discriminant filters may indeed be useful for culling countries for closer examination by one of the more in-depth country assessment techniques.

Outside Views

Aside from internal country evaluations, a bank or institutional investor may avail itself of outside services that monitor country conditions around the world. A number of political risk services and global country reviews are marketed by consulting firms, all of which claim special methodological expertise, information sources, or analytical competence. Individual consultants, particularly former public officials, offer similar services. Few fully understand the international banking or investment business or have intimate knowledge of individual institutions, however, so some of their advice tends to be of limited practical value. By contrast, outside consultants can provide useful "second opinions" and serve as a sounding board for internal reviews. From time to time, surveys of bank country ratings are combined into overall rankings of "what financial institutions think" of individual countries.

To summarize, figure 12-7 depicts the kinds of country evaluation systems that are available to international banks and investors in terms of (1) their ability to capture country-specific details that may ultimately lead to losses in the value of exposures and (2) the usability of their respective informational outputs in decision-making. There is a clear trade-off: the more com-

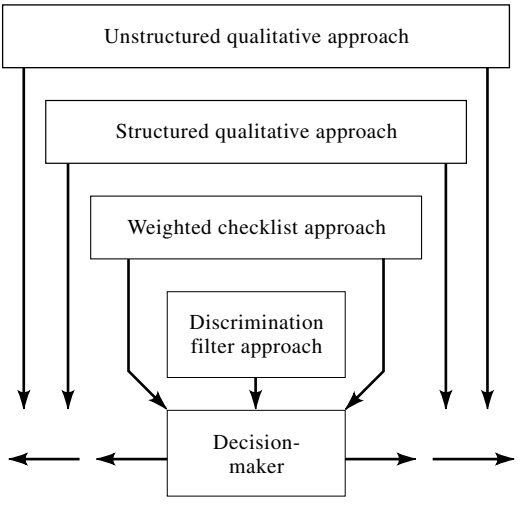

Figure 12-7. Breadth versus usability in country evaluation systems.

prehensive the analysis, the less usable it is in an exposure-setting context. The more mechanical and formal the system, the less country-specific information it tends to capture—information about developments that may ultimately be the source of grief for the bank. Reconciling the two requisites for sound country evaluation systems—usability and completeness—is largely a matter of organizational design.

Institutional Design and Country Exposure Decisions

Figure 12-8 represents a simplified schematic of a decision system, one that will vary to some extent among international banks and investment firms,

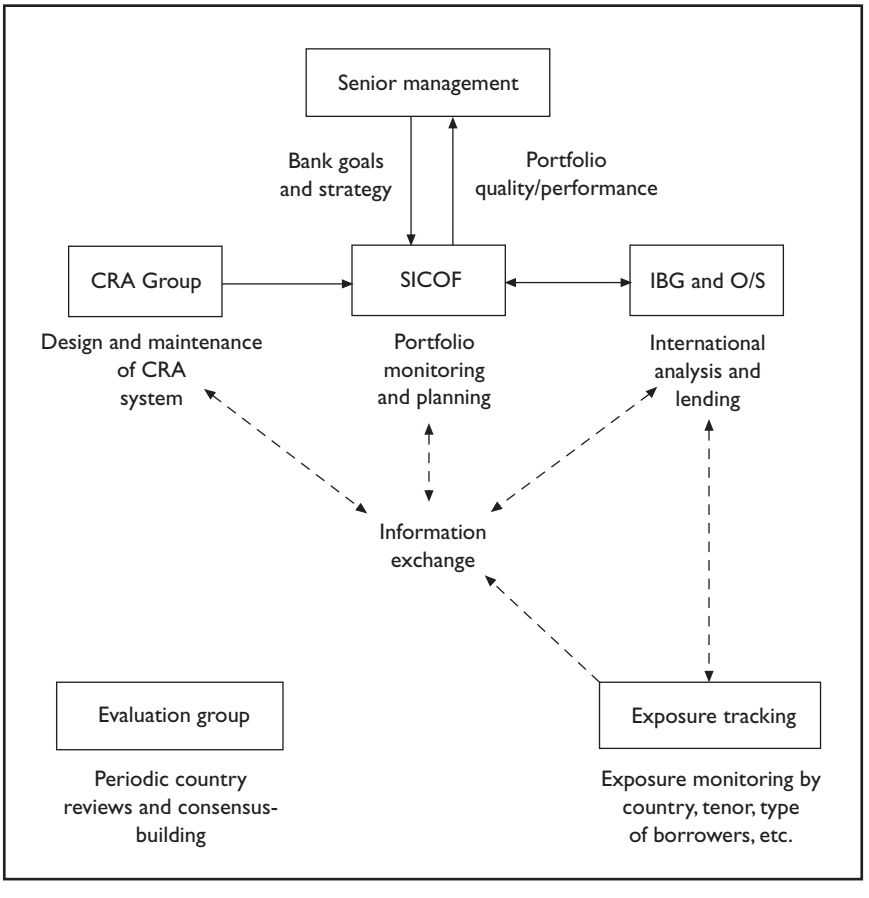

Figure 12-8. Schematic of a country decision: solid lines represent reporting relationships; dashed lines represent information flows; CRA = country risk assessment; SICOF = senior international exposure officer; IBG = international banking group; O/S = overseas offices.

with the solid lines representing reporting relationships and the dashed lines representing information flows. Information on cross-border exposure is maintained by a monitoring system at the head office, which receives and consolidates information on the size and tenor of cross-border exposures. As noted earlier, care must be taken so that exposure is correctly measured, frequently updated, and allocated in the light of possible guarantees, as well as certain other factors that might be considered to shift the locus of risk.

The degree of decentralization of decision making differs substantially among institutions, but the need to secure competitive advantages through close client contact, quick response times, and adequate lending or investing authority can also lead to decentralization. This places a premium on the existence of some type of centralized country assessment system, which ensures that the global portfolio as a whole is in line with the institution's risk constraints and earnings targets and at the same time does not inherently restrict activities in a highly competitive marketplace.

There will normally be a substantial two-way exchange of information between those responsible for the system and the line bankers or investment officials if they are not one and the same. In the event that a major change in exposure is contemplated, if a shift in exposure limits seems justifiable by profitability, or if an alteration in the perceived risk in existing exposure develops, an ad hoc country review group may be formed, consisting of responsible line officers, senior officials with regional responsibility, country economists and other specialists, and possibly other interested individuals. Given the overall strategic goals of the bank or investment firm and its positioning in the target market as set by top management, such a review group may make a recommendation of appropriate action in the case involved. The purpose is to bring together as many different and conflicting viewpoints as possible—as, for example, between the country economists emphasizing the risks and the line officers emphasizing the business opportunities, competition, and associated returns. Ultimately, responsibility in such a system lies with senior management, notably a top manager, who is charged with monitoring and planning the international portfolio within broad policy guidelines.

It is in the *use* of country evaluation that it becomes clear that whatever approach is adopted represents the beginning, not the end, of the task. Approaches that are too general may fail to concentrate on the true sources of risk in country exposure and on the specific concerns that face a particular institution's cross-border exposure. Risk related to medium- and long-term exposure requires a far more complex analysis than exposure to short-term risk. Special-purpose lending such as project finance, may require different risk-assessment emphasis than FDI exposure that a firm may have in a particular country.

The twin temptations of "quick and dirty" and "overloaded" country assessments seem to constantly confront international financial institutions. The first approach promises mechanical shortcuts and the use of low-priced

talent to grind out country ratings at low cost, but it often appears to succeed only in producing nonsense—there really is no substitute for high-quality analysis, flexibility, judgment, and familiarity. The second approach may rely on well-qualified internal personnel at high cost, yet encounter a dangerous narrowing of country expertise, possibly cause dissension in the ranks, and create bottlenecks in the decision-making process.

The conflicting demands of country assessment in international exposure management—ranging from high levels of usability, auditability, and comparability and the need to capture exceedingly complex and country-specific qualitative judgments over extended periods of time, to the need to avoid abuse of the results in decision-making—probably means that there is no such thing as an "ideal" country evaluation system. "Appropriate" systems will certainly differ for different institutions.

The key may reside as much on the training side as on the systems design. To train line bankers and portfolio managers in using sensible country assessments properly, and in being sensitive to changing country risk profiles as they go about their business, may in the end contribute more to sound exposure decisions than would comparable resources devoted to the design and implementation of more elegant systems.

Portfolio Aspects

In this chapter we have focused on the problems of exposure to country risk, what it means from the standpoint of the real value of a bank's or investor's exposure in a particular country, and the assessment of that risk. The discussion has concentrated mainly on country-by-country analysis, putting countries individually under the microscope to see what makes them tick and how this is likely to evolve in the future with regard to external debt service or equity-related remittances.

However, international banks and investors are really in the business of managing a global portfolio of country exposures in the same way that they are managing a portfolio of exposures to companies, individuals, and other entities. This means either maximizing returns on the entire portfolio subject to a given risk constraint set by management or minimizing the level of risk to which the firm is exposed with a given target rate of return—this is the standard portfolio optimazation problem. One difficulty in managing global portfolios of country exposures is that a country exposure often cannot easily be sold in broad and deep markets like stocks or bonds when risk or return perceptions change. It may only be possible to "run down" exposures over time as loans come due, for example, or as they are transferred through loan sales programs in the secondary loan market.

Yet the basic principles of portfolio approaches remain valid, since the institution is trying to maximize returns subject to risk in the *entire* portfolio, not on a country-by-country basis. It may very well be the case, for example, that increasing exposure in, say, India under relatively unfavor-

able risk-return conditions may still make a lot of sense if, by taking on that exposure, the *overall* level of risk on its portfolio decreases through additional diversification there. In particular, if the country has little in common with others in the portfolio (low correlations in expected returns), such an outcome may be possible. It is the risks and returns associated with *global* portfolios that define the value of that portfolio to shareholders, although shareholders themselves may hold internationally diversified portfolios as well.

Country assessment and exposure setting should be a coherent managerial process that unambiguously focuses an institution's network of information and actively involves individuals with different functions and perspectives. The exercise itself will thus have tangible portfolio benefits of its own, quite apart from its more visible output in the form of defensible country-by-country evaluations. Mechanization and decentralization of the country review process will tend to cut down and perhaps eliminate this benefit and may thereby help stifle an environment that is already conducive to sound global portfolio decisions.

Each institution's information-flow and decision-making setup is different, depending on factors such as the organization's size and structure. Some incorporate country assessments to portfolio decisions quite flexibly and informally, while others seem to rely on rigid and formalized review procedures. In some cases, the review process is also closely tied to the annual budget cycle and the allocation of exposure authority to countries and regions. These again may be quite rigid in some institutions, while in others they are relatively easily altered as perceived market and risk conditions change.

While few international banks and investment firms fail to maintain adequate cross-border exposure measurement and monitoring, there seems to be far greater variability in the state of the country assessment systems themselves. Some are carefully thought through, while others remain largely cosmetic. Some are well integrated into the life of the organization, while others seem separate and even isolated. Whatever the approach, rational portfolio decisions with respect to country exposure management demand that forecasts of country futures be maintained on a comparable basis—and modified in the light of correlations arising from common export markets or sources of supply, conditions in and access to international financial markets, and both regional and global political developments.

Emerging-Market Banking and Finance

For the better part of two centuries, countries with shortages of internally generated capital have relied on foreign investment to augment their growth and development. The foreign investment principally took the form of bank loans, corporate bonds and stocks, and direct investments. In the nineteenth century, the investment flows mainly originated in Great Britain, Germany,

and France to the then-emerging markets of the United States and Latin America. In the twentieth century, the United States became a major capital exporter and joined the Europeans in lending to and investing in developing countries in the Americas and in Asia.

The financing came in waves, however. Periods of cautious optimism that attracted investment at relatively high rates of return were followed by periods of "irrational exuberance" in which others sought to duplicate the seemingly easy successes of the early investors only to see returns dramatically reduced, as money rushed in. Subsequently came periods of financial distress, defaults, reschedulings, and other events that ignited an attitude of pessimism, which, in turn, caused the inflows to cease and even reverse. Then time would pass, and another cycle would begin.

In this century, there have been two major periods of default on emerging market debt instruments. In the 1930s large number of bonds issued by Latin American governments and others (mainly solicited, underwritten, and sold by the securities affiliates of U.S. banks) defaulted. And in the 1980s, many developing countries entered into massive bank debt rescheduling exercises that lasted until the early 1990s when debt-for bonds swaps (so-called Brady bonds) extinguished most of the legacy bank debt.

In the 1990s, following a number of important economic policy changes in developing countries that encouraged the creation of internal free markets, a new wave of investment unfolded. These changes have come to constitute a new model of economic development in the Third World loosely known as the "Washington Consensus." This time, the investment wave was accompanied by a surge of privatizations, which made available shares of large-capitalization companies that promised to be actively traded. Between 1991 and 1994, not only did foreign portfolio investment into emerging market countries soar, but, encouraged by the new free-market policies, so did foreign direct investment. However, the collapse of the Mexican peso in late 1994 and early 1995 stopped the euphoria. Emerging-market equity securities crashed in a simultaneous pattern all over the world. The IFC (Emerging Markets) Investable Composite index in U.S. dollars dropped 12% in calendar 1994 (having risen by 79.6% in 1993, 3.3% in 1992, and 39.5% in 1991), but measured in dollar terms at the end of January 1995 (compared to January 1, 1994) the damage was much greater. The stock market in Turkey was down 57%, Mexico 56%, China 54%, Poland 50%, and Hong Kong 41%, with plunges of 20% to 30% common in most countries.

The aftermath revealed that large foreign institutional investors, especially dedicated country-fund managers, were shocked to discover politically motivated, deceptive, and misleading reports of apparently wrong-headed financial practices in Mexico, and they decided it was time to get out. These investors had rushed into emerging markets all over the world, and, all at once they (and their clients) appeared to lose confidence in all of them. Mutual fund shareholders began to demand redemptions, and liquidations were often necessary to retain portfolio balancing. Panic sales

by both foreign and local investors greatly overloaded the relatively illiquid markets in most parts of Latin American, in eastern Europe, and in Asia. These markets, which were seen to offer low-correlation investment (in accordance with modern portfolio theory) ended up highly correlated after all: they all had the same large and volatile investors—the big American and European fund managers. This lesson has now been learned, too; emerging-market investors have been more cautious, and market returns have reflected it. The IFC Composite lost 8.4% in 1995 and gained 9.4% in 1996, but these returns were meager indeed compared to returns on the Standard and Poor's 500 of 37.5% in 1995 and 23% in 1996. The relatively low returns were in spite of the recovery of aggregate emerging-market equity portfolio inflows in 1996 to the $45 billion level achieved in 1993.

Soon after the Mexican crisis, there was evidence to suggest another turn in the foreign investment patterns of emerging markets. Banks and bond market investors took up where the equity investors have left off. J.P. Morgan's Emerging Market Bond Index rose 39.3% in 1996, having nearly doubled from its low point in early 1995. Emerging-market borrowers issued $74 billion of investment-grade bonds in 1996, and $20 billion more were sold by more than 50 different issuers in 1997. A record $3 billion uncollateralized 30-year Brazilian sovereign Eurobond was issued in June 1997 at 395 basis points over U.S. Treasuries. Three-quarters of these bonds were exchanged for higher-yielding Brady bonds issued by the government as part of its debt restructuring plan. Indeed, during the preceding year, more than $9 billion of similar bond exchange offers to reduce outstanding Brady bonds were offered by Latin American governments. However, the Brazil issue, rated B1 and BB−, was the most aggressively priced. Bond market rallies also occurred in other emerging-market countries, particularly eastern Europe, where Russian bonds had received much support.

The renewing enthusiasm for Third World debt was not limited to bond investors; banks were jumping in again, also. In 1996, syndicated bank loans to Latin American borrowers exceeded $250 billion, an increase of nearly 50% over those in 1995. Major U.S. banks doubled or tripled their Latin American exposures during this time, and, on average, lending spreads over LIBOR were 50% less than those in the preceding year.

Later in 1997 disaster struck emerging markets once again. A Thai currency crisis quickly spread to a number of Asian countries, including Indonesia, Malaysia, the Philippines, and Korea. One after the other suffered outflows of portfolio investments in local markets which, coupled to a virtual cessation of new emerging-market bond issues and withdrawal of bank lending, led to full-fledged currency crises in all of these countries and, in the case of Malaysia, imposition of exchange controls that inhibited repatriation of investments. In many cases, local borrowers had unhedged foreign currency debts that were difficult to service after severe currency depreciations and led to business failures and massive banking crises, especially in Indonesia and Korea. Everyone rushed for the exits at the same

time. The Asian crisis was compounded by the Russian default on foreign debt in August 1998, followed by significant problems in Brazil and the failure of a major global hedge fund, Long Term Capital Management, (LTCM) a month later. This succession of events almost immediately led to a bail-out of LTCM brokered by the Federal Reserve, which was concerned about the effects of the collapse on the global financial system. Emerging markets were, once again, in the cellar of world financial markets.

Massive and controversial stabilization efforts by the International Monetary Fund and bilateral assistance were combined with uneven and politically difficult adjustment measures in the various countries. Some were quicker and more successful than others, while the IMF itself came in for much criticism, with arguments ranging from excessively Draconian policy prescriptions to excessive willingness to bail out countries with bad economic policies. In the process, the IMF bailed out creditors and investors who had learned from the Mexican crisis shortly before that they were indeed likely to be bailed out. This "safety net" was thought to encourage reckless future behavior by countries, lenders, and investors (an admitted "moral hazard") and to increase the likelihood of future emerging-market financial crises. Many proposals for IMF reform followed suit.

Capital flows to emerging markets revived somewhat during the period 1999–2001, but the revival was weak and conditioned by the dot-com bubble and the ensuing recession in the United States and Europe, as well as persistent economic weakness in Japan, all of which were transmitted by international trade (reduced export prices and volumes) and investor behavior to emerging markets. This was compounded by still further crises, notably the default on external debt by Ecuador in 2000 and a massive financial crisis, multiple defaults and debt restructuring in Argentina in 2001 and 2002. Other problems developed in Brazil and Turkey in 2002.

We can see in these patterns that the basic cycle of loan and investment exposures to emerging-market loans and securities is compressed and its volatility is accentuated by factors related not only to the economic and financial conditions in the emerging-market countries but also to the international investors themselves. These investors have their own problems. They must compete to attract and retain funds under management by demonstrating outstanding investment results. They are competing with hundreds if not thousands of other fund managers. All are trying to beat their benchmarks, and the vast majority fail to do so. All attempt to increase returns for the same amount of risk by shifting into new and different asset classes. The record shows that, up to a point, adding a modest amount of high-risk/high-return investment to a well-diversified portfolio will increase risk-adjusted portfolio returns. Emerging market securities are thought to be good examples of high-risk/high-return investments, so portfolio managers seek to have them among their assets in modest quantities. But with recurrent crises, even these modest quantities have been pared in many cases.

Invariably, however, global investors move in herds. Given the pressure

to perform well against their market indices, they must move into whichever asset class seems to be the most promising at the time. As their investments in the chosen asset class accumulate and prices are bid up, expected returns erode. Then, as the sector deteriorates in appeal, they begin to withdraw at the same time in search of the next fashionable sector. This is not the irrational behavior of crowds infected by investment euphoria but the rational behavior (however volatile) of a large number of institutional investors with huge stakes in the market, each trying to outperform or at least keep up with the others.

Two things make this confluence of factors distressing news to emerging-market countries. First is the fact that these investors manage such large quantities relative to the market capitalization of the emerging financial markets that their relative impact can be enormous: a sudden interest in, say, Chile or Taiwan could result in a huge inflow of capital to the relatively small markets in those countries; equally, a loss of interest could initiate a sudden market collapse. Second is the fact that the institutional herd tends to look for new investment areas rather than to revisit former, once discredited, ideas. After the herd has left, it can be much more difficult because of the trailing disappointment to reattract foreign portfolio investment in significant amounts. To some emerging-market countries, it must seem that when the herd is running, it can attract overseas capital without any effort to improve investment conditions beyond making securities available. But after the boom has subsided, interest in local investments becomes extremely difficult to restart. The risks facing global banks and investors are clear.

Country Risk and Pricing Issues

As discussed earlier in this chapter, country risk is of macroeconomic underperformance due to policy errors, political intervention, or other causes. The investment losses experienced in the Mexican peso crisis of late 1994 is an example of country risk materializing. This risk is the purview of sovereign credit analysts and is reflected, inter alia, in government debt ratings. Yield differentials for various country debt instruments relative to U.S. Treasuries or LIBOR are observable in the market daily. These differentials may be the best indications of country risk that is available. If Brazilian sovereign debt trades at 330 basis points above a comparable-maturity U.S. Treasury security yielding 6.5% (i.e., a Brazil risk-free rate of 9.8%), then that differential represents the return necessary to compensate investors for the Brazilian credit risk that has been assumed. Today's active markets for many emerging-market sovereign and other debt issues cover a range of credit ratings from BBB to B, and these ratings can provide a useful indication of country risk. Indeed, such indicators of country risk are available even for untraded bonds by extrapolation from a table showing rating versus risk premium and/or by estimating the probable ratings for an unrated country by using country risk ranking tables or benchmarking against non-investment-grade corporate debt.

Market Imperfections

Emerging-market economies are often plagued by substantial market imperfections, such as poorly defined or enforced legal rights of investors, inadequate investment information, poor custody or clearance and settlement arrangements, inefficient secondary markets, and corruption and fraudulent trading activities. These imperfections appear to affect equity investments considerably more than they affect debt investments, but for domestic debt traded mainly inside the country the imperfections can be comparable to the risks experienced by equity investors.

The conventional capital asset pricing model requires the addition to the risk-free rate of a premium to reflect the risks inherent in a particular equity investment. Suppose in the United States the equity risk premium is about 3%, a rate that compensates investors for the economic uncertainties of owning the stock and the imperfections of the market in which it trades. The Capital Asset Pricing Model measures the risk of any individual stock by its volatility relative to that of the market. An emerging-market equity risk premium should similarly compensate the investor for equity risk. One way to calculate the emerging-market equity premium is to multiply, for example, (1) the U.S. equity premium by (2) the ratio of (a) the beta of the emerging market stock market index to (b) the beta of the S&P 500. But forecasting volatility ratios is always difficult and perhaps more unreliable in emerging-market situations, especially those that involve substantial market imperfections. The effect on investors of deficiencies in market structure is to impair liquidity—that is, to interfere with the investors' right to buy or sell securities at a fair market price at any time. The interference shows up either in the ability to transact at all or in the ability to transact at fair prices. We know that the market applies a penalty to investments that are illiquid in the form of a price discount or yield premium. It has been estimated that the amount of the discount in cases involving equity investments that were restricted from trading, or "locked up," for approximately two years was often more than 30%. Depending on the degree of illiquidity that appears to be threatened through market imperfections, one could project a required increase in the expected return to investors that would be equivalent to a discount from 0% to perhaps as much as 40%. Examples of markets with low levels of structural illiquidity might include Chile, Hong Kong, and Taiwan, and those with high levels would include Russia, China, and Vietnam.

Correlation Risk

Central to the principle of diversification is that the different investments selected for a portfolio not have returns that are highly correlated with the returns of the rest of the portfolio. Low correlation is as important to asset allocation as is any other factor under the control of the investor. But as we have seen in the aftermath of the Mexican peso crisis, an investor does not always know whether investment choices are going to be highly cor-

related in the future. Not knowing is a risk, one that to some degree can be estimated. Especially before the 1994–1995 Mexican problem, an investor seeking an optimum portfolio consisting of major global equity markets and emerging equity markets would have found evidence only of low correlation across the various emerging markets and between them and the major markets. Six months later, after the effects in one emerging market had been transferred to virtually all the others, it was clear that the earlier assumption of low correlation across those markets was a mistake. The lesson was reinforced during the 1997–1998 Asian crisis.

As long as large U.S. and European investors are among the most significant trading factors in these small-capitalization emerging markets, some form of correlation instability must be assumed; it must also be assumed that this distortion could involve an increase in portfolio volatility. But not all emerging-market countries were equally affected by a given crisis. Many countries with large domestic investor bases, such as Singapore, Hong Kong, Chile, and Argentina, suffered far less from the Mexican peso collapse than did countries with large foreign investor participation such as Peru, Pakistan, Hungary, the Philippines, and China. Similarly, some emerging markets were less dramatically affected than others by the Asian crisis of 1997–1998, and the Argentine crisis of 2001–2002 failed to propagate to other emerging markets.

Financial Market Development and Economic Growth

Countries have plenty of incentives to pursue policies that deal with both the country and market risk elements facing foreign investors. Recent evidence suggests that the development of local equity markets plays a critical role in the economic growth process:

- Countries that had more-liquid stock markets in 1976 tended to grow much faster over the next 18 years than those which did not.
- High levels of stock market liquidity, measured by the turnover ratio (trading volume divided by market capitalization) tends to be associated with more rapid growth over the same period.
- Countries with high trading-to-volatility ratios likewise tended to grow faster, after controlling for conventional economic, political, and policy variables associated with growth differentials for various periods and country samples. Volatility per se does not seem to be related to growth. The ease with which stocks can be traded *is* growth related, however.
- Stock market development seems to complement—rather than substitute for—bank finance, and both of them seem to promote growth independent of each other. Higher levels of development of the banking system are associated with faster growth, no matter what the state of development of the stock market, and vice versa, for reasons that are not yet well understood. Although most corporate investment in developing

countries is financed through bank loans and retained earnings, both (along with the debt-equity ratio) are positively associated with stock market liquidity.

Such findings suggest that international portfolio capital flows may play a substantially more critical role in the emerging-market growth process than previously thought. They can contribute disproportionately to market liquidity. They can force securities prices into line with those prevailing on global markets. The portfolio flows can encourage upgrading of the legal infrastructure, trading systems, clearance and settlement utilities, information disclosure and accounting standards, and custody services. They can improve the process of corporate governance, perhaps in association with significant shareholdings by banks. And they can serve as a bellwether for local portfolio investors, who may find encouragement from a significant foreign presence in the marketplace. The same holds true of the presence of foreign banks in emerging-market countries.

Banking and Financial Market Initiatives

Many governments have been reluctant to act to improve investment conditions in their capital markets. Market reforms have often been extremely slow in coming—and when they have come, they have often been gradual, irregular, and sometimes ineffective. On the one hand, it may be that policymaking officials do not fully appreciate, relative to other matters of concern to them, the importance of market reform and reregulation. On the other hand, there may be a reluctance to change rules that have permitted powerful local insiders to amass great fortunes. However, as investors become more aware of the special risks of investing in emerging-market securities, they are likely to be more selective and to choose countries that provide a higher-quality market environment. In other words, market forces will ultimately compel those countries seeking foreign capital to conform to world standards. There appear to be considerable advantages in being among the earliest converts to so conform. Some of the initiatives that can be taken by governments to do so are the following (see table 12-2).

Sound Macroeconomic Policies

Providing an economic environment that holds out adequate prospects of good, long-term, risk-adjusted returns is a big job that includes many changes and reforms, and one that by no means should be shrugged off with the notion that legislation is planned to take care of this or that. Banks and investors care about what actually happens, not whether legislative bills are passed.

Reforms must begin with the basics: strong macroeconomic policies that transform the country's economic system from the centralized, social-

Table 12-2 Steps to a Viable Financial Market

Presuppositions	***Legal Infrastructure***
Macroeconomic stabilization	Securities law (basic principles)
Basic law of property	Fiduciary responsibility
Political commitments to market solutions	Truth in new issues and due diligence
Existence of a viable banking system	Resistance to market manipulation
Prerequisites	• Insider dealing
Accounting infrastructure	• Front-running—customer comes first
Company law	Structure of securities agency
Role of boards	• Independence
Ownership (shareholding)	• Powers/staffing/enforcement
Capitalization of state-owned enterprise debt	Tax basis of companies
Formation of the Securities Industry	Dividend taxation
Rules for securities firms	Bearer vs. registered shares
• Capital	Undercut parallel market
• Management (fitness and properness)	***Process***
• Employee certification	Time schedule for implementation
Joint ventures with foreign firms	Training people for financial sector
Role of banks and universal banking	Industry infrastructures
Market structure	Lawyers
• Exchanges	• Accountants
• Trading techniques	• Dispute settlement
• Price disclosure	• Arbitration
• Settlement/delivery	• English language
• Custody	
Policies toward foreign investors	
• Ownership limits	
• Funds-only	
• Differental share classes	

istic, import-substituting, foreign aid–dependent models of the past to the new "consensus" model of the open-market, low-inflation, deregulated, private-sector oriented economy of the future. Many countries have moved in this direction in recent years, notably several in Latin America and eastern Europe, but much remains to be done. Privatization, the elimination of government subsidies, and the removal of restrictions on foreign investment have been powerful tools to jump-start the transition. Once market forces begin to take hold and shape events, a great deal of progress can be observed.

Progress breeds an appetite for further progress. Increased transparency of government economic policies and market transactions represents progress, as does increased toughness in dealing with failed institutions—especially those financial institutions that were used to finance and prop up inefficient state-owned enterprises in the past. Such toughness, however, can be politically expensive, especially as it often results initially in higher unemployment, as many countries have experienced. Backsliding is an expected outcome when this occurs, and some amount of it may be tolerated

for brief periods, but the long-term requirement for the institutionalization of free-market practices must have greater priority. No doubt, much of the separation in the future of emerging-market countries into winners and losers will be determined by the degree of success that is experienced in making the free-market conversion and in sticking to it.

Building Financial Infrastructure

Governments that want to attract international investment must be clear about the importance of creating some basic preconditions for viable capital markets—an obvious point honored as much in the breach as in practice. Fundamental is a functional financial system that embraces a viable banking industry, insurance and securities industries, and pension and mutual funds. All too often, in many emerging-market countries, banks are large, subsidized bureaucratic institutions that possess few skills in finance and drive customers to transact in parallel (unofficial) markets. Many of these banks are loaded down with nonperforming loans from state-owned enterprises or large domestic corporate combines that are deemed "too big to fail." The worst of this debt ultimately will have to be separated from the banking system and put into "bad banks," from which future recoveries might someday be paid. The bad bank in such a country, possibly a subsidiary of the central bank, can "purchase" impaired loans from commercial banks using government bonds. Thus recapitalized and solvent, banks can begin again to develop a viable lending business. Banks in some developing countries should be encouraged to develop close relationships with particular companies to improve information flows and to monitor their progress.

Foreign banks can make an important contribution in this regard. The evidence suggests that foreign banks bring various kinds of expertise to emerging-market economies, which leads to both lower costs and lower credit losses. In addition, a major bank's local affiliate is unlikely to be allowed to fail, barring a disaster scenario, and home country regulators today evaluate banks on a global, consolidated basis, which adds another layer of comfort. Foreign banks and other investors have often done a good job of restructuring damaged banks in emerging-market countries and restoring them to both stability and profitability. But sometimes, as in Argentina during 2001 and 2002, they can suffer massive losses as well.

Countries also need to enact sensible securities laws in order to provide regulatory and enforcement authority against market fraud and other abuses, and many countries have done this in recent years, so ample precedents are available. Rules should address the principles of fiduciary responsibility, full disclosure, fair markets, surveillance, and enforcement, and the regulations showed require that minimum standards for training and certification of fiduciaries and intermediaries be met. This involves providing a central market place, a trading system that includes rules for price disclosure and settlements, and rules providing for the fitness and capital-

ization of securities firms dealing with the public. Some developing countries also have created short-term markets in government securities and commercial paper—in tandem with banking activities—as a competitive alternative for borrowers and depositors. Such countries as Korea, the Philippines, and Colombia have had domestic commercial paper markets in operation for 20 years or more, while Poland has more recently created one.

The role of banks in the securities industry also must be determined (specialized securities firms versus universal banks), as well as the extent to which the participation of qualified foreign firms is to be permitted. As in the case of banking, foreign securities firms (often through joint ventures) can contribute considerably to the training of employees and management of local firms, and to the general professionalism and efficiency of national financial systems.

Overhauling Corporations

Governments also must attach priority to making corporations fit for public ownership, which requires common financial accounting and auditing standards, a company law, and protection against exploitive concentrations of voting power by insiders. The largest source of shares in many countries will come from the privatization of state-owned enterprises that is intended to end such firms' operating inefficiencies, raise capital for the government, develop a public shareholder base, and establish a growing, profitable, market-oriented private sector. Some, especially in Latin America and Asia, have enjoyed great success with privatization programs. Others, such as Russia and the former Czechoslovakia, rushed through privatization programs in the interest of quick reform but on a basis that may ultimately prove to be self-defeating. For instance, none of the foregoing conditions for public ownership were initially in place, and few of the enterprises were economically viable in their own right—or depended on continued government subsidies or public procurement to continue in business. Management was not substantially improved, and the process of ownership-distribution through vouchers was rife with fraud, corruption, and racketeering. It was not until the start of the new millennium that such countries, notably Russia, began to make much progress.

Role of Capital Controls

Certain techniques for limiting capital may not always be ill advised. At the end of 2001, all emerging equity markets combined represented only about 13% of global stock market capitalization, so that the effect of portfolio equity inflows on many countries has often been a glut of foreign exchange and liquidity. This can have severely adverse effects. Principal among these is inflationary pressure—caused by a sudden, substantial increase in the money supply—and appreciation of real exchange rates. Im-

ports in some countries subjected to such inflows consequently increased, exports declined, and trade balances deteriorated. Some governments—such as those in Chile, South Africa, and several Asian countries—have limited portfolio capital inflows in various ways to avoid the problem of excess liquidity and to maintain a competitive exchange rate. In Chile, such controls sought to increase the cost of investment by imposing reserve requirements on loans, stamp taxes on securities transactions, and widening the bands within which the currency can fluctuate. Of the countries that experienced increased stock market prices during the 1990s, as against overall emerging market trends at the time, most maintained restrictions on capital inflows. Without such controls, the impact of massive portfolio flows is hard to counteract.

Even the World Bank has suggested—its strong advocacy of free-market economic policies notwithstanding—that capital-inflow controls can be useful techniques under appropriate circumstances in fostering macroeconomic stability, long-term capital formation, and economic growth. Its recommendations are nevertheless heavily qualified in order to preempt justification of a reversion to traditional, highly distortive uses of cross-border capital controls.

Summary

Whereas country evaluation is itself an exceedingly difficult task, building country assessments into the design of international exposure portfolios that are in some sense "efficient" is even more complicated. Neither the risks nor the returns are clearly definable, and even exposure measurement is a difficult task. Portfolio ideas can contribute importantly in clarifying the overall risks. At the same time, the development of informational and assessment capabilities as part of the country evaluation process can itself lead to improved international exposure decisions that implicitly embody portfolio concepts. Application of these concepts also helps pin down the link between risks and pricing of international loans and bonds. And portfolio theory says that the riskiness of any single cross-border exposure is not what is important, but rather the effect of that exposure on the risk of the overall portfolio.

Perhaps few emerging-market countries have the economic capacity or the political will to adopt far-reaching free-market policies affecting banking and financial markets all at once. Who does? Gradual but steady approaches work perhaps best of all. Successfully rebuilt, former developing countries like Japan, Germany, South Korea, Taiwan, Singapore, Spain, and Chile at no point adopted a totally free-market approach. They moved purposefully in that direction, but only at a pace that could be accommodated by the accompanying political thinking and building of infrastructure. Other countries that have tried hard to accept the new policies (Mexico, Argentina, Brazil, perhaps India) have had considerable success, despite

some disappointments. They clearly needed more time for their efforts to bear the fruit than their more successful peers enjoyed, but so far it appears there is little likelihood of a reversion to isolation and nonmarket allocation of capital. Developing countries must know that it all depends on them. A consistent barometer of their efforts, flawed as it may be from time to time, is in the capital they are able to attract and the foreign-based participants that are active in their banking and financial markets.

13

Global Banking Regulation

The financial services industry worldwide has been, and will continue to be, subject to significant public-authority regulation and supervision due to the fiduciary nature of the business, the key role of financial systems in driving economic performance, the potential for financial fraud, and the possibility of serious social costs associated with financial failure. Moreover, we know from experience that even small changes in financial regulation can bring about large changes in financial system activity. We also know that, to the extent that information flows among participants in financial activities are imperfect, regulation can significantly improve the operation of financial systems:the greater the information asymmetries and transaction-cost inefficiencies that exist, the greater is the value of regulation, quite apart from its benefits in terms of financial safety and soundness.[1] And it sometimes seems that the more the banks and other financial intermediaries complain, the better the regulators are doing their jobs.

The reasons can be traced to the industry's important fiduciary element—the use of other people's money—and the central role banking plays in the modern national and global economic and financial system. Banks cannot be allowed to impose politically unacceptable costs on society, either by failing those people deemed worthy of protection in financial matters or by permitting bank failure to contaminate other financial institutions and, ultimately, the economic system as a whole. Consequently, every country imposes regulations intended to ensure that banks are safe and sound, that they contribute to the efficient allocation of resources and economic growth, and that they and other financial firms deal with the public in a fair and honest way. This requires making often-difficult choices between financial efficiency and creativity, institutional and systemic safety and stability, and the ability to ensure compliance and sound business conduct. And because the services provided by banks and financial intermediaries in

general affect nearly everything else in the economy, regulation is taken very seriously and regulatory failures become traumatic events for all concerned.

The complexity of the financial services industry described in the previous chapters has major implications for regulation. Markets and institutions tend, perhaps more often than not, to run ahead of the regulators. Regulatory initiatives sometimes have consequences that were not and perhaps could not have been foreseen. The regulatory dialectic in the financial services sector is both sophisticated and complex, and it often confronts both heavily entrenched and politically well-connected interests (as well as some of the brightest minds in business). The more complex the industry—perhaps most dramatically in the case of massive, global financial services conglomerates where comprehensive regulatory insight is difficult and perhaps implausible—the greater the challenge to sensible regulation. In this chapter we discuss some of the basic regulatory parameters that are consistent with the financial services industry dynamics presented earlier in this volume.

Regulatory Trade-offs

The right side of figure 13-1 identifies the policy trade-offs that invariably confront those charged with designing and implementing a properly structured financial regulatory system. On the one hand, they must strive to achieve maximum static and dynamic efficiency with respect to the financial system as a whole. They need to ensure both efficiency in financial flows and innovation in financial products and processes, and they need to promote the competitive viability of financial institutions that are subject to

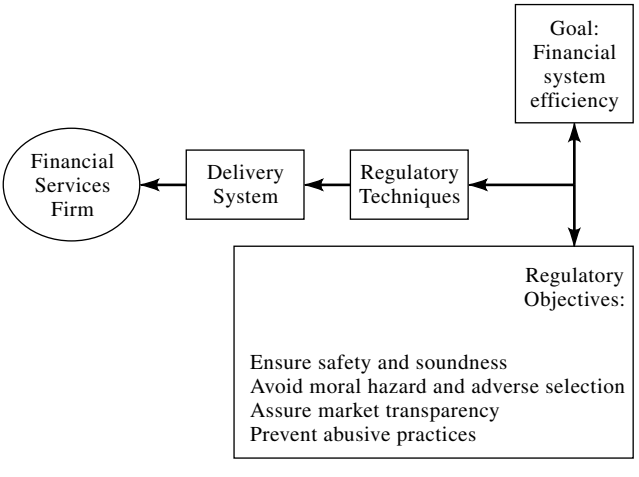

Figure 13-1. Regulatory trade-offs.

regulation. On the other hand, they must safeguard the stability of institutions and the financial system, in addition to helping to ensure what is considered "acceptable" market conduct—including the politically sensitive implied social contract between financial institutions and unsophisticated clients.

The first problem, safety-net design, is beset with difficulties such as moral hazard and adverse selection and becomes especially problematic when products and activities shade into one another, when on-and off-balance sheet activities are involved, and when domestic and offshore business is conducted by financial firms for which the regulator is responsible. The second problem, market conduct, is no less difficult when end users of the system range across a broad spectrum of financial sophistication from mass-market retail clients to highly sophisticated, interprofessional trading counterparties.

In short, regulation has as its objective the maintenance of a safe and sound banking system—one that is resistant to collapse and avoids contamination of the payments system and the credit allocation system (and therefore the real economy), yet without precluding the failure of institutions that are not competitively viable or are poorly managed. Additional objectives are safeguarding the assets of uninformed retail customers who have deposited their savings in good faith under the presumption of absolute safety backed by the institutions themselves and by the state, and the assurance of fair dealing in financial transactions—but without at the same time losing the value of caveat emptor with respect to informed clients.

Difficult as these objectives are to achieve in a national banking environment, bank regulation in the global environment involves still more complex issues, since the regulatory function is a matter of national sovereignty, yet banks and other financial firms can and do operate across national jurisdictions, as well as offshore markets that can help avoid significant parts of the regulatory net altogether. Regulatory burdens deemed excessive in one country can prompt firms and their clients to move to another jurisdiction where the burdens are lighter—a form of "regulatory arbitrage" that can both shift the gains associated with financial intermediation and cause regulators to soften their approach, possibly excessively so. Here we explore the problems associated with bank regulation, specifically from the perspective of its effect on competitive performance of the financial institutions themselves, both among each other and against nonbank financial intermediaries.

Edward Kane is one of the pioneers in thinking about financial regulation and supervision as imposing a set of "taxes" and "subsidies" on the operations of financial firms exposed to them.[2] On the one hand, the imposition of reserve requirements, capital adequacy rules, and certain financial disclosure requirements can be viewed as imposing "taxes" on a financial firm's activities in the sense that they increase intermediation costs. On the other hand, regulator-supplied deposit insurance, information produc-

tion and dissemination, and lender of last resort facilities serve to stabilize financial markets, reduce information and transaction inefficiencies, improve liquidity, and lower the risk of systemic failure—thereby improving the process of financial intermediation. They can therefore be viewed as implicit "subsidies" provided by taxpayers.

The difference between these "tax" and "subsidy" elements of regulation can be viewed as the "net regulatory burden" (NRB) faced by particular types of financial firms in any given jurisdiction. If all else is equal, financial flows tend to migrate toward those regulatory domains where the NRB is lowest. NRB differences can induce financial-intermediation shifts shift when the savings realized exceed the transaction, communication, information, and other economic costs of shifting. Indeed, it has been argued that a significant driver of financial disintermediation, and its effect on various types of financial firms, has been due to differences in NRB, which is arguably highest in the case of commercial banks. Competition triggers a dynamic interplay between demanders and suppliers of financial services, as financial firms seek to reduce their NRB and increase their profitability. If they can do so at acceptable cost, they will actively seek product innovations and new avenues that avoid cumbersome and costly regulations by shifting them either functionally or geographically.

In going about their business, regulators continuously face the possibility that "inadequate" regulation will result in costly failures, and, alternatively, the possibility that "overregulation" will create opportunity costs in the form of financial efficiencies not achieved, or in the relocation of firms and financial transactions to other regulatory regimes offering a lower NRB. Since any improvements in financial stability can only be measured in terms of damage *that did not occur* and costs that were *successfully avoided*, the argumentation surrounding financial regulation is invariably based on "what if" hypotheticals. In effect, regulators are constantly compelled to rethink the balance between financial efficiency and creativity on the one hand, and safety, stability, and suitable market conduct in the financial system on the other. They face the daunting task of designing an "optimum" regulatory and supervisory structure that provides the desired degree of stability at minimum cost to efficiency, innovation, and competitiveness—and to do so in a way that effectively aligns such policies among regulatory authorities functionally and internationally and avoids "fault lines" across regulatory regimes. There are no easy answers. There are only "better" and "worse" solutions as perceived by the constituents to whom the regulators are ultimately accountable.

Regulatory Options

The principal options that regulators have at their disposal, identified in figure 13-2, range from "fitness and properness" criteria—under which a financial institution may be established, continue to operate or be shut

down—to line-of-business regulation as to what types of business financial institutions may engage in, adequacy of capital and liquidity, limits on various types of exposures, and the like, as well as policies governing marking-to-market of assets and liabilities. As noted, regulatory initiatives can create financial market distortions of their own, which become especially problematic when financial products and processes evolve rapidly and the regulator can easily get one or two steps behind.

It is not difficult to see why applying the regulatory techniques depicted in figure 13-2 are so probelematic in optimizing across the trade-offs depicted in figure 13-1, especially when gains or losses in static and dynamic efficiency are often exceedingly difficult to measure, and when the costs of underregulation or undersupervision do not become apparent until it is too late. Nor is it difficult to see why, under such conditions, there is sometimes a tendency for overregulation in the financial services sector. It is also useful to bear in mind the distinction between the regulatory environments of onshore and offshore banking.

Onshore, or domestic, markets for financial services are fully subject to national supervisory, regulatory, and monetary policy controls. Whether and how foreign-based financial institutions may compete in these markets is strictly a matter for national political decisions. When domestic institutions are systematically protected from outside competition, they are frequently highly profitable. But they can also use that "artificial" profitability to cross-subsidize the penetration of other markets for financial services. These may also be relatively uncompetitive and inefficient by international standards.

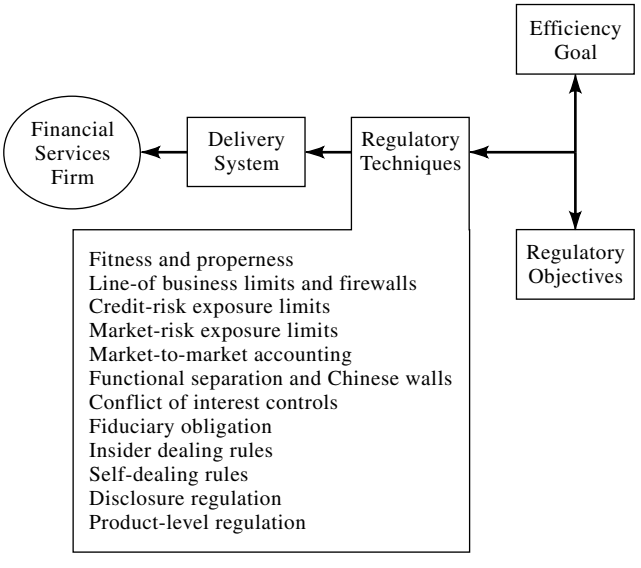

Figure 13-2. Regulatory techniques.

Offshore markets for financial services are substantially beyond the reach of national authorities. They include Eurocurrency and Eurobond markets and are largely untaxed, unregulated, and highly efficient activities in which any number can play. While it seems fair to say that such characteristics have exposed the international economic and financial system to certain risks from time to time (some of them serious), offshore markets nevertheless set standards of performance in financial efficiency against which all other financial markets must be measured. It is important to recall, for example, that the Eurobond market and more recently the Euroequity market (see chapters 3 and 7) are the outcomes of confused and often muddled behavior on the part of national regulators since the 1960s. Authorities in EU member nations were unable to agree, for example, on the establishment of an integrated European banking market in fulfillment of their obligations under the Treaty of Rome until this was finally accomplished in the early 1990s. Individual national authorities permitted greater freedom of cross-border capital movement, yet excluded foreign borrowers and issuers from their national capital markets and drove them offshore. And the beginning of the twenty-first century still has not seen a coherent European regulatory structure for financial markets.

All of these characteristics have combined to make financial services at the national level a "sensitive" industry, both as a central vehicle for the implementation of economic policy and as an industry subject to collective crises and failures by individual firms. The history of the United States, for example, records well over 15,000 bank failures—5,000 during the Great Depression of the 1930s alone and an annual average of well over 100 during the 1980s, not including massive failures of thrift institutions and $150 billion taxpayer bailout in the late 1980s. Mismanagement or outright fraud have left prominent names like Banco Ambrosiano, BCCI, Bank Bumiputra, Crédit Lyonnais, Franklin National Bank, Herstatt, Schroder Münchmeyer Hengst, Seafirst, and Continental Illinois among the failed or seriously damaged over the years—plus essentially the entire Japanese banking system and, in the early 1990s, those of Finland, Mexico, Norway, and Sweden. The Asian crisis of the late 1990s led to massive financial failures in Indonesia, Korea, and Thailand.

Governments are well aware of the inherent risks and potential conflicts involved in national and international banking; securities underwriting; and trading and dealing in financial instruments, foreign exchange, derivatives, and the like. Most notably in banking, these risks focus on the solvency of borrowers and the liquidity of institutions that are highly leveraged. Banking crises always carry with them negative externalities—damage imposed on individuals and institutions outside the firms directly involved and, in some cases, outside the industry itself. It is conventional wisdom that major banking crises can lead to severe damage to employment, income, economic growth, and related goals of society.

To protect themselves against such adverse consequences, countries

have built elaborate "safety net" systems that are designed to provide liquidity to institutions in trouble, insure depositors, and sometimes bail out borrowers to help the bank maintain solvency. The operation of domestic financial safety nets invariably creates problems of efficiency and fairness—for example, how to distinguish between institutions that are "TBTF" (too big to fail) and those that are "TSTS" (too small to save), and how to neutralize competitive distortions that may result from people's expectations about the operation of the safety net. Even more important, the existence of a safety net creates potential "moral hazard" problems where management of financial institutions—knowing that they are likely to be bailed out—will behave in a less risk-averse manner and thus impose substantial contingent liabilities on those who hold up the safety net: the taxpayers and the general public. They also trigger "adverse selection," with precisely the least-fit organizations surviving and expanding.

To cope with these problems, and to ensure the safety and stability of national financial systems, governments apply various techniques of financial surveillance and control, ranging from careful bank-examination procedures, reserve requirements, mandatory asset ratios, and maximum lending limits to risk-related deposit insurance premiums, disclosure provision, securities laws, and moral suasion. Countries deal with this problem in different ways. Some simply have on occasion nationalized all or major parts of the domestic financial services industry. As noted, regulation and control usually damages the efficiency of the domestic financial system, but this loss in efficiency can be considered as something of an "insurance premium" and is sometimes considered to be more than offset by the resulting gain in the safety and stability of the system—at least temporarily.

Problems arise when national financial institutions take some of their activities offshore into the European or other foreign markets. While home countries are supposed to regulate offshore branches and host countries are supposed to regulate subsidiaries and other affiliates, the effectiveness of government regulation and control with regard to these activities remains the subject of occasional lapses and intense debate.

Capital Adequacy

As global banking activities have expanded, new financial products proliferated, and many of these are tradeable in the market. And as competition between banks from different countries grew, the difficulties in maintaining uniform standards for both bank safety and "level" competitive conditions between banks from different countries became a serious problem. Regulatory differences, particularly those pertaining to capital adequacy, encouraged banks subject to less restrictive conditions to compete aggressively against other banks, which in turn pushed the more thoroughly regulated institutions to increase other forms of activities as a way of keeping up.

Achieving a "Level Playing Field"

Implementation of a truly level playing field in the financial services sector depends both on similar sets of restraints on the various different types of lending that banks perform and on common definitions as to what is and is not bank "capital." The task is complicated by the structure of regulatory and prudential constraints already in place, and accepted, in each of the countries involved. These have traditionally differed with respect to both lending practices and capitalization. There is a wide array of rules, for example, as to bank reserves—some countries permit "hidden" reserves against loan losses (in the form of deliberately undervalued assets)—and in the regulation of domestic deposit rates, deposit insurance, domestic competition policies, and a variety of other rules that can affect an institution's competitive positioning internationally. While these differences are comparable in nature to the competitive effects of subsidies and governmental participation in other industries, the differences are perhaps more serious in the banking sector. Moreover, in no other industry have uniform global standards been attempted.

Bank regulators have discussed the issue of standardization for years, time and again confronting the fact of national sovereignty in banking supervision and monetary control, along with the entrenched interests of banks themselves. At a meeting in Amsterdam in October 1986, however, banking supervisors resolved to work toward uniform minimum capital standards for all banks that do business across national borders, as a matter of competitive fairness and prudential soundness. Such a minimum was to represent the maximum capital standards that countries will impose if their banks are not to suffer in international competition. Supervisors also agreed to work toward a uniform definition of capital—which, in many cases, included not only equity but also various forms of long-term debt—as well as greater commonality in loan-loss provisioning. Although the standards that emerged, discussed below, largely accomplished these tasks, it was nonetheless clear that the job was not finished. Regulatory coordination had to focus as well on sanctions (including exclusion from specific businesses and markets) for institutions that violate or circumvent banking rules, questions of prudential requirements governing market and operational risk, and the problem of one set of standards being applied to the banking sector and another, looser set of rules for the nonbanking financial services sector.

The BIS Capital Adequacy Rules

In January 1987, after three months of discussion, the Bank of England and the U.S. federal banking regulatory authorities (the Federal Reserve, the Federal Deposit Insurance Corporation [FDIC], and the Comptroller of the Currency) announced that they had reached agreement on proposals for a common measure of capital adequacy for banks. The proposals were

for a risk-related approach similar in many respects to those already in use in the United Kingdom and proposed in policy papers released by the U.S. regulatory authorities in January 1986. The proposals also drew on work of the Banking Regulations and Supervisory Practices committee of the Bank for International Settlements (BIS) in Basel.

The Basel Committee's approach was to seek a convergence of the various regulatory methods to form a package that could be used by banking regulators from all of the Group of Ten (industrialized) countries plus Switzerland and Luxembourg. The issues involved were controversial, and the goal of the committee was ambitious. The 1987 U.S.-U.K. proposals were circulated for comment, then adopted by the Basel Committee as a whole in July 1988 and subsequently ratified by each country. The Federal Reserve announced its final version of the guidelines in January 1989 and noted that the guide had been designed to achieve certain important goals:

- Establishment of a uniform capital framework, applicable to all federally supervised banking organizations
- Encouragement of international banking organizations to strengthen their capital positions
- Reduction of a source of competitive inequality arising from differences in supervisory requirements among nations

The guidelines were intended to establish a systematic analytical framework that makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations, takes "off-balance-sheet" exposures into explicit account in assessing capital adequacy, and minimizes disincentives to holding liquid, low-risk assets.

Off-balance-sheet items represent contingent assets (or liabilities) that the accounting profession did not require to be entered on the face of a bank's financial statements because of the uncertain nature of the contingencies that determine whether these items become due and payable (i.e., move onto the balance sheet). Most accountants did require that, as contingent items, they be disclosed in footnotes to the financial statements, but they escaped being included in regulatory ratios. Since many financial products, such as note issuance facilities, swap, and financial futures transactions involve contingent obligations, they were not included on balance sheets. The rapid growth in off-balance-sheet items, however, had been a cause of concern to regulators, which led to an effort to "capitalize" off-balance-sheet items so as to include them in the overall grasp of banking regulations.

In principle the BIS approach was a simple one, although the actual structure was fairly complex. The basic idea was to assign each asset owned by a bank (or accounted for on an off-balance-sheet basis) to one of four "risk categories." Each risk category was assigned a "risk weight," which is used to multiply the amounts in each risk category to determine the amount of "capital" required by the bank. Capital was divided into "tier

1," or "core" capital (consisting of retained earnings, common stock, and qualifying perpetual preferred stock and minority interests in equity accounts of consolidated subsidiaries—minus "goodwill") and "tier 2" capital (various forms of "supplementary" capital).

Before these proposals were adopted, the principal means of assessing capital adequacy for banks in the United States had been to divide "total capital" (which included retained earnings, common and preferred stock, and certain forms of subordinated debt) by "total assets." The Federal Reserve and other banking supervisory bodies set different ratio requirements for different types of banks. At the beginning of 1989, when the final BIS guidelines were announced, U.S. money center banks were required to maintain a 6 % capital-to-total assets ratio, although many banks were not in compliance at the time. By the early 1990s virtually all U.S. banks had been brought into compliance.

The face amount of an off-balance-sheet item (such as a letter of credit, a swap, or a foreign exchange obligation) was taken into the risk-based capital ratio by multiplying it by a "credit conversion factor." The resultant "credit equivalent amount" was assigned to the appropriate risk category (according to the identity of the obligor or guarantor). Among those items converting to credit risks at 100% of face value were all direct credit substitutes, risk participations in bankers acceptances or direct credits substitutes (such as letters of credit), sale and repurchase agreements, and certain forward agreements.

Those items entitled to 50% conversion factors included transaction-related contingencies, revolving credit agreements, note issuance facilities, and similar arrangements. Items converted at 20% included short-term self-liquidating trade-related contingencies. Items converted at 0% included unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancelable at any time. The guidelines included among off-balance-sheet items all interest rate and foreign exchange contracts for which credit-equivalent amounts were calculated in the case of each individual contract.

The BIS rules included a schedule for implementing the new system, with a ratio of 8% (of which at least 4% had to be in the form of tier 1 capital) in effect beginning on January 1, 1993. They provided a common standard for safe and prudent banking capitalization. Once countries agreed on the same minimum base, there was no advantage in being undercapitalized or for countries to unduly subsidize banking institutions—for example, by setting interest rate controls to allow banks to accumulate excess profits as a cushion against future losses at the expense of economic growth and efficiency. Riskier instruments became more costly to hold, lessening the chances of excessive exposure and the prospect that regulators would have to step in to provide support in a crisis. There was less incentive to underprice off-balance-sheet commitments. Given the rate of financial innovation and the deluge of new instruments, it was necessary that the guidelines provide regulators with a coherent framework into which to slot

new types of exposures as they evolved, instead of always lagging events by as much as several years. Each new type of instrument was assigned to the highest risk category until such time as the regulators ruled otherwise.

The BIS risk-based capital approach increased pressure on banks to charge higher spreads or fees for financial transactions in which they participated, in order to recover the incremental cost of the additional capital needed to support specific loans and advances, or simply to recover the higher overall cost of capital. This condition was seen by many banks to place them at a substantial disadvantage relative to securities firms, with which they were increasingly in direct competition. Securities firms, not being regulated by banking authorities who must look after the deposits they are guaranteeing, were not subject to the new rules or to any similar constraints. Coordination with authorities regulating the securities industry was seen as essential if competitive rules under which firms in the two sectors (banking and securities) of the industry operate were not to serve as further distortions to competitive conditions in the case of financial services that are performed by both banks and nonbanks.

Nor were the provisions of the BIS accord uniform between banks of different countries. For example, wide international differences existed in the availability of information on bank performance, which influenced their relative competitive positioning and certainly affected the ability to determine whether the international competitive playing field is in fact relatively level. Transparency in U.S. accounting for banks was assured by the regulatory structure, and any disclosure problems were relatively quickly remedied—including cross-border exposures and off-balance-sheet exposures in such transactions as swaps. In other countries, disclosure was far less extensive and in some cases was relatively meaningless. Disclosure of off-balance-sheet exposures in many cases was absent altogether, and many home countries of multinational banks failed to disclose their worldwide operations on a consolidated basis. There was also the issue whether banks could emerge among the nonparticipating countries to challenge banks from the participating countries for business and to possess a competitive edge over the participating banks through less rigorous regulatory standards. Conceivably, banks could migrate to unregulated areas for the purpose of competing with the banks from the major countries. However, since only a small percentage of the world's international banking assets were booked outside the participating BIS countries, the effect of such a migration did not appear to be large.

Finally, it was argued that coordinated risk-based capital requirements could actually be counterproductive, since assets categorized in the same risk class may have vastly different risk profiles. Moreover, since different assets and off-balance-sheet exposures required different BIS levels of capital, the result could well be distortions in banking decisions—for example, loading up on highly interest rate-sensitive U.S. government securities that require less capital backing than perhaps less-volatile asset deployments which require more capital—decisions that ultimately could lead to in-

creased, rather than decreased, vulnerability of individual institutions. It also threatened financial innovation and, as noted, placed banks at a competitive disadvantage against nonfinancial institutions operating in the securities markets that were not subject to similar requirements.

In general, by the mid-1990s, banks in most of the advanced countries had attained the BIS guidelines with greater or lesser difficulty. Banks in each country faced more or less unique difficulties associated with, for example, loan losses related to real estate and country lending in the United States and various European countries, the stock market collapse and the end of the "bubble" economy in Japan, the simultaneous creation of a single market in financial services under universal banking conditions in the European Union, and the Russian debt defaults and financial crises of the late 1990s.

The problem of derivatives exposure and position risk also had to be considered. The rapid growth in bank holdings of interest-sensitive instruments such as government bonds at a time of declining rates—in part encouraged by zero-weighting of government securities under the BIS rules—in addition to the enormous growth in over-the-counter and exchange-traded derivative instruments such as swaps, futures, options, and various types of structured financial instruments, raised the issue of position risk. This is the risk that financial instruments of contingent obligations held by banks on or off the balance sheet could change dramatically in value as a result of changes in interest rates or market conditions.

Basel II: Improved Bucketing and Granularity

Many of the weaknesses incorporated into the original BIS capital adequacy standards were addressed in proposals, floated in 1999, for an improved set of rules, generally termed Basel II.

The Basel I standards just described used broad-gauge risk weights that in some cases made little sense—for example, requiring larger amounts of capital for low-rated country exposures than for highly rated corporate exposures—and in the process distorting global capital allocation. In addition, banks had become much more sophisticated in understanding and monitoring credit risk and market risk using internal models usually based on a "value at risk" (VAR) approach. Consequently, it was increasingly felt that the BIS standards forced banks to hold excess capital and to do so in a way that was not fully reflected in the risk of their overall exposure portfolio.

Consequently, an initial set of proposals was floated by the BIS that would give banks a choice of using "external" credit ratings issued by the major rating agencies, such as Moody's and Standard and Poor's, to calibrate the amount of capital to be maintained against credit exposures. Alternatively, they could develop "internal" credit scoring models, which would assess overall credit exposures in a more sophisticated, portfolio context and could base their capital provisions on those models. In turn,

the models would be audited by the regulators. Initially, it was expected that only the most sophisticated banks would choose the second alternative but that the internal ratings approaches would gradually spread to other banks as well. The idea was to create finer distinctions ("granularity") among credit quality of obligors and more sensible "risk buckets" while at the same time recognizing the ability of banks to diversify among exposure portfolios.

The Basel II proposals elicited a great deal of comment: each of the issues covered affected some banks one way and other banks another way, and many were expected to have unintended consequences. So the Basel II comment period was extended, and the definitive application of Basel II capital adequacy rules was deferred to the end of 2002. Complicating matters further was the fact that the Basel II proposals cover "operational risk"—risk associated with compliance failures, system failures, civil litigation, and the like. Nobody knows how to measure these things, much less how to price them in order to provide adequate capital. So the initial Basel II proposals suggested a 20% capital charge—a simple heads-up galvanizing banks into getting to work on the issue. But a final solution is some time away, and its specifics remain far from obvious.

Financial Supervision

The final element, identified in figure 13-3, involves the regulatory machinery itself, extending from reliance on *self-control* on the part of boards and senior managements of financial firms concerned with protecting the value of their franchises, through financial services industry *self-regulation* via self-regulatory organizations (SROs), to *public oversight* by regulators with teeth—including civil suits and criminal prosecution.

Self-regulation remains controversial, since financial firms continue to

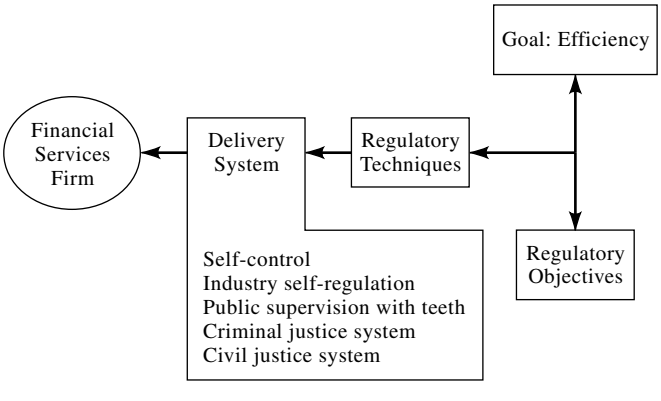

Figure 13-3. The regulatory delivery system.

suffer from incidents of business losses and misconduct, despite the often devastating effects on the value of their franchises. Financial firms respond with often impressive and expensive compliance infrastructures. But nothing is perfect, and serious problems continue to slip through the cracks. And "ethics" programs intended to ensure appropriate professional conduct are often pursued with lack of seriousness, at worst creating a general sense of cynicism. People have to be convinced that a good defense is as important as a good offense in determining sustainable competitive success. This is something that is extraordinarily difficult to put into practice in a highly competitive environment, and it requires an unusual degree of senior management leadership and commitment.[3]

Control through SROs is likewise subject to dispute. Private-sector entities that have been certified as part of the regulatory infrastructure in the United States, for instance, have repeatedly encountered problems. For example, in 1996 one of the key U.S. SROs, the National Association of Securities Dealers (NASD) and some of its member firms were assessed heavy monetary penalties in connection with rigging over-the-counter equity markets. A vigorous attempt to refute empirical evidence of improprieties eventually yielded to major changes in regulatory and market practices. As another example, in 2001 Moody's was a defendant in connection with an SEC investigation of the firm's unsolicited ratings practices. One has to wonder how such management lapses in such highly reputation-sensitive institutions could occur. Other well-known examples occurred in the United Kingdom, which relies heavily on the SRO approach. In 1994 the self-regulatory body governing pension funds (IMRO) failed to catch the disappearance of pension assets from Robert Maxwell's Mirror Group Newspapers, and the Personal Investment Authority (PIA) for years failed to act against deceptive insurance sales practices at the retail level. In that connection, a 2001 report of the Department of Trade and Industry (DTI) described the conduct of the financial firms as beset with "cliquishness, greed and amateurism."

Inevitable in self-regulation are political charges of the fox watching the henhouse to contend with. As in the Maxwell case, the City of London came in for a good deal of criticism for the "easygoing ways" that have done so much to contribute to its competitive success in the global marketplace. But reliance on public oversight for financial regulation has its own problems, since virtually any regulatory initiative is likely to confront powerful vested interests that would like nothing better than to bend the rules in their favor. The political manipulation of the savings and loan regulators in the United States during the 1980s is a classic example; it created massive incremental losses for taxpayers. Even the judicial process that is supposed to arbitrate or adjudicate matters of regulatory policy may not always be entirely free from political influence or popular opinion.

Just as there are trade-offs implicit in figure 13-1 between financial system performance and stability, there are also trade-offs between regulation and supervision. Some regulatory options (e.g., capital adequacy

rules) are fairly easy to supervise but are full of distortive potential from their broad-gauge nature (even with the higher level of granularity proposed in the revised Basel II accords). Others (such as fitness and properness criteria) may be highly cost effective but devilishly difficulty to supervise. Finally, there are trade-offs between supervision and performance, with some supervisory techniques far more costly to comply with than others. Regulators must try to optimize across this three-dimensional set of trade-offs under conditions of rapid market and industry change, blurred institutional and activity demarcations, and functional and international regulatory fault lines.

Market Supervision

In addition to regulation of financial institutions, there is the matter of market conduct. A first observation from the U.S. experience is that, on balance, commercial banks clearly carry a net regulatory burden that, in terms of the actual requirements and costs of compliance, is vastly greater than that which applies to the securities industry and other nonbank intermediaries. This has arguably had much to do with the evolution of the country's financial structure, generally to the detriment of commercial banking. Institutional regulation on nonbank intermediaries is relatively light, but regulation of business conduct is relatively heavy.

For example, when Congress passed the Securities Act of 1933 it focused on "truth in new issues," requiring prospectuses and creating underwriting liabilities to be shared by both companies and their investment bankers. It then passed the Securities Act of 1934, which set up the Securities and Exchange Commission and focused on the conduct of secondary markets. Later, in the 1960s, it passed the Securities Investor Protection Act, which provided for a guarantee fund (paid in by the securities industry and supported by a line of credit from the U.S. Treasury) to protect investors who maintain brokerage accounts from losses associated with the failure of the securities firms involved. None of these measures, however, provided for the government to guarantee deposits with securities dealers, nor did it in any way guarantee investment results. So there was less need to get "inside" the securities firms where the taxpayer was not at risk. Where the taxpayers were at risk, in commercial banking and savings institutions, regulation was much more onerous and compliance was much more costly, and ultimately regulation damaged these institutions' market shares in the financial evolution process.

Although the SEC developed into a forthright regulator, willing to use its powers to protect individual investors and ensure the integrity of the markets, most of the discipline to which U.S. nonbank financial firms have been subject since 1934 is provided by the market itself. Prices have risen and fallen. Investors have often lost money. Many firms have failed or have been taken over by competitors. Others have entered the industry with a

modest capital investment and succeeded. Firms are in fact "regulated" by the requirements of their customers, their creditors and their owners—requirements demanding marked-to-market accounting, adequate capitalization, and disclosure of all liabilities, as well as supervisory and legal proceedings. Customers presumably require good service and honest dealings, or they will change vendors. These market-driven requirements, many would argue, have proven to be as effective regulators of business conduct as any body established by government, particularly in the securities industry.

The U.S. approach also forces independent securities firms (or separately capitalized securities firms that are part of bank holding companies) to pay great attention to managing risks, managing costs, and ensuring profitability in a marked-to-market environment, in part because there is no lender of last resort for the individual securities firm. In addition, they are subject to the costs of maintaining expensive compliance systems, and since they depend on banks for much of their funding, they have to meet acceptable credit standards. Even in the case of massive failures like Drexel Burnham Lambert, regulators allowed the failure to run its course, taking care only to provide sufficient liquidity to the market during the crisis period. When multifunctional financial firms began to emerge in the United States during the 1990s—and particularly after 1999—the basic approach has been regulation by function, requiring holding company structures with separately capitalized banking and nonbanking affiliates.

Regulation of market conduct in the United States has been carried out through a crazy-quilt of agencies, including the Federal Reserve, FDIC, Office of the Comptroller of the Currency, and the SEC, as well as SROs like the NASD, Financial Accounting Standards Board (FASB), Community Future Trading Corp. (CFTC), and the major financial exchanges. Sometimes nonfinancial regulators get involved, like the Department of Labor, the Special Trade Representative, the antitrust and consumer protection agencies and various congressional committees. In addition, there are the courts, with particular importance accorded the Chancery Court of the State of Delaware. The whole thing is replicated to some extent at the state level, with state banking and securities commissions as well as insurance regulation, which rests entirely with the states. The system is certainly subject to unnecessary complexity and excessive regulatory costs.

In recognition of this, regulation was partially streamlined in the 1999 Gramm-Leach-Bliley bill that scrapped the line-of-business limits between banking, insurance, and securities. Nevertheless, there is a sense that regulatory competition may not be so bad in fostering vigorous competition and financial innovation. "Regulator shopping" in search of lower NRBs can sometimes pay economic dividends. And some of the major regulatory problems of the recent past—notably the BCCI debacle in 1991, the theft of client assets in the custody unit of Bankers Trust Company in 1998, and the evasion of banking regulations in the case of the Crédit Lyonnais—

Executive Life scandal in 2001—were all uncovered at the state, not federal, level. This suggests that sometimes more eyes are better than fewer.

Mistakes have certainly been made in U.S. financial regulation, and doubtless there have been significant opportunity costs associated with overregulation—as with ongoing self-dealing prohibitions under the Employee Retirement Income Security Act of 1974 (ERISA), which prohibits transactions between the investment banking and pension fund management units of the same financial firm. And the way the Long Term Capital Management collapse in 1998 was handled by the Federal Reserve continues to be widely debated. But by and large, the system has delivered an efficient and creative financial structure that is supportive of U.S. growth and development and at the same time has been tolerably stable. Maybe this is as good as can be expected. If there are lessons, they are that regulatory messiness and competition is not always bad and can lead to unexpected dynamism as default solutions are left to the market instead of to the regulators. There are accidents imbedded in this approach, but so far they have been reasonably tolerable.

In Europe, there has been no tradition of separation of commercial banking, investment banking, and insurance of the type that existed in the United States since 1933 and was only liberalized fully in 1999. Instead, the "universal banking" model has predominated from Finland to Portugal, and, for the most part, banks have been able to engage in all types of financial services: retail and wholesale, commercial banking, investment banking, and asset management, as well as insurance underwriting and distribution. Savings banks, cooperative banks, state-owned banks, private banks, and in a few cases more or less independent investment banks have also been important elements in some of the national markets. Reflecting this structure, bank regulation and supervision has generally been in the domain of the national central banks or independent supervisory agencies working in cooperation with the central banks, responsible for all aspects of universal bank regulation—usually except for insurance and in some cases specialized activities like mortgage banking placed under separate regulatory authorities. And in contrast to the United States, there is little history or tradition of regulatory competition *within* national financial systems, with some exceptions like Germany and its regional stock exchanges.

Given their multiple areas of activity centered around core commercial banking functions, the major European players in the financial markets can reasonably be considered "too big to fail" in the context of their national regulatory domains. This means that, unlike the United States or Japan, significant losses incurred in its securities or insurance business could bring down the bank which, in turn, is likely to be bailed out by taxpayers through a government takeover, recapitalization, forced merger with a government capital injection, or a number of other techniques, leaving aside the question whether a small country is in fact capable of bailing-out a major global bank under its regulatory jurisdiction. This means that Eu-

ropean financial regulators may find it as necessary to safeguard those businesses in order to safeguard the banking business in general. Failure to provide this kind of symmetry in regulation could end in disaster. No bank failure in Europe has so far been triggered by securities or insurance losses. But it can easily happen. Despite the disastrous trading activities that ultimately brought it down, for instance, it was the responsibility of the Bank of England, as home country regulator, to supervise Baring's global activities—a case that was an object lesson in how difficult this is to do.

The European regulatory overlay anchored in EU directives cover the right of banks, securities firms, asset managers, and insurers to engage in business throughout the region; the adequacy of capital, and the establishment and marketing of collective investment vehicles like mutual funds. One can argue that the "single passport" provisions and home-country responsibility for institutional fitness and properness were an appropriate response to reconciling the single-market objectives in the EU with appropriate regulation of the financial services sector. All was supposed to be in place at the beginning of 1993. But delays and selective implementation by member governments dragged out the process so that, almost a decade later, the benefits of the single-market initiatives in this sector are probably a fraction of what they might have been. There remain important problems with respect to regulatory symmetry between banks and nonbank financial services firms. Perhaps most seriously, there remains persistent dissonance in rules for the conduct of business.

The latter continue to be the exclusive responsibility of host-country authorities. Financial institutions doing business in the EU must deal with 16 different sets of rules (if the Eurobond market is included). These have gradually converged toward a consensus on minimum acceptable conduct-of-business standards, although they remain far apart in detail. Areas of particular interest include insider trading and information disclosure. For example, the view that insider trading is a crime, rather than a professional indiscretion, has been new in most of Europe—few have been jailed for insider trading, and in several EU countries it is still not a criminal offense. On information disclosure in securities new issues, there has been only limited standardization of the content and distribution of prospectuses covering equity, bond, and Eurobond issues for sale to individuals and institutions in the member countries.

If a sound regulatory balance is difficult to strike within a single sovereign state, it is even more difficult to achieve in a regional or global environment where differences in regulation and its implementation can lead to migration of financial activities in line with relative net regulatory burdens. In a federal state like the United States there are limits to NRB differences that can emerge, although there are some. A confederation of sovereign states like the EU obviously has much greater scope for NRB differences, despite the harmonization imbedded in the EU's various financial services directives. Each of these represents an appropriate response to the regulatory issues involved. But each leaves open at least some prospect

for regulatory arbitrage among the participating countries and "fault lines" across national regulatory systems, particularly as countries strive for a share of financial added-value. Players based in the more heavily regulated countries will successfully lobby for liberalization, and the view that there ultimately has to be a broad-gauge consensus on common-sense, minimum acceptable standards will gain momentum. As usual, the devil is in the details.

So far, progress in Europe has been painfully slow. As a result, the cost and availability of capital to end users of the financial system (notably in the business sector) remains unnecessarily high and the returns to capital for end users (notably households and most importantly pension investors) remains unnecessarily low. This has doubtless had an adverse overall impact on Europe's economic performance, in terms of both static welfare losses to consumers and producers and dynamic underperformance reflected in the process of structural adjustment and the rate of growth.

The most promising European response to this regulatory drag on economic welfare was a framework report in 2000 of a committee chaired by Alexandre Lamfalussy, former head of the BIS. Its conclusions were straightforward and essentially performance-driven: (1) modernizing financial market regulations, (2) creating open and transparent markets that facilitate achieving investor objectives and capital-raising, (3) encouraging the development of pan-European financial products that are easily and cheaply traded in liquid markets, and (4) developing appropriate standards of consumer protection.[4]

Judging from the Lamfalussy Committee final report in 2001, European convergence is likely to involve centralized regulatory structures at the national level—emphasizing efficiency, and accountability—along the lines of the U.K. Financial Services Authority (FSA), which was created in 2000 as a result of reforms that began in 1997. It covers both institutions and market practices. The idea is that national regulatory convergence along these lines will contribute to reducing fragmentation of financial markets. Denmark, Sweden, Belgium, Luxembourg, and Finland moved in this direction.[5] In Germany, a debate continued about regulatory domains of the federal and state level. France focused on the merits of separate regulators, one for wholesale business and institutional soundless and the other for retail activities. The French approach tried to be responsive to consumer protection and potential conflict of interest problems, as well as to the criticism that omnibus market regulators like the SEC lean too heavily to the retail side and that this can lead to overregulation of interprofessional wholesale markets. This general convergence on a more or less consistent regulatory and corporate governance approach at the national level still leaves open the question of pan-European regulation, with wide differences of opinion as to necessity and timing.

The Lamfalussy report simply recommended a fast-track "securities committee" intended to accelerate the process of convergence based on a "framework" agreed by the EU Commission, Council of Ministers, and

European Parliament. As noted earlier, small changes in regulation tend to trigger big changes in the playing field. Some win and some lose, and the losers' political clout can postpone the day of reckoning, especially if the "common interest" is hard to document. So the committee also had more concrete recommendations on investment rules for pension funds, uniformity in accounting standards, access to equity markets for financial intermediaries on a "single passport" basis, the definition of investment professionals, mutual recognition of wholesale financial markets, improvements in listing requirements for the various exchanges, a single prospectus for issuers throughout the EU, and improvements in information disclosure by corporations.

Many of these recommendations were already incorporated in the 1992 EU Investment Services Directive, but they had been implemented unevenly or sometimes not at all. The committee made a compelling case for accelerated and forthright implementation, hardly too much to ask a decade after launch. So a "regulators committee" was foreseen in order to ensure that enabling legislation and market rules are actually implemented. The European Securities Committee (ESC) was created in June 2001 to accelerate progress in line with the Lamfalussy report's target of the end of 2003. Comprised of representatives of the member states, the ESC was ultimately to be transformed into a pan-EU regulatory body charged with implementing securities legislation. The European Parliament immediately demanded the power to review decisions of the ESC. In June 2001 the draft single-prospectus directive was generally welcomed, although the "market abuse" draft directives were highly criticized for being excessively broad. The reception of both suffered from a lack of consultation by the commission with national financial regulators and the financial community.

All of these recommendations made a great deal of sense. The best features of the Anglo-American approach were adopted, and those that might not work well in the European context (including perhaps a central SEC with substantial enforcement powers) were deemphasized. The Lamfalussy proposals, if vigorously implemented, would go a long way toward achieving the efficiency and growth objectives of both the BIS and the EU.

Summary

This chapter has considered the key regulatory overlays of the global financial services industry, emphasizing that balancing efficiency against stability and fairness is never easy. Linkages were drawn between structural change in financial intermediation and supervisory and regulatory functions, including some comparisons between U.S. and European legacies and prospects.

The regulatory environment is central to the evolution of the financial services industry. Overregulation leads to opportunity costs in the form of inefficient allocation of capital to the detriment of end users of the financial system and overall economic performance. Underregulation can promote

financial collapse and all of the costs associated with systemic crises or can engender market inequities that eventually come back to haunt the system. Even a finely balanced degree of regulation carries with it the risks associated with moral hazard and adverse selection.

Financial regulation imposes both benefits and costs on participants, and it is *optimum* rather than *minimum* regulation that will attract transactions flows to particular markets. Often, a broad range of financial services activities are imbedded in large universal banks which are doubtless too big to fail; in turn, these have to compete on a global playing field with independent financial firms or separately capitalized affiliates of bank holding companies. The former benefit from an implied taxpayer guarantee but at the same time are deprived of the need to be quite as sharp in managing their businesses. Achieving optimum regulatory structures in increasingly integrated financial markets characterized by intense competition among regulatory jurisdictions may well be impossible without a significant degree of coordination and some degree of regulatory centralization. It is for this reason that ongoing regulatory efforts are so important.

The global regulatory environment must ultimately allow various players to compete in each others' markets geographically, cross-client, and cross-product. The regulatory outcome must therefore provide a reasonably level playing field for all kinds of financial institutions to compete for business across the entire financial intermediation spectrum. Only in this way will countries harvest the gains of a highly efficient and creative financial architecture—one that is fully competitive with evolving markets elsewhere in the world.

Notes

1. For example, public agencies like the SEC in the United States force firms to produce timely accounting statements and comply with market rules such as Regulation FD (fair disclosure), enacted in 2001. Nongovernmental entities like the Financial Accounting Standards Board (FASB) lay down accounting rules and conventions, and bank supervisors both monitor and produce information about financial institutions. All these play an extremely important role in engendering both efficiency and confidence in financial markets and institutions. These contributions to economic performance have increasingly been documented in empirical studies. For a review, see Jonathan Story and Ingo Walter, *Political Economy of Financial Integration in Europe* (Manchester: Manchester University Press, and Cambridge: MIT Press, 1998).

2. See Edward J. Kane, "Competitive Financial Reregulation: An International Perspective," in R. Portes and A. Swoboda (eds.), *Threats to International Financial Stability* (Cambridge: Cambridge University Press, 1987).

3. For a discussion, see Roy C. Smith and Ingo Walter, *Street Smarts: Leadership, Professional Conduct and Shareholder Value in the Securities Industry* (Boston: Harvard Business School Press, 1997).

4. Alexandre Lamfalussy, *Final Report on the Regulation of European Securities Markets*. (Brussels, Commission of the European Union, February 2001).

5. "A Ragbag of Reform," *Economist*, March 1, 2001.

14

Strategic Positioning and Competitive Performance

Few industries have encountered as much "strategic turbulence" in recent years as the financial services sector. In response to far-reaching regulatory and technological change, together with important shifts in client behavior and the de facto globalization of specific financial functions, the organizational structure of the industry has been profoundly displaced, and there remains a great deal of uncertainty about the nature of any future equilibrium in the industry's contours.

This chapter summarizes the generic processes and linkages that comprise global financial intermediation discussed in this book—the basic "financial hydraulics" that ultimately drive efficiency in the financial system and its effect on real-sector resource allocation and economic growth. Maximum economic welfare demands a high-performance financial system. We ask and answer, What does this actually mean? Then we document some of the structural changes that have occurred in both national and global financial systems and suggest how the microeconomics of financial intermediation actually works. These can have an enormous effect on the industrial structure of the industry and on individual firms, and this will continue in the foreseeable future. Sequentially, financial channels that exhibit greater dynamic efficiency have supplanted less efficient ones. Competitive distortions can retard this process, but they usually extract significant economic costs and at the same time divert financial flows into other venues, either domestically or elsewhere. Next, we examine the consequences of this process in terms of financial services industry reconfiguration, both within and between the four major segments of the industry (commercial banking, securities and investment banking, insurance, and asset management), as well as within and between national financial systems.

Finally, we look at the implications for the strategy of financial firms: How should they decide *what* to do, for *which clients*, and in *which markets*? Doing "the right thing" is called *strategic positioning*. "Doing it right," *strategic execution*, will be examined in chapter 15.

A Stylized Process of Financial Intermediation

The central component of any structure of a modern financial system is the nature of the conduits through which the financial assets of the ultimate savers flow through to the liabilities of the ultimate users of finance, both within and between national economies. This involves alternative and competing modes of financial intermediation, or "contracting," between counterparties in financial transactions.

A guide to thinking about financial contracting and the role of financial institutions and markets is summarized in Figure 14-1. The diagram depicts the financial process (flow of funds) among the different sectors of the economy in terms of underlying environmental and regulatory determinants or drivers, as well as the generic advantages needed to profit from three primary linkages:

Fully intermediated financial flows. Savings (the ultimate sources of funds in financial systems) may be held in the form of deposits or

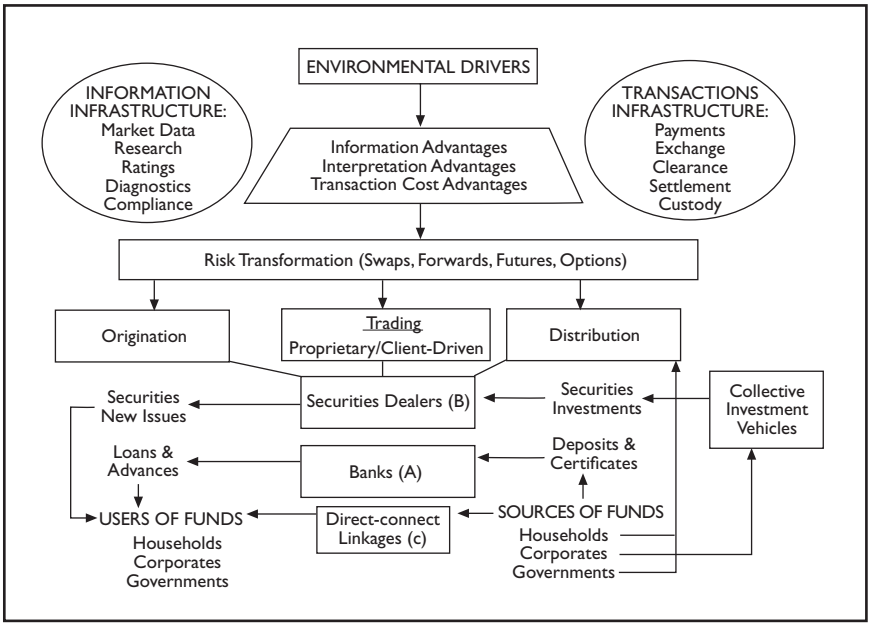

Figure 14-1. Financial intermediation.

alternative types of claims issued by commercial banks, savings organizations, insurance companies, or other types of financial institutions that finance themselves by placing their liabilities non directly with the general public. Financial institutions ultimately use these funds to purchase assets issued by nonfinancial entities such as households, firms, and governments.

Investment banking and securitized intermediation. Savings may be allocated directly or indirectly via fiduciaries and collective investment vehicles, to the purchase of securities publicly issued and sold by various pubic- and private-sector organizations in the domestic and international financial markets.

Direct-connect mechanisms between ultimate borrowers and lenders. Savings surpluses may be allocated to borrowers through various kinds of direct-sale mechanisms, such as private placements, usually involving fiduciaries as intermediaries.

Ultimate users of funds comprise the same three segments of the economy—the household or consumer sector, the business sector, and the government sector:

- Consumers may finance purchases by means of personal loans from banks or by loans secured by purchased assets (hire-purchase or installment loans). These may appear on the asset side of the balance sheets of credit institutions on a revolving basis, for the duration of the respective loan contracts, or they may be sold off into the financial market in the form of securities backed by consumer credit receivables.
- Corporations may borrow from banks in the form of unsecured or asset-backed straight or revolving credit facilities and may sell debt obligations (e.g., commercial paper, receivables financing, fixed-income securities of various types) or equities directly into the financial market.
- Governments may likewise borrow from credit institutions (sovereign borrowing) or issue securities directly.

With the exception of consumers, other borrowers such as corporations and governments also have the possibility of privately issuing and placing their obligations with institutional investors, thereby circumventing both credit institutions and the public debt and equity markets. Consumer debt can also be repackaged as asset-backed securities and sold privately to institutional investors.

In the first mode of financial contracting in figure 14-1, depositors buy the "secondary" financial claims or liabilities issued by credit institutions, and they benefit from liquidity, convenience, and safety through the ability of financial institutions to diversify risk and improve credit quality by means of professional credit management and monitoring of their holdings of primary financial claims (both debt and equity). Savers can choose from

among a set of standardized contracts and receive payments services and interest.

In the second mode of financial intermediation in figure 14-1, investors may select their own portfolios of financial assets directly from among the publicly issued debt and equity instruments on offer. This may provide a broader range of options than standardized bank contracts and permits larger investors to tailor portfolios more closely to their objectives while still achieving acceptable liquidity through rapid execution of trades—all aided by linkages with banks and other financial institutions that are part of the domestic payments mechanism. Investors may also choose to have their portfolios professionally managed, for a fee, through various types of mutual funds and pension funds, designated in figure 14-1 as collective investment vehicles.

In the third mode of financial intermediation, institutional investors buy large blocks of privately issued securities. In doing so, they often face a liquidity penalty—due to the absence or limited availability of a liquid secondary market—for which they are rewarded by a higher yield. However, directly placed securities can be specifically "tailored" to more closely match issuer and investor requirements than can publicly issued securities. Market and regulatory developments have added to the liquidity of some direct-placement markets.

Value to ultimate savers and investors, inherent in the financial processes described here, accrues in the form of a combination of yield, safety, and liquidity. Value to ultimate users of funds accrues in the form of a combination of financing cost, transactions cost, flexibility, and liquidity. This value can be enhanced through credit backstops, guarantees, and derivative instruments such as forward-rate agreements, caps, collars, futures, and options. Furthermore, markets can be linked functionally and geographically, both domestically and internationally:

- Functional linkages permit bank receivables, for example, to be repackaged and sold to nonbank securities investors. Privately placed securities, once they have been seasoned, may be able to be sold in public markets.
- Geographic linkages make it possible for savers and issuers to gain incremental benefits in foreign and offshore markets, thereby enhancing liquidity and yield or reducing transaction costs.

Static and Dynamic Efficiency Characteristics of Financial Systems

Static efficiency properties of the three alternative financial processes are modeled as the all-in, weighted average spread (differential) between rates of return provided to ultimate savers and the cost of funds to users. This spread is a proxy for the total cost of using a particular mode or type of

financial process and is reflected in the monetary value of resources consumed in the course of financial intermediation. In particular, it reflects the direct costs of production (operating and administrative costs, cost of capital, etc.). It also reflects losses incurred in the financial process, as well as any excess profits earned and liquidity premiums. Financial processes that are considered "statically inefficient" are usually characterized by high all-in margins due to high overhead costs, high losses, barriers to entry, and the like.

Dynamic efficiency is characterized by high rates of financial product and process innovation through time:

- *Product innovations* usually involve creation of new financial instruments, along with the ability to replicate certain financial instruments by bundling or rebundling existing ones (synthetics). There are also new approaches to contract pricing, new investment techniques, and other innovations that fall under this rubric.
- *Process innovations* include contract design methods of trading, clearance and settlement and trading, techniques for efficient margin calculation, and the like.

Successful product and process innovation broadens the menu of financial services available to ultimate issuers, ultimate savers, or other participants in the various financial channels described in figure 14-1.

It is against a background of continuous pressure for static and dynamic efficiency that financial markets and institutions have evolved and converged. Global financial markets for foreign exchange, debt instruments, and (to a lesser extent) equity have developed various degrees of "seamlessness," and it is arguable that the most advanced of the world's financial markets are approaching a theoretical, "complete" optimum where there are sufficient financial instruments and markets, and combinations thereof, to span the whole state-space of risk and return outcomes. Financial systems that are deemed inefficient or incomplete are characterized by a limited range of financial services and obsolescent financial processes.

Recent technological change in financial intermediation, particularly leveraging the properties of the Internet, have enhanced financial intermediation efficiencies. Internet applications have already dramatically cut information and transaction costs for both retail and wholesale end users of the financial system, as well as for the financial intermediaries themselves. The examples of on-line banking, insurance, and retail brokerage are well known and continue to evolve and change the nature of the process, sometimes turning prevailing business models on their heads: for example, financial intermediaries have traditionally charged for transactions and have provided advice almost for free, but increasingly they are forced to provide transactions services almost for free and to charge for advice. The new models are often far more challenging for market participants. At the same

time, on-line distribution of financial instruments such as commercial paper, equities, and bonds in primary capital market activities not only cuts the cost of market access but also improves and deepens the distribution and bookbuilding process—including providing issuers with information on the investor-base. And as figure 14-1 suggests, it is only one further step to cutting out the intermediary altogether by putting the issuer and the investor or fiduciaries into direct electronic contact. The same is true in secondary markets, as shown with an increasing array of alliance-based competitive bidding utilities and reverse auctions in foreign exchange and other financial instruments, as well as interdealer brokerage, cross-matching, and electronic communications networks (ECNs). This Internet-based technology overlay is likely to turbocharge the cross-penetration story depicted in figure 14-1.

A further development consists of e-based end-user platforms for corporate treasury operations and households, with real-time downloads of financial positions, risk profiles, market information, research, and so on. By allowing end users to "cross-buy" financial services from best-in-class vendors, such utilities may well upset conventional thinking that focuses on "cross-selling."

Both static and dynamic efficiency are obviously important from the standpoint of national and global resource allocation, not only within the financial services industry itself but also as it effects users of financial services. That is, since financial services can be viewed as "inputs" to real economic processes, the level of national output and income—as well as its rate of economic growth—are directly or indirectly affected. A "retarded" financial services sector can be a major impediment to a nation's overall economic performance. Financial-system retardation represents a burden on the final consumers of financial services and potentially reduces the level of private and social welfare. It also represents a burden on producers, by raising their cost of capital and eroding their competitive performance in domestic and global markets. These inefficiencies ultimately distort the allocation of labor as well as capital.

The Facts: Shifts in Intermediary Market Shares

Developments over the past several decades in intermediation processes and institutional design across time and geography are striking. In the United States, "commercial banks"—institutions that accept deposits from the pubic and make commercial loans—have seen their market share of domestic financial flows between end users of the financial system decline from about 75% in the 1950s to under 25% today. In Europe (EU plus Switzerland), the change has been much less dramatic, and the share of financial flows running though the balance sheets of banks continues to be well over 60% but it is declining nonetheless. And in Japan, banks continue to control in excess of 70% of financial intermediation flows. Most emerging-market

countries cluster at the highly intermediated end of the spectrum, but in many of these economies there is also factual evidence of declining market shares of traditional banking intermediaries. In short, classic banking functionality has been in long-term decline more or less worldwide.

Where has all the money gone? Clearly, disintermediation as well as financial innovation and expanding global linkages have redirected financial flows through the securities markets. Figure 14-2 shows developments in the United States from 1970 to 2000, highlighting the extent of commercial bank market share losses and institutional investor gains. While this may be an extreme case, even in highly intermediated financial systems like Germany (figure 14-3) direct equity holdings and managed funds increased from 9.6% to 22.7% in just the 10-year period from 1990 to 2000.

Ultimate savers increasingly use the fixed-income and equity markets directly and through fiduciaries which, through vastly improved technology, are able to provide substantially the same functionality as classic banking relationships—immediate access to liquidity, transparency, safety, and so on—coupled to a higher rate of return. The one thing they cannot guarantee is settlement at par, which in the case of transactions balances (e.g., money market mutual funds) is mitigated by portfolio constraints mandating high-quality, short-maturity financial instruments. Ultimate users of funds have benefited from enhanced access to financial markets across a broad spectrum of maturity and credit quality using conventional and structured financial instruments. Although market access and financing cost normally depend on the current state of the market, credit and liquidity backstops can be easily provided.

At the same time, a broad spectrum of derivatives overlays the markets,

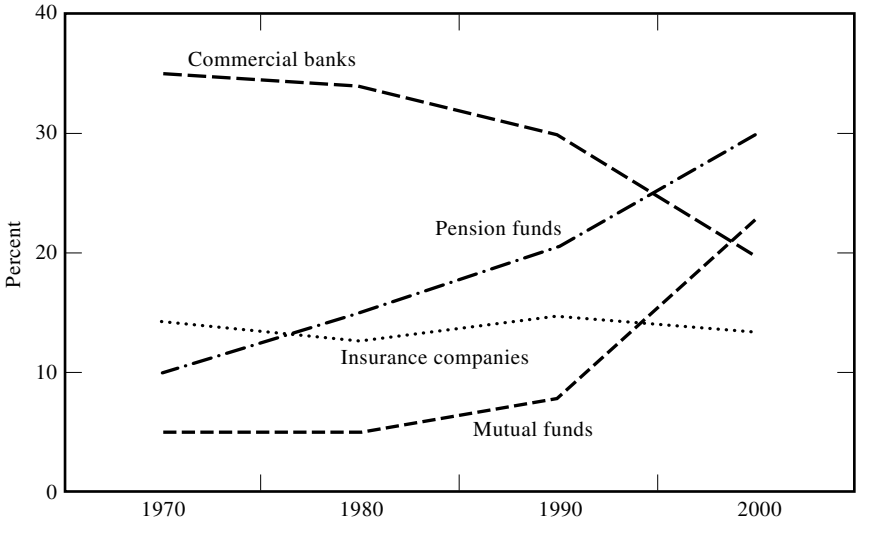

Figure 14-2. U.S. financial assets, 1970–2000 (Source: Federal Reserve).

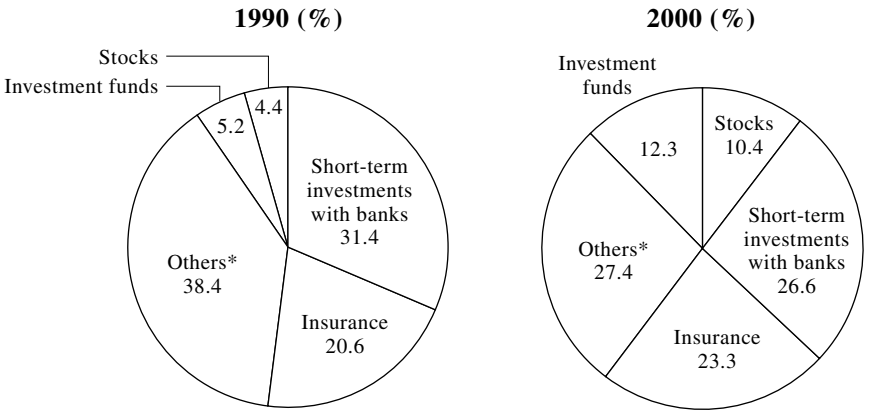

*Figure 14-3. Private asset allocation in German households: includes fixed interest deposits, long-term investments with banks, and building society deposits. *Others includes fixed interest deposits, long-term investments with banks, and building society deposits (Source: Tecis; J.P. Morgan).*

making it possible to tailor financial products to the needs of end users with increasing granularity, further expanding the availability and reducing the cost of financing on the one hand and promoting portfolio optimization on the other. And as the end users themselves have been forced to become more performance-oriented in the presence of much greater transparency and competitive pressures, it has become increasingly difficult to justify departures from highly disciplined financial behavior on the part of corporations, public authorities, and institutional investors.

In the process, two important and related differences are encountered in this generic financial-flow transformation: intermediation shifts (1) from book-value to market-value accounting and (2) from more intensively regulated to less intensively regulated channels, generally requiring less oversight and less capital. Both have clear implications for the efficiency properties of financial systems and for their transparency, safety, and soundness.

Consequences for Institutional Competitive Advantage

To a significant extent, the basic microeconomics of financial intermediation have been reflected in the process of financial sector reconfiguration, as summarized in figure 14-4.

In retail financial services, extensive banking overcapacity in some countries has led to substantial consolidation, often involving M&A activity. Excess retail production and distribution capacity has been slimmed down in ways that usually release redundant labor and capital. In some cases, this process is retarded by large-scale involvement of public-sector institutions and cooperatives that operate under less rigorous financial discipline. Also at the retail level, commercial banking activity has been linked

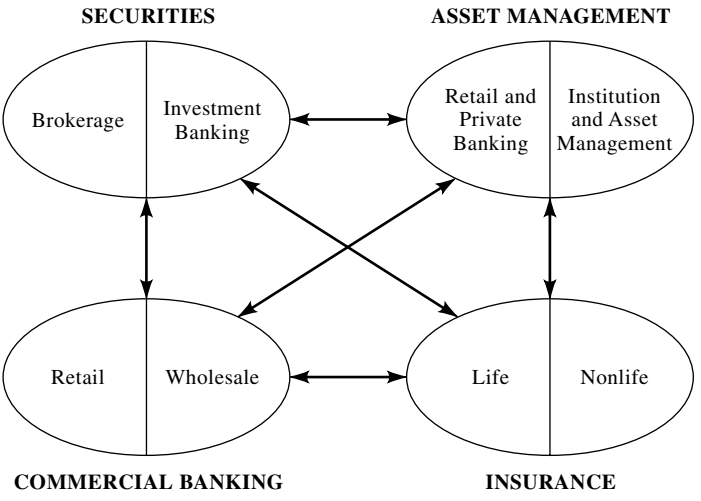

Figure 14-4. Multifunctional financial linkages.

strategically to retail brokerage, retail insurance (especially life insurance), and retail asset management through mutual funds, retirement products, and private-client relationships. Sometimes this linkage process has occurred selectively (e.g., Lloyds TSB) and sometimes using simultaneous multilinks coupled to aggressive cross-selling efforts (e.g., Citigroup). At the same time, relatively small and focused firms have sometimes continued to prosper in each of the retail businesses, especially where they have been able to provide superior service or client proximity while taking advantage of outsourcing and strategic alliances where appropriate.

Similar links have emerged in wholesale financial services. Wholesale commercial banking activities such as syndicated lending and project financing have often been shifted toward a greater investment banking focus, while investment banking firms have placed growing emphasis on developing institutional asset management businesses, in part to benefit from vertical integration and in part to gain some degree of stability in a notoriously volatile industry.

Figure 14-5 shows the global volume of financial services restructuring through merger and acquisitions activity from 1986 through 2000, roughly two-thirds of which occurred in the banking sector, one-quarter in insurance, and the rest in asset management and investment banking. The vast bulk of this activity occurred on an "in-sector" basis—banks acquiring other banks. Worldwide, 78% of the dealflow (by value) was in-sector—85% in the United States (where line-of-business restrictions existed for most of the period) and 76% in Europe (where there were no such barriers). So cross-sector M&A deals (e.g., banks buying insurance companies) were a small part of the picture—only 11.4% even in Europe, home of Bancassurance. In addition to being largely in-sector, restructuring via M&A

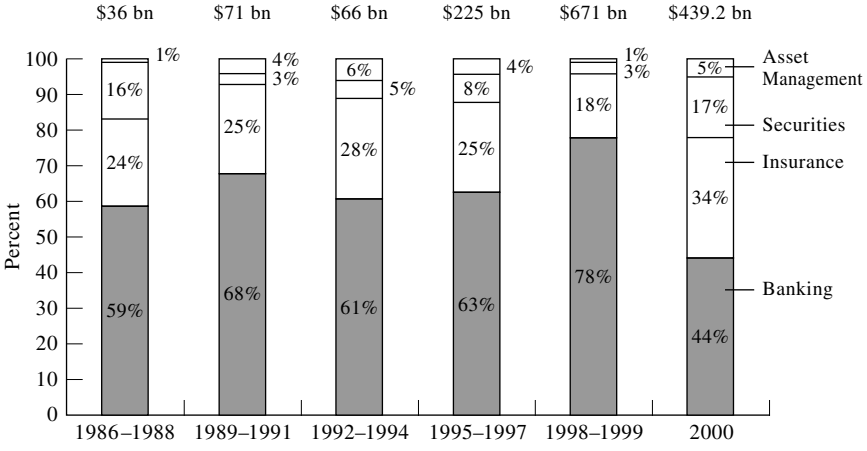

Figure 14-5. Worldwide financial services merger volume.

transactions was also largely domestic. Worldwide in commercial banking, less than 23% (by value) was cross-border. Only 12.7% and 20.2% of the U.S. and European banking deal flow, respectively, was cross-border (mostly European banks buying U.S. banks). Cross-border intra-European banking deals amounted to 25.8% of the European total. The share of cross-border activity in the insurance sector has been roughly twice that of banking, which possibly suggests somewhat different economic pressures at work. With a few exceptions like HCBC and Citigroup globally, and Fortis, Nordia, ABN AMRO, ING, BSCH, and BBVA as parts of regional or interregional strategies, the aggressive development of cross-border platforms seems to be the exception in the banking sector. In insurance, in contrast, global initiatives by firms like AXA, AIG, Zurich, AEGON, ING, Allianz, Assicurazioni Generali, and GE Capital Services seem to be a more important part of the M&A picture.

Industrial economics suggests that structural forms in any sector, or between sectors, should follow the dictates of institutional comparative advantage. If there are significant economies of scale that can be exploited, it will be reflected in firm size. If there are significant economies of scope, either with respect to costs or revenues (cross-selling), then that will be reflected in the range of activities in which the dominant firms are engaged. If important linkages can be exploited across geographies or client segments, then this too will be reflected in the breadth and geographic scope of the most successful firms.

It seems clear, from a structural perspective, that a broad array of financial services firms may perform one or more of the roles identified in figure 14-1: commercial banks, savings banks, postal savings institutions, savings cooperatives, credit unions, securities firms (full-service firms and various kinds of specialists), mutual funds, insurance companies, finance companies, finance subsidiaries of industrial companies, and others. Mem-

bers of each strategic group compete with each other, as well as with members of other strategic groups. Assuming it is allowed to do so, each organization elects to operate in one or more of the financial channels according to its own competitive advantages. Institutional evolution therefore depends on how these comparative advantages evolve, and whether regulation permits them to drive institutional structure. In some countries commercial banks, for example, have had to "go with the flow" and develop competitive asset management, origination, advisory, trading, and risk-management capabilities under constant pressure from other banks and, most intensively, from other types of financial services firms.

Take the United States as an example. With financial intermediation distorted by regulation—notably the Glass-Steagall provisions of the Banking Act of 1933—banks a half-century ago dominated classic banking functions, broker-dealers dominated capital market services, and insurance companies dominated most of the generic risk-management functions. Some 50 years later this functional segmentation had changed almost beyond recognition despite the fact that full *de jure* deregulation was not implemented until the end of the period with the Gramm-Leach-Bliley Act of 1999. There has been a virtual doubling of strategic groups competing for the various financial intermediation functions, and there is today vigorous cross-penetration among them in the United States. Most financial services can be obtained in one form or another from virtually every strategic group, each of which, in turn, is involved in a broad array of financial intermediation services. If cross-competition among strategic groups promotes both static and dynamic efficiencies, then the evolutionary path of the U.S. financial structure probably served macroeconomic objectives (particularly growth and economic restructuring) very well indeed. And as an unintended consequence, line-of-business limits in force since 1933 have probably contributed, to a much more heterogeneous financial environment, certainly more heterogeneous than existed in the United States of the 1920s or in most other countries today.

In Europe, in contrast, banks dominate most intermediation functions with the exception of insurance, and some observers think a broad-gauge banking-insurance convergence is likely. Except for the penetration of continental Europe by U.K. and U.S. specialists, many of the relatively narrowly focused firms seem to have found themselves sooner or later acquired by major banking groups than in the United States and correspondingly greater dominance of major financial firms that include banking as a core business.

The rough comparisons presented in table 14-1 seem to show that the structural evolution of national and regional financial systems has an effect on global market-share patterns. With about 28.9% of global GDP, U.S. banking assets and syndicated bank loans are well underweight (they are overweight in Europe and Japan), whereas bond and stock market capitalizations, capital market new-issues, and fiduciary assets under management are overweight (they are underweight in Europe and Japan). One

Table 14-1 The U.S. Financial System in Perspective, 2000

Global Metric	U.S. Share (%)
Population[a]	4.5
GDP	28.9
Banking assets	10.6
Syndicated lending	13.5
Bond market capitalization	44.9
Equity market capitalization	50.0
Nongovt. debt new issues	53.2
Equity new issues	57.0
Completed M&A (by value)	52.8
Pension assets under mgt.	59.4
Mutual fund assets	53.0
Asset management (AUM)	51.1
Loan lead managers	77.2
Debt and equity bookrunners	66.3
M&A advice (by value)	78.6

[a]Population data for 1998, not 2000.

result is that U.S. financial firms have come to dominate various intermediation roles in the financial markets: over 50% of global asset management mandates, over 77% of lead manager positions in wholesale lending, about 66% of bookrunning mandates in global debt and equity originations, and almost 80% of advisory mandates (by value of deal) in completed global merger and acquisitions transactions. Indeed, it is estimated that in 2000 U.S.-based investment banks captured about 70% of the fee-income on European capital markets and corporate finance transactions.

Why? The reasons include the size of the U.S. domestic financial market (accounting for roughly two-thirds of global capital-raising and M&A transactions in recent years), early deregulation of markets (but not of institutions) dating back to the mid-1970s, and performance pressure bearing on institutional investor as well as corporate and public-sector clients, leading to an undermining of client loyalty in favor of best price and best execution. Perhaps as an unintended consequence of separated banking since 1933, institutions dominating disintermediated finance—the American full-service investment banks—evolved from close-knit partnerships with unlimited liability to large securities firms under intense shareholder pressure to manage their risks well and to extract maximum productivity from their available capital. At the same time, it was clear that, unlike the major commercial banks, regulatory bailouts of investment banks in case of serious trouble were highly unlikely. Indeed, major firms like Kidder Peabody and Drexel Burnham (at the time the seventh-largest U.S. financial institution in terms of balance sheet size) were left to die by the regulators. Subsequently, the capital intensity and the economic dynamics of the investment banking business have caused most of the smaller and medium-size independent firms in the United States, the United Kingdom, and else-

Table 14-2 The 15 Most Valuable Financial Services Businesses in North America and Europe (market capitalization, 4 May 2001, in $ millions)

North America		Europe	
Firm	US$ million	Firm	US$ million
Citigroup	250,143	HSBC	140,693
AIG	206,084	Allianz	86,530
GECS	194,636	ING	83,530
Berkshire	105,238	UBS	73,497
JPM Chase	103,133	RB Scotland	60,865
Morgan Stanley	99,055	Lloyds TSB	60,663
Bank of America	82,745	Munich Re	60,532
American Express	72,069	AXA	58,235
Merrill Lynch	60,883	CS Group	57,719
Goldman Sachs	54,297	Barclays	53,630
Banc One	46,395	Deutsche	51,047
Schwab	41,609	AEGON	50,753
Bank of New York	41,466	Zurich	50,194
MBNA	33,007	BSCH	48,310
Marsh & McLennan	30,457	BBVA	46,774

Source: Company Reports.

where (e.g., Paribas in France and MeesPierson in the Netherlands) to disappear into larger institutions.

At least so far, the most valuable financial services franchises in the United States and Europe in terms of market capitalization seems far removed from a financial intermediation monoculture (see table 14-2). In fact, each presents a rich mixture of banks, asset managers, insurance companies, and specialized players. How the institutional structure of the financial services sector will evolve is anybody's guess. Those who claim to know often end up being wrong, but influential consultants sometimes convince multiple clients to do the same thing at the same time, and this spike in strategic correlation can contribute to the wrongness of their vision. What is clear is that the underlying economics of the industry's microstructure depicted in figure 14-1 will ultimately prevail, and finance will flow along conduits that are in the best interests of the end users of the financial system. The firms that comprise the financial services industry will have to adapt and readapt to this dynamic in ways that profitably sustain their raison d'être.

The CAP Model

There are three principal dimensions that define the global market for financial services:

Client (C-dimension)
Arena (A-dimension)
Product (P-dimension)

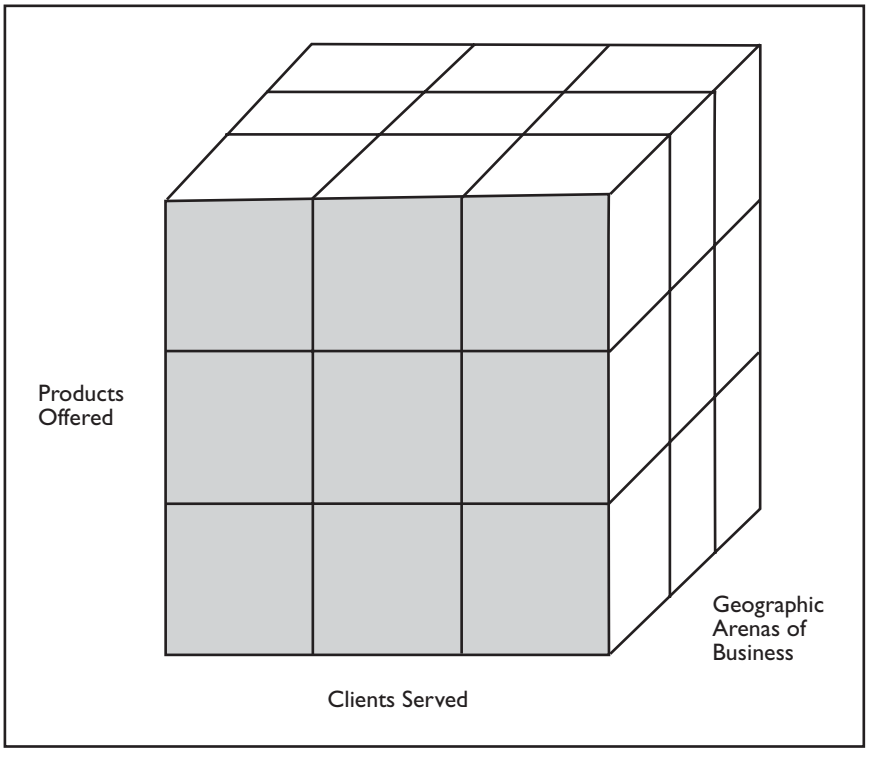

Figure 14-6. The CAP matrix.

Firms in the global financial services industry have an unusually broad range of choice with respect to each of these dimensions, and different combinations yield different strategic and competitive profiles. Figure 14-6 depicts these dimensions in the form of a matrix comprised of C × A × P cells. Each cell has a distinctive competitive structure based on fundamental economic and public policy–related considerations.

Largely as a result of technological change and deregulation, financial institutions confront increasing potential access to each of the dimensions in the global CAP opportunity set. Financial deregulation in particular has had an important influence in terms of (1) accessibility of geographic arenas, (2) accessibility of individual client groups by players originating in different parts of the financial services business, and (3) substitutability among financial products in meeting personal, corporate, or public-sector financial needs.

Client

As conventionally used, the distinction between generic "wholesale" and "retail" financial services is not particularly helpful in the context of the CAP model, and the following categorization of the major client groups may be more appropriate:

Sovereign: National states and their instrumentalities
Corporate: Nonfinancial corporations, regardless of industry classification, ranging from multinational corporations and parastatals to middle-market and small, privately owned companies
Financial services: Other financial institutions in the same industry subcategory (e.g., correspondent banks) or in other segments of the financial services industry, such as brokerage or insurance
Private: High net worth and high net income individuals
Retail: Mass-market financial services, either sold cross-border or within domestic financial services markets, aimed at individuals and households

These client groups can be broken down into narrower segments, each differing with respect to product-related attributes such as currency requirements, liquidity and maturity needs, risk levels, industry categories, overall service-level requirements, price sensitivity, and timing aspects. Effective market definition and segmentation involves identifying coherent client clusters that embody relative uniformity with respect to each of these variables.

Arena

The international market for financial services can be divided into onshore and offshore arenas with respect to geographic location. The "arena" dimension is different from the standard definition of market "region" in that it encompasses the concepts of regulatory and monetary sovereignty, which are of critical importance in defining the geographic dimension in figure 14-6. Each arena is characterized by different risk-return profiles, levels of financial efficiency, regulatory conditions, client needs, and other factors.

As discussed earlier in this chapter, geographic interpenetration on the part of commercial and investment banking institutions with respect to various domestic and offshore markets has become very significant indeed. The A-dimension in figure 14-6 can be considered analysis at the global, regional, national, subregional, and location-specific levels, so that it is not purely country-specific. However, the country level of analysis remains paramount due to the importance of national monetary policies, financial regulation, and competition policies, all of which are imposed at the country level. It is mainly in federal states that the rules of the game are sometimes importantly set at the subnational level.

Product

Financial services offered in the international market have undergone dramatic proliferation. With a clear requirement for product differentiation in the marketplace, firms in the industry have created new instruments and

techniques tailored to the needs of their clients. The range of financial services that can be supplied to the various client segments is evident from previous chapters.

Credit Products. Although credit products have become a less significant source of returns for many international institutions, they remain the core of much of the business. Credit activities range from straightforward general-purpose term lending to sophisticated and specialized forms of lending such as project finance.

Financial Engineering Products. These comprise the design and delivery of financial services specifically structured to satisfy often complex client objectives at minimum cost. In a world where borrowers, issuers, savers, and investors often have distinctive and complex objectives, financial engineering is perhaps the ultimate form of product differentiation and accounts for a great deal of the value-added creation observed in the international capital markets. It can be either "disembodied" or "embodied," depending on whether the engineering components are part of specific financial transactions. Purely disembodied financial engineering may take the form of advisory functions that an American investment bank might undertake, based on client-specific information, for a Japan-based multinational manufacturing firm seeking an acquisition in the same industry in the United States. Embodied financial engineering combines this with one or more financial transactions sold to the same client as part of a financing package. Other examples include structuring of project financings, leveraged buyouts, complex multicurrency financings, and advice on appropriate capital structure.

Risk Management Products. Risk bearing has long been recognized as one of the key functions of financial institutions and one of the reasons they tend to be heavily regulated. The main forms of exposure include credit risk, interest rate risk, liquidity risk, foreign exchange risk, country risk, project risk, commodity risk, and technical risk in areas such as cash transmission. Risk-management activities can be broken down into (1) those in which financial institutions themselves assume all or part of the exposure and (2) those in which the institutions provide technology needed to achieve a shifting of risk or themselves take on exposure only on a contingent basis—that is, an off-balance-sheet commitment to buy or sell, borrow or lend. Effective risk reduction through diversification clearly depends on the independence of the various risks represented in the portfolio. Financial institutions provide risk-management services that range from simple standby credit lines, swaps, and forward interest rate agreements to explicit, tightly defined products addressed to a broad range of contingencies.

Arbitrage and Positioning. Activities that financial institutions engage in for their own account facilitate and in many cases make possible the supply

of the first four types of financial services to clients internationally. Arbitrage opportunities occur when the same asset is priced differently in different markets (or market segments), often because of information asymmetries. "Pure" arbitrage takes place when an asset is simultaneously bought and sold. By this definition, financial institutions rarely engage in pure arbitrage. Rather, they engage in "risk arbitrage"—buying an asset in a particular market, holding it for a time (however short), and reselling it in the same or different market. The institution is thus exposed to "differential risk," due to the possibility that the underlying price differential may evaporate or be reversed during the time needed to complete the transaction. Exposure to differential risk depends jointly on the time necessary to complete the transaction and the underlying volatility in the price of the specific asset and the markets in which it is traded. Positioning is a form of risk arbitrage that has become an integral part of managing international financial institutions during a time of significant exchange rate and interest rate volatility. Interest rate–linked and foreign exchange–linked positioning drives securities, options, and futures trading and dealing.

Cell Characteristics and Competitive Dynamics

The competitive structure of each CAP cell in figure 14-6 is an important determinant of the returns a financial institution may be able to obtain. Competitive structure is conventionally measured using concentration ratios based on the number of vendors, distribution of market share among vendors, and similar criteria. Cell characteristics can be analyzed in terms of conventional market-structure criteria, as summarized in Figure 14-7.

The inherent attractiveness of each cell clearly depends on the size of the prospective risk-adjusted returns associated with it. Entry into a new

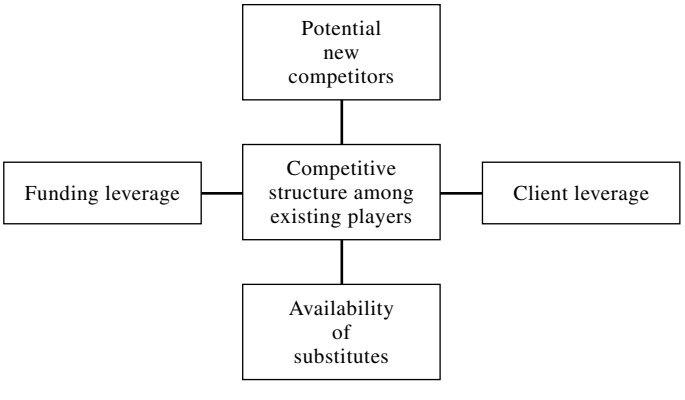

Figure 14-7. Application of a competitive analysis framework to financial services.

market (related either to a new product, client group, or arena), if initially successful, can be described in terms of a time-path of subnormal, supernormal, and normal returns such as that depicted in figure 14-8. This time path is important with respect to the entry and exit costs, as well as size and durability of excess returns. Durability is described by the time path (decay) of excess returns that can be extracted from the new market in this context, and their discounted net present value can be compared with other market initiatives, including transfers of financial innovations across clients, arenas, or products.

Normally, the addition of vendors to a particular CAP cell would be expected to reduce market concentration, increase the degree of competition, lead to an erosion of margins, and trigger a more rapid pace of financial innovation. If the new vendors are from the same basic strategic groups as existing players (e.g., one more commercial bank joining a number of others competing in a given cell), then the expected outcome would be along conventional lines of intensified competition. But if the new player comes from a completely different strategic perspective (e.g., an industrial company offering banking services), the competitive outcome may be quite different. Cell penetration by a player from a *different* strategic group may lead to a greater increase in competition than an incremental player from the same strategic group. This is because of potential diversification benefits, scope for cross-subsidization and staying power, and incremental hor-

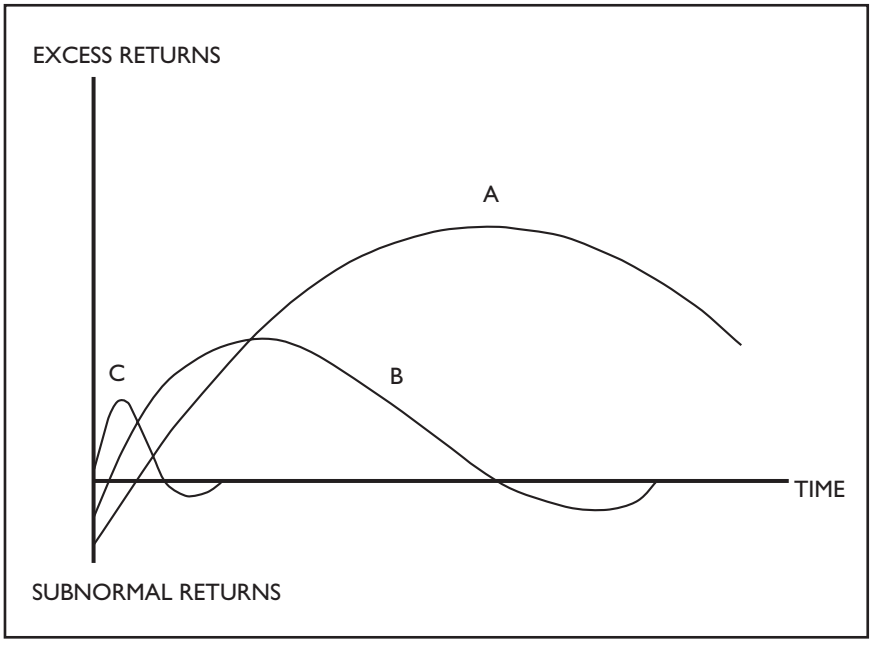

Figure 14-8. Time path (decay) of cell-specific excess returns.

izontal or vertical integration gains that the player from a "foreign" strategic group may be able to capture.

The higher the barriers to entry, the lower the threat of new entrants' reducing the level of returns available in each CAP cell. Natural barriers to entry include the need for capital investment, human resources, technology, and the importance of economies of scale. They also include the role of contracting costs avoided by a close relationship between the vendor and its client, which, in turn, is related to the avoidance of opportunistic behavior by either party.

Not least, the competitive structure of each cell depends on the degree of potential competition. This represents an application of the "contestable markets" concept, which suggests that the existence of potential entrants causes existing players to act *as if* those entrants were already active in the market. Consequently, pricing margins, product quality, and the degree of innovation in a given cell may exhibit characteristics of intense competition even though the degree of market concentration is, in fact, quite high.

In penetrating a particular cell or set of cells, it may be to the advantage of a particular player to "buy into" a potential market by cross-subsidizing financial services supplied in that cell from returns derived in other cells. This may make sense if the assessed horizontal, vertical, or lateral linkages—either now or in the future—are sufficiently attractive to justify such pricing. It may also make sense if the cell characteristics are expected to change in future periods, so that an unprofitable presence today is expected to lead to a profitable presence tomorrow. And it may make sense if a player's behavior in buying market share has the potential to drive out competitors and fundamentally alter the structure of the cell in his or her favor.

The latter can be termed "predatory" behavior and is no different from predation in the markets for goods. The institution "dumps" (or threatens to dump) financial services into the cell, forcing out competitors either as a result of the direct effects of the dumping in the face of more limited staying power or because of the indirect effects, working through expectations. Once competitors have been driven from the market, the institution takes advantage of the reduced degree of competition to widen margins and achieve excess returns. However, it is important to note that the predatory behavior is not consistent with the view of market contestability. The greater the contestability and the credibility of prospective market entry, the less will be the scope for price discrimination and predation.

Conversely, it may also be possible for an institution with significant market power to keep potential competitors out of attractive cells through explicit or implied threats of predatory behavior. It can make clear to new entrants that it will respond very aggressively to incursions and that they face a long and difficult road to profitability. In this way, new competitors may be discouraged and the cell characteristics kept more monopolistic than would otherwise be the case.

Scale and Scope Linkages

Financial institutions clearly will want to allocate their available financial, human and technological resources to those CAP cells in figure 14-6 that promise to produce the highest risk-adjusted returns. To do this, they will have to appropriately attribute costs, returns, and risks across cells. But beyond this, the economics of supplying financial services internationally is jointly subject to economies of scale and economies of scope. The existence of both types of economies have strategic implications for players in the industry.

Economies of scale suggest an emphasis on *deepening* activities within a cell, or across cells in the P dimension. Economies of scope suggest an emphasis on *broadening* activities across cells—that is, a player can produce a given level of output in a given cell more cheaply or more effectively than can institutions that are less active across multiple cells. This depends importantly on the benefits and costs of *linking* cells together in a coherent web of joint products.

The gains from linkages among CAP cells depend on the possibility that an institution competing in one cell can move into another cell and perform in that second cell more effectively than can a competitor who lacks a presence in the first cell. The existence of economies of scope and scale is a critical factor driving institutional strategy. Where scale economies dominate, the objective will be to maximize throughput of the product within a given CAP cell configuration, driving for market penetration. Where scope economies dominate, the drive will be toward aggressive cell-proliferation.

Client-Driven Linkages. Client linkages exist when a financial institution serving a particular client or client group can, as a result, supply financial services either to the same client or to another client in the same group more efficiently in the same or different arenas. With respect to a particular client, this linkage is part of the value of the "relationship." With respect to a particular client segment, it will clearly be easier for an institution to engage in business with a new client in the same segment than to move to another client segment. It is possible that client-driven linkages will decline as market segmentation in financial services becomes more intense.

Arena-Driven Linkages. Arena-driven linkages are important when an institution can service a particular client or can supply a particular service more efficiently in one arena as a result of having an active presence in another arena. The presence of multinational corporate clients in the same set of arenas as their financial institutions is one important form such linkages can take. By competing across a large number of arenas, a financial institution also has the possibility of decreasing the overall level of risk to

which it is exposed and thereby increasing its overall risk-adjusted rate of return.

Product-Driven Linkages. Product-driven linkages exist when an institution can supply a particular financial service in a more competitive manner because it is already producing the same or a similar financial service in different client or arena dimensions. Product specializations would appear to depend on the degree of uniformity of the resource inputs required, as well as on information and technology commonalities. Thus, certain types of skills embodied in key employees may be applied across different clients and arenas at relatively low marginal cost within a given product category, as may certain types of information about the environment, markets, or client needs.

To summarize, the CAP model discussed here can be applied in both a descriptive and a strategic positioning context in several ways:

- It can be used to analyze the size and durability of excess returns associated with individual segments of domestic and international financial markets by applying conventional market-structure analysis. In the case of imperfect competition, it can be used to identify the importance of scale economies in the financial services industry.
- It can help in understanding the linkages that exist between different types of financial services and to identify the importance of economies of scope in this industry.
- It can be used to explain industry internationalization both through the value coefficients embedded in individual CAP cells and by superimposing on the basic structure economies of both scale and scope.
- It can be used to identify appropriate public policies toward the financial services industry in a competitive context of structure, conduct, and performance.
- It can serve a normative function by identifying coherent firm strategies that combine correctly identified market characteristics and firm-specific advantages.

Competitive Challenges

Developing and implementing strategies in firms hoping to secure a permanent and profitable place in the rapidly evolving global financial system thus presents challenges that will test the mettle of even the most far-sighted and determined managers. Competitive position centers around seven basic questions:

1. *Strategic positioning.* What are the target markets—in terms of clients, products, and geographic spread—that promise the most attractive opportunities for growth over time?
2. *Prospective market structure.* How are these targeted markets likely

to evolve over time in terms of competitive structure? There is not much sense in going through the effort and expense of gearing up for what looks like a potentially profitable market if, at the end of the day, competitors are doing the same thing and market structure ends up approximating perfect competition—incapable of supporting attractive, sustained returns on the capital employed. Herdlike behavior is well known among financial services managers and strategists, especially in the face of major parameter shocks like creation of the euro-zone, and it may be advisable to stay out of the way of the stampede.

3. *Core competencies.* What is the firm really good at, in terms of its baseline market position and franchise, creativity and innovation, flexibility, ability to manage complexity, and command of financial and human resources? What competitive resources can be rolled out geographically or focused on defensible market segments in response to developments in the euro-zone?
4. *Operating economies.* To what extent are there economies of scale, cost economies of scope, and production efficiencies that can be exploited to reinforce the firm's competitive position?
5. *Revenue synergies and earnings diversification.* Are there revenue economies of scope that can be exploited by linking products and clients, and are these cross-selling gains likely to prevail across the euro-zone for target retail or wholesale client segments? Relatedly, are there significant earnings-stability gains to be had by diversifying across clients, financial services activities, and geographies within the euro-zone?
6. *Institutional configuration.* What types of institutional configurations do the strategic positioning considerations suggest are the ones most likely to maximize the value of the enterprise, running across the institutional spectrum from massive euro-zone universals or multifunctional financial services conglomerates to specialists that are highly focused on best-in-class delivery of specific types of financial services?
7. *Ability to execute.* Based on the firm's existing situation and an objective assessment of competitive strengths and weaknesses—a "reality check"—is it reasonable to envision its transformation into what will be required in light of the environmental suppositions, given resource and managerial constraints, with reasonable but not excessive urgency?

Economies of Scale

Whether economies of scale exist in financial services has been at the heart of strategic and regulatory discussions about optimum firm size in the financial services sector. Can increased average size of firms by itself create a more efficient financial sector, and can it increase shareholder value?

For example, large organizations may be more capable of the massive and "lumpy" capital outlays required to install and maintain the most efficient information technology and transactions processing infrastructures. If extremely high technology spend levels result in higher efficiency, then large financial services firms will tend to benefit in competition with smaller ones. However, smaller organizations ought to be able to pool their resources or outsource scale-sensitive activities in order to capture such gains.

In an information- and distribution-intensive industry with high fixed costs such as financial services, there should be ample potential for scale economies, as well as potential for diseconomies of scale attributable to disproportionate increases in administrative overhead, management of complexity, agency problems, and other cost factors once very large firm size is reached. If economies of scale prevail, increased size will help create systemic financial efficiency and shareholder value. If diseconomies prevail, both will be destroyed.

Examples of financial sector megamergers in 1998 alone include Deutsche Bank and Bankers Trust as the first intercontinental megadeal, creating the world's largest bank with combined assets of $849 billion in November 1998; Swiss Bank Corporation and Union Bank of Switzerland in Europe to form UBS AG ($749 billion); Citibank and Travelers to form Citigroup ($702 billion); Banco Santander and Banco Central Hispanoamericano to form BSCH ($300 billion) in January 1999; and such major 1998 U.S. deals as First Chicago NBD and BancOne, and BankAmerica and NationsBank; and the proposed takeover in 1999 of Paribas and Société Generale by Banque Nationale de Paris to form the world's largest bank ($1.3 trillion). Bankers regularly argue that "bigger is better" from both systemic and shareholder-value perspectives, and they usually point to economies of scale as a major reason why. What is the evidence?

Many studies of economies of scale have been undertaken in the banking, insurance and securities industries over the years. Virtually all of them have found that economies of scale are achieved with increases in size among small banks (below $100 million in asset size), although some have shown that the scale economies may also exist in banks falling into the $100 million to $5 billion range. There is very little evidence so far of scale economies in the case of banks larger than $5 billion and no evidence whatsoever of scale economies among very large banks. All of the top 20 largest European, Japanese, and U.S. banks are much larger than the size of banks for which any empirical evidence of scale economies has been found. The inability to find major economies of scale among large commercial and universal banks is also true of insurance companies and broker-dealers. Furthermore, the consensus among empirical studies of the matter seems to be that scale economies and diseconomies generally do not result in more than about 5% difference in unit costs of financial services firms.

So, for most banks and nonbank financial firms except the very smallest among them, scale economies seem likely to have relatively little bearing

on competitive performance. The basic fallacy seems to be management's emphasis on firmwide scale economies when the really important scale issues are encountered at the level of individual financial services. There is ample evidence, for example, that economies of scale are both significant and important for operating economies and competitive performance in areas such as global custody, processing of mass-market credit card transactions, and institutional asset management but are far less important in other areas—private banking and M&A advisory services, for example. Unfortunately, empirical data that would permit identification of economies of scale at the product level are generally proprietary and therefore unavailable. Still, it seems reasonable that a scale-driven pan-European strategy may make a great deal of sense in specific areas of financial activity, even in the absence of evidence that there is very much to be gained at the firmwide level.

Economies of Scope

There should also be potential for economies of scope in the financial services sector—competitive benefits to be gained by selling a broader rather than a narrower range of products—which may arise either through supply- or demand-side linkages as discussed in the CAP model. Indeed, management of universal banks and financial conglomerates often argue that broader product and client coverage, and the increased throughput volume or margins this makes possible, leads to value enhancement for shareholders.

On the supply side, scope economies involve cost-savings achieved through sharing of overheads and improving technology via joint production of generically similar services. Cost-diseconomies of scope may arise from such factors as inertia and lack of responsiveness and creativity that may come with increased firm size and bureaucratization, "turf," and profit-attribution conflicts that increase costs or erode product quality in meeting client needs, or from serious cultural differences across the organization that inhibit seamless delivery of a broad range of financial services.

Most empirical studies have failed to find cost-economies of scope in the banking, insurance, and securities industries, and most of them have concluded that some diseconomies of scope are encountered when firms in the financial services sector add new product ranges to their portfolios.

On the revenue side, economies of scope attributable to cross-selling arise when the all-in cost to the buyer of multiple financial services from a single supplier—including the cost of the service, plus information, search, monitoring, contracting and other transaction costs—is less than the cost of purchasing them from separate suppliers. Revenue diseconomies of scope could arise, for example, through agency costs that may develop when the multiproduct financial firm acts against the interests of the client in the sale of one service in order to facilitate the sale of another, from problems

encountered in attempting to manage highly complex organizations, or as a result of internal information transfers that are considered inimical to the client's interests.

Despite an almost total lack of hard empirical evidence, it is nonetheless reasonable to suggest that revenue economies of scope may indeed exist, but that these are likely to be very specific to the types of services provided and the types of clients served. Strong cross-selling potential may exist for retail and private clients among banking, insurance, and asset-management products (one-stop shopping), for example. Yet such potential may be totally absent between trade finance and M&A advisory services for major corporate clients. So demand-related scope economies in the euro-zone are clearly linked to a firm's specific strategic positioning across clients, products, and geographic areas of operation. Indeed, a principal objective of strategic positioning is to link market segments together in a coherent pattern—what might be termed "strategic integrity"—that permits maximum exploitation of cross-selling opportunities, and the design of incentives and organizational structures to ensure that such exploitation actually occurs. These are, extraordinarily difficult to achieve however, and must work against multiple-vendor behavior on the part of corporate and institutional clients, as well as a new generation of retail clients who are comfortable with non-traditional approaches to distribution such as the Internet, as discussed earlier.

Production Efficiency

Besides economies of scale and cost-economies scope, financial firms of roughly the same size and providing roughly the same range of services can have very different cost levels per unit of output. There is ample evidence of such performance differences, for example, in comparative cost-to-income ratios among banks or insurance companies or investment firms, both within and between national financial-services markets. The reasons involve differences in production functions, efficiency and effectiveness in the use of labor and capital, sourcing and application of available technology; acquisition of inputs, organizational design, and compensation and incentive systems—in short, in better management.

Various studies have found very large disparities in cost structures among banks of similar size, suggesting that the way banks are run is more important than their size or the selection of businesses that they pursue. The consensus based on U.S. experience seems to be that average unit costs in the banking industry lie some 20% above "best-practice" firms producing the same range and volume of services, with most of the difference attributable to operating economies rather than differences in the cost of funds. This suggests that any shareholder value gains in many of the financial services mergers of the 1990s were more highly associated with increases in production efficiency than with reductions in competition. If very large institutions are systematically better managed than smaller ones

(which may be difficult to document in the real world of financial services), then there may be a link between firm size and their operating efficiency. In any case, from both systemic and shareholder-value perspectives, management is (or should be) under constant pressure though their boards of directors to do better, to maximize operating efficiency in their organizations, and to transmit that pressure throughout the enterprise. If the euro-zone intensifies that pressure, this may in the end be one of the most significant sources of financial-sector performance gains.

Taken together, the available empirical data suggest very limited prospects for firmwide cost-economies of scale and scope among major financial services firms and that operating efficiency seems to be the principal determinant of observed differences in cost levels among banks and nonbank financial institutions. Demand-side economies of scope through cross-selling may well exist, but they are likely apply very differently to specific client segments and can be vulnerable to erosion from greater client promiscuity in response to sharper competition and new distribution technologies. Based on these considerations alone, therefore, there appears to be room in the euro-zone for viable financial services firms that range from large to small and from universal to specialist in a rich mosaic of institutions, as against a competitive monoculture dominated by financial mastodons.

Concentration and Market Power

In addition to the strategic search for operating economies and revenue synergies in the financial services industry of the future, firms will also seek to dominate markets in order to extract economic rents. Europe has a long history of imperfect market structures and sometimes cartel formation in various industries, and the financial services market has been no different.

The role of concentration and market power in the financial services industry is an issue that empirical studies have not yet examined in great depth, although in many national markets for financial services, suppliers have shown a tendency toward oligopoly. Supporters have argued that high levels of national market concentration are necessary to provide a platform for a viable pan-European or global competitive position. Opponents argue that, without convincing evidence of scale economies or other size-related gains, monopolistic market structures serve mainly to extract economic rents from consumers or users of financial services and redistribute them to shareholders, cross-subsidize other areas of activity, or reduce pressures for cost-containment. They therefore advocate vigorous antitrust action to prevent exploitation of monopoly positions.

Universal Banks and Financial Conglomerates

Proponents of universal banking as the dominant current and future form of strategic organization of financial services argue that the aforementioned

operating economies and synergies, as well as nondestructive competition, can best be assured if the core of the evolving financial system comprises bank-based multifunctional financial organizations. There is also the argument that greater diversification of income from multiple products, client groups, and geographic areas creates more stable, safer, and ultimately more valuable institutions. Indeed, there is some evidence that this is the case. The main risk-reduction gains appear to arise from combining commercial banking with insurance activities, rather than with securities activities. Such arguments may, exaggerate the risk-reduction benefits of universal banking however, because they tend to ignore many of the operational costs involved in setting up and managing these activities.

It is certainly is the case that a number of large financial institutions will play a major role in the future financial configuration of most regions in the world. Failure of one of these institutions is likely to cause unacceptable systemic consequences, and the institution is virtually certain to be bailed out by taxpayers—as happened in the case of comparatively much smaller institutions in the United States, Switzerland, Norway, Sweden, Finland, and Japan during the 1980s and early 1990s. Consequently, too-big-to-fail (TBTF) guarantees create a potentially important public subsidy for universal banking organizations.

Of course, "free lunches" usually don't last too long, and sooner or later such guarantees invariably come with strings attached. Possible regulatory responses include tighter limits on credit-and market-risk exposures, stronger supervision and surveillance intended to achieve "early closure" in advance of capital depletion, and structural barriers to force activities into business units that can be effectively supervised in accordance with their functions even at the cost of a lower levels of cross-efficiency and scope economies.

Conflicts of Interest

The potential for conflicts of interest is endemic to the kinds of multifunctional financial services firms runs across the various types of activities in which they are engaged.

First, when firms have the power to sell affiliates' products, managers may no longer dispense "dispassionate" advice to clients because they have a salesman's stake in pushing "house" products, possibly to the disadvantage of the customer. Second, a financial firm that is acting as an underwriter and is unable to place the securities in a public offering may seek to ameliorate this loss by "stuffing" unwanted securities into accounts over which it has discretionary authority. Third, a bank with a loan outstanding to a client whose bankruptcy risk has increased, to the private knowledge of the banker, may have an incentive to induce the corporation to issue bonds or equities to the general public, with the proceeds used to pay down the bank loan. Fourth, to ensure that an underwriting goes well, a bank may make below-market loans to third-party investors on condition that

the proceeds are used to purchase securities underwritten by its securities unit. Fifth, a bank may use its lending power to coerce a client to also use its securities or its securities services. Sixth, by acting as a lender, a bank may become privy to certain material inside information about a customer or its rivals that can be used in setting prices, advising acquirors in a contested acquisition, or helping in the distribution of securities offerings underwritten by its securities unit.

Mechanisms to control conflicts of interest can be market-based, regulation-based, or some combination of the two.

In some countries few impenetrable walls exist between banking and securities departments within universal banks, and few external firewalls exist between a universal bank and its nonbank subsidiaries (e.g., insurance). Internally, there appears to be a reliance on the loyalty and professional conduct of employees, with respect to both the institution's long-term survival and the best interests of its customers. Externally, reliance appears to be placed on market reputation and competition as disciplinary mechanisms. The concern of a bank for its reputation and its fear of competitors are viewed as enforcing a degree of control over the potential for conflict exploitation. The United States, in contrast, has had a tendency since the 1930s to rely on regulation, in particular on "walls" between types of activities. Either way, preventing conflicts of interest is an expensive business. Compliance systems are costly to maintain, and various types of walls between business units can have high opportunity costs because of inefficient use of information within the organization.

The conflict of interest issue may seriously limit effective strategic options. For example, inside information accessible to a bank as lender to a target firm would almost certainly prevent it from acting as an adviser to a potential acquirer. Entrepreneurs are unlikely to want their private banking affairs dominated by a bank that also controls their business financing. A mutual fund investor is unlikely to have easy access to the full menu of available equity funds though a universal bank offering competing in-house products. These issues may be manageable if most of the competition is coming from other universal banks. But if the playing field is also populated by aggressive insurance companies, broker-dealers, fund managers, and other specialists, these issues will prove to be a continuing strategic challenge to management.

Is There a Conglomerate Discount Embedded in Universal Banks?

It is often argued that the shares of multiproduct firms and business conglomerates tend (all else equal) to trade at prices lower than shares of more narrowly focused firms. There are two reasons that this "conglomerate discount" is alleged to exist.

First it is argued that, on the whole, conglomerates tend to use capital inefficiently. A number of studies in the nonfinancial sector have assessed the potential benefits of diversification (greater operating efficiency, less in-

centive to forego positive net present value projects, greater debt capacity, lower taxes) against the potential costs (higher management discretion to engage in value-reducing projects, cross-subsidization of marginal or loss-making projects that drain resources from healthy businesses, misalignments in incentives between central and divisional managers). These studies generally conclude that the latter outweigh the former.

A second possible source of a conglomerate discount is that investors in shares of conglomerates find it difficult to "take a view" and add pure sectoral exposures to their portfolios. Investors may avoid such stocks in their efforts to construct efficient asset-allocation profiles. This is especially true of highly performance-driven managers of institutional equity portfolios who are under pressure to outperform cohorts or equity indexes. So the portfolio logic of a conglomerate discount may indeed apply in the case of a multifunctional financial firm that is active in retail banking, wholesale commercial banking, middle-market banking, private banking, corporate finance, trading, investment banking, asset management, and perhaps other businesses. In effect, financial conglomerate shares are a closed-end mutual fund of a broad range of assets.

Both the portfolio-selection and capital-misallocation effects (perhaps mitigated by the franchise and TBTF effects mentioned earlier) may thus weaken investor demand for financial conglomerate shares and lower their equity prices. In universal banks and other types of financial conglomerates, management will have to come up with a compelling set of counterarguments, particularly when investors have the choice of placing their bets on more narrowly focused financial specialists.

Linkages between Financial and Nonfinancial Firms

In many countries, banks and insurance companies have traditionally held large-scale shareholdings in nonfinancial corporations or have been part of multi-industry holdings of financial groups. There are various historical reasons for this, such as politically driven interests of the state to intervene directly in the control of industry and past economic crises that forced banks to capitalize debt in the face of threatened client bankruptcies. There are also portfolio reasons, such as the need of insurance companies to invest massive reserves in the absence of sufficiently broad and deep local capital markets—inevitably leading to major equity positions in nonfinancial corporations and banks. And there are relationship reasons, with banks viewing shareholdings in client firms as an important part of "Hausbank" ties that would attract most of the client's financial services business, even as clients themselves value the presence of a reliable lender who looks beyond a purely arm's length credit relationship.

Sources of Competitive Advantage

The ability of financial institutions to exploit opportunities within the CAP framework depicted in figure 14-6 depends on a number of key firm-

specific attributes. These include the adequacy of the institution's capital base and its institutional risk base, its access to human resources, its access to information and markets, its technology base and managerial culture, and the entrepreneurial qualities of its people.

Adequacy of the Capital Base

In recent years, financial institutions and their regulators have started to pay increasing attention to the issue of capital as a source of both competitive power and prudential control. This has always been true with respect to activities appearing on the balance sheet. But with increasing concentration of domestic and international finance in the securities markets, the role of capital has become important as the principal determinant of risk-bearing ability in securities underwriting and dealing, as well as in off-balance sheet activities. One step removed, a large capital base that allows an institution to be a successful player in securities underwriting and dealing also may enable it to undertake mergers and acquisitions activities, private placements, and other value-added services for its clients. Capital adequacy thus conveys a decided competitive advantage in bringing specific products to specific international markets, in maximizing firepower and reducing costs in funding operations, in being able to stick with particular clients in good times and bad—thus being considered a reliable financial partner—and in achieving compliance with capital requirements mandated by the regulators.

The Institutional Risk Base

Financial institutions fund themselves by creating financial assets held by others. In a deregulated environment where financial institutions are forced to bid for funds, the perceived quality of an institution is an important determinant of its ability to fund itself at the lowest possible cost. The level of embedded exposure to institutional risk has become particularly significant in the interbank market and in the securities industry, leading to a substantial spread in funding costs between institutions and in erosions of funding availability from time to time, particularly in crisis situations. Institutions of lesser-perceived quality can be caught in a difficult position in terms of liquidity or if they are forced to pay a premium over the other institutions to fund themselves. A high credit rating thus assures a financial institution substantial advantages on the funding side. This is also true in dealings with corporate and other institutional clients that are often highly sensitive to the perceived quality of suppliers of financial services.

Quality of Human Resources

While it has long been recognized that financial services are basically a "people business," it is only recently that the importance of having truly superior human resources has become apparent to all of the major players.

Human capital can be viewed as a financial institution's most important asset, and many of the critical opportunities to exploit individual CAP cells, or clusters of them, depend directly on the quality of human resources encompassed within the organization. Both credit and risk evaluation depend on the intellectual caliber, experience, and training of the decision maker—qualities that are no less important in the securities business than they are in the more traditional dimensions of banking. Due to the increase in the role of transactions-driven financial services, individuals are increasingly having to make decisions of a highly complex nature very quickly or lose deals. The need for rapid and accurate decision making is particularly evident in the trading function but is no less important in maintaining relationships with clients, specifically to anticipate client financial requirements and respond to them in ways that add value. Growing competition and increased complexity have placed a premium on human resource—based advantages, as reflected in the severe rivalry to attract top-quality people in the labor markets of various financial centers, with compensation levels bid up at an extraordinary rate.

Information Advantages

The drive by financial institutions to move beyond commodity-type activities into higher value-added services is augmenting the importance of information-intensive products, both quantitatively and qualitatively. Indeed, asymmetries of information among various competitors and their clients contribute a great deal toward explaining differentials in competitive performance. Information is embedded in specific financial services sold in various arenas to various clients, and all forms of lending and credit-related activities depend on the collection, processing, and evaluation of large amounts of information. Similarly, the assimilation of information about the needs of clients is critical in the development of services addressed to their needs. There are three special factors regarding information as a determinant of competitive performance.

First, information is the only resource that can be used simultaneously in the production of any number of services, and this gives it some unique characteristics. For example, information generated to build an international cash-management system for a multinational corporate client can also be used to develop a long-term financial strategy for the same company, or perhaps to develop a slightly different international cash-management system for another multinational firm.

Second, the half-life of information as a source of competitive advantage has been decreasing. Due to a great deal of financial market volatility, important types of financial information decay at a rapid rate, and actions that may have been warranted at one moment in time may no longer be appropriate shortly thereafter. It is an environment consisting of many small windows of opportunity.

Third, the growing complexity of the international financial environ-

ment and the wide variety of services offered has made it increasingly difficult for companies and individuals to plan in a straightforward manner. In effect, what clients often need is a means to evaluate the information that is available and some way to distinguish relevant information from irrelevant. Financial institutions can provide information-related services that help accomplish this; in turn, they are increasingly served by vendors of sophisticated research and analytics (e.g., Reuters, Extel, and Bloomberg).

Financial Technology and Innovation

Financial innovation depends heavily on information incorporated in value-added services sold to clients. The parts of the international financial services industry that have seen the most far-reaching structural changes are those that appear to be the most knowledge intensive. Information technologies allow financial institutions to have at their disposal increasing amounts of data, and they reduce the time necessary to transfer data across arenas, client segments, and product applications. With information increasing at a rapid pace, internal decision and filter systems of financial institutions have come under pressure and new ones have had to be built, as have transaction-driven "back-office" systems. Along with management and marketing know-how, these technologies are principally process related.

There is an equally important set of product-related financial technologies, which to a significant degree are made possible by information- and transactions-oriented advances in financial processes. Technology-intensive financial services may be either embodied or disembodied. Embodied services incorporate technology in a financial transaction and differentiate that transaction from others available in the market. Disembodied technology is provided to clients independent of a specific financial transaction (e.g., in the form of financial advice), although it may subsequently lead to transactions. Returns on financial technology may come through positioning (trading) profits, fees, or enhanced returns associated with financial product differentiation.

Whether process- or product-related, financial technology permits the innovating firm to open up an "intertemporal gap" between itself and its competitors, as reflected either in the cost of delivering financial services or in product differentiation. That gap has implications for both size and durability, and it may also be more or less cell-specific within the CAP model. In general, there appears to be a strong positive relationship between innovation and client specificity in the international financial services industry. There also seems to be a positive relationship between the complexity of the innovation and the imitation lag, perhaps partly offset by a negative relationship between product complexity and success of the innovation—with some innovations being too complex to be put to effective use. In the absence of anything like patent or copyright protection, the imitation lag

for financial innovations tends to be relatively short. It is therefore important for an institution to maintain a continuous stream of innovations. Innovation in this industry can thus be looked on as the introduction of a new process or technique—new in terms of a particular cell—that provides durable returns and adds significant value to the client. The spread of an innovation through the matrix allows the firm to take advantage of its inherent profit potential across the cells.

Innovative capabilities—the continuous application of new product and process technologies—are very much a function of the quality of human capital and of investments in the financial equivalent of research and development (R&D), which is usually much more market driven, informal, and inductive than industrial R&D. Such capabilities are also highly sensitive to the "culture" of an organization, its management, the incentives associated with successful innovations versus the penalties of unsuccessful innovation, and the amount of horizontal communication and information transfer that takes place within the organization. Financial institutions compete in the same capital and labor markets, and people move from one institution to another with growing frequency. Yet some institutions appear to be consistently more innovative than others.

Franchise

A financial institution's "franchise" is probably its most important asset. While it is also the most intangible of assets, it clearly distinguishes the more successful competitors in the financial services industry from the rest. A franchise can arise from a number of different sources. It is generally related to a specific expertise—expertise valued by the market—that an institution has developed over time. It results from the institution's "standing" in the market: a synergistic combination of all competitive attributes in which the whole is greater than the sum of the parts. Franchise is a function of past performance projected over future transactions. Especially in commodity-type activities, there is little to differentiate one institution from another, and franchise becomes an all-important performance variable. A firm's franchise can be either product specific or industry specific, and the choice is an important consideration with respect to the strategy that the bank should follow.

Franchise value is thus reflected in the market as it is driven by the perceived quality of its services, but also by the quality and quantity of its public relations and advertising activities. Some banking services depend more on advertising than others do. For many institutions, advertising and public relations are relatively new activities and, in keeping with market orientation, are becoming increasingly important, as reflected in growing advertising expenditures. Still, some banking services are quite independent of promotional outlays and are driven largely by past performance. In such cases—securities underwriting, for example—one failure is worth more

than many successes, and a single bad deal can cause a bank to lose an enormous amount of face in markets that have very long memories.

An institution's franchise is thus its most intangible asset, yet one that clearly distinguishes the most successful competitors in the international financial services industry from the rest. It is of great value when seeking new business, and it can be used to explain a variety of competitive phenomena. It appears to be related to an institution's standing in the market as a result of a synergistic combination of all the above attributes—where the whole is greater than the sum of the parts. It is embedded in the value of the firm as a reflection of its past performance, projected into the future.

The Importance of Corporate Culture

Culture is something every bank and securities firm has, even if it is weak. In one important sense, corporate culture can be boiled down to the institutional environment in which people have to work. If a firm wants to get a lot out of people, the first thing management has to give them is a highly desirable workplace environment, where they spend more of their time than anywhere else. Some key ingredients:

- High-quality peers from whom to learn, and with whom to compete
- A sufficiently loose organizational structure that permits ideas to rise, be taken seriously, considered carefully on the basis of merit, and acted upon quickly—a structure that protects high-potential individuals from bureaucratic stifling
- An esprit de corps that thrives on measurable competitive success, such as significantly increasing market share or profit margins, in a business where winners and losers are not difficult to distinguish and where valuable franchises are difficult to build but easy to lose
- A performance-based compensation and advancement system that is generally respected as being fair and right not less than about 80% of the time; this must be an integral part of a benign form of ruthless Darwinism, one that includes a reasonably high level of involuntary turnover, in which only the best survive and progress

In short, there has to be a climate in which bright people, if they are found suitable, will *want* to spend their careers. This climate requires a sense of continuity; admired and respected seniors; and a serious, consistent commitment to careful recruitment, management development, and training. Especially in times of growing international activity, those who are not from the institution's home country cannot be deemed unworthy of high office.

Corporate culture in a highly competitive industry such as global financial services increasingly has to be regarded as an important competitive

weapon, centered on grasping and preserving the qualities of winning. This includes:

- Sound strategic direction and leadership from the top: knowing the right thing to do, then getting it done by providing sufficient resources
- An overriding attention to teamwork, the avoidance of "stars" and stamping out of arrogance (many "strong" cultures are really not much more than institutionalized arrogance)
- The selection of hundreds of loyal and efficient "squad and platoon leaders" to carry out day-to-day activities at high levels of quality and professionalism, to include a fine, ingrained sense of what is unacceptable conduct—including conduct that does not violate law or regulation but nevertheless could impair the franchise of the firm and compromise its responsibility to clients
- A high level of adaptability by the whole organization in an industry subject to rapid change

This is what the cultures of investment banks like Goldman Sachs do so well. It is why they continue to rank as top market players year after year. Nevertheless, *sic transit gloria.* Senior management must be keenly aware of the need for adaptability and communicate it effectively by word and deed. A certain amount of corporate angst keeps people on their toes.

To become a market share and a profitability winner overall, a firm must be positioned and structured to deliver the best possible products to the greatest number of clients in the shortest period of time. It must also learn to take and manage large trading risks quickly. When failures occur, replacements must be available to step forward until the right people are in the right jobs. If the front-line people are well selected and trained, nurtured, and coached, the number of failures will be minimized.

Today, however, to *become* a winner is not enough. To *stay* a winner, a firm must be able to adapt to wrenching industry change, intense margin competition, and the management of vastly complicated technology and risk issues. Few people can do all of this without becoming obsolete after a while. Then they need to be moved out of the way, with dignity and grace if possible, to make room for more up-to-date replacements. This implies that such a culture—not unlike professional athletics or an effective military—needs to have young people on the front lines and plenty of senior coaching backing them up. The young don't know everything, and a good institutional memory is an invaluable asset.

In view of its importance as a determinant of competitive performance, corporate culture has disproportionate importance in the banking and securities sector because of a number of more or less unique industry characteristics, among which are the following:

- As a service industry, banking and securities activities frequently involve close personal contact with clients. Consequently, the morale of the

banker is more directly identified with the quality of the service than in other industries.
- Clients tend to associate their own prestige with the prestige of the firm under the rubric "First-class clients are served by first-class institutions." The franchise of the firm therefore has direct marketing implications.
- Banking involves longer-lasting client relationships than many other industries, both wholesale and retail, sometimes extending over decades. Setbacks suffered by a bank are sometimes felt as setbacks by clients.
- By definition, banking involves a fiduciary relationship with clients, who expect the culture of the bank to validate that relationship. However, a strong fiduciary culture may not be one that welcomes innovation.
- Financial services require trust in institutional stability and bureaucratic procedures, which may promote a culture that resists change and innovative thinking.
- Banking and securities activities are and will continue to be highly regulated due to its "special" role in the economy, and regulated firms with "utility" characteristics may develop cultural attributes that are not ideal for the more dynamic parts of the industry.
- Nonprice competition in banking and securities services may be more important than in other industries where price and cost differences are relatively greater, especially in lines of activity whose competitive structure is oligopolistic.
- Product differentiation in commercial and investment banking is often unusually difficult to achieve (given the lack of copyright or patent protection, ease of entry and exit, and short imitation cycles that exist in the industry), so that the mode of delivery becomes extraordinarily important.
- Cross-selling of products and economies of scope may be more important in banking, particularly among universal banks, than in some other industries, so that a cooperative culture that maximizes lateral communication and internal referrals may be of unusual significance.

Each of these aspects, and perhaps others as well, may make competitive performance in banking and financial services particularly "culture sensitive," which means that firms with superior cultural attributes outperform others that otherwise may have substantially the same resources.

One question that constantly arises is whether a single culture is appropriate for an organization that covers a very broad range of activities, extending from foreign exchange dealing to mass-market retail banking and to M&A transactions in investment banking. Even so, there are often some overarching cultural attributes (a superculture) that can be an effective "umbrella" covering widely different business cultures and national cultures within an organization. If it is considered impossible to achieve this balance, then it is likely that a holding company form of organization—where unit cultures are closely aligned to the respective businesses—is superior to a more integrated structural form. However, cultural fragmen-

tation in such a structure has potential drawbacks, including the fragmentation of market delivery and quality control that are not to be taken lightly.

Strategic Targeting

To maximize performance in the international financial services industry, a firm clearly has to go through some sort of strategic process to seek an optimal expansion-path within the CAP matrix depicted in figure 14-6 that may involve either deepening penetration of individual cells or incursions into new cells. Decisions in this regard obviously depend on the perceived cost and risk versus benefits of opportunities that present themselves or that are sought out. The process itself involves the following:

- Development of a consensus on the future macroenvironment (e.g., interest rate and exchange-rate stability, disequilibria, real-sector shocks, etc.) that could affect markets and products globally or represent sources of covariance in returns and hence systematic risk
- Surveying of existing activities in terms of market structure, risk and return, linkage effects, and effect on overall competitive performance, along with identification of each in terms of its client-, arena-, or product driven characteristics
- Assessment of the feasibility set of additional cell-based activities in terms of market structure, risk and return, linkage effects, and prospective effect on overall competitive performance, as well as client-, arena-, or product-driven characteristics
- Breakdown of the relevant client, arena, and product variables into components that identify key competitive factors
- Development of an inventory of organizational resources and prospective access to incremental resources
- Identification of strategic options that involve possible deepening or broadening of cell activities, acquisitions or divestitures, and their effect on economies of scale and scope, as well as actuarial risk base
- Identification of resistance lines, cost, and risk dimensions associated with each strategic option
- Selection of an optimum strategic path that is consistent with prospective profiles of returns, cost, and risk and institutional resource constraints

Some institutions will be able to react more rapidly than others to competitive opportunities and therefore may have a key advantage over their rivals. This ability to react will tend to depend jointly on an organization's inherent flexibility and its organizational structure.

Finally, it is important that some sort of coherent competitive positioning emerge from the strategic process. In taxonomy of possible strategies for international financial institutions, at the client level, the strategy can

be defined as focused, segmented, or nonsegmented; at the arena level, it can be defined as national, international, or global; and at the product level, it can be defined as niche, diversified, or supermarket. Segmentation in this context does not necessarily mean that a financial institution has actively segmented the market but that it supplies products to some but not all client groups. Across this taxonomy, an institution's strategic positioning and clarity is invariably projected to clients, regulators, and competitors alike. It becomes a significant competitive advantage or disadvantage for the financial institution in the marketplace.

Successful players in the global financial services sector must therefore identify (1) the specific sources of their competitive advantage; (2) those markets where this competitive advantage can be applied, adds value, and is sustainable; and (3) the competitive potential inherent in the cell linkages. Application of a competitive-structure framework, such as the one presented here, will help identify the cells and cell clusters where significant returns based on market power are likely to exist and (equally important) where they are likely to be durable.

Given the potential size of the CAP matrix and the complexity of the linkages that exist among the individual cells, it becomes clear how wide is the range of strategic options that faces a financial institution in the global environment. Consequently, it is not surprising that an examination of individual organizations' international structures and their development through time often appears somewhat haphazard, lacking in consistency or coherence. This is the result of management actions under conditions of bounded rationality, when faced with the task of determining expansion paths. In effect, management confronts an enormous opportunity set, of which it is usually familiar with only a small part. So management appears to operate much of the time by a process of trial and error—trying various options under best-available information, assessing results to the extent possible, and trying again. It is therefore not surprising that many institutions appear in retrospect to have a relatively ambiguous strategic positioning in the global market for financial services.

To perform well in working through the strategic process, institutions must first develop the ability to scan the environment and to identify potential changes in that environment, including strategic moves by competitors and changes in the regulatory setting. Moreover, some institutions will be able to react more quickly than others to changes in the competitive environment and therefore may have a key advantage over their rivals.

In the pervasive economic restructuring that goes on in response to changing consumer and demand patterns, resource costs, international competition, and perceived economies of scale and scope, individual industrial firms in search of maximum shareholder value constantly reassess the activity span of their businesses. Vertical integration to secure sources of supply or downstream distribution may serve this purpose. Horizontal and geographic expansion to acquire market share, complementary product lines, or risk spreading may be attempted for the same reason.

When management appears to be on the wrong track, the financial markets provide appropriate signals that lead to further restructuring or retrenchment. When the firm's objectives collide with the public interest in keeping markets functioning efficiently or in achieving noneconomic objectives—even at a cost to the economy—regulatory constraints are imposed in the form of antitrust, environmental, employment, consumer protection, or other types of legislation, along with appropriate enforcement measures. These involve a delicate balancing act to ensure that the social benefits of regulation more than justify any social costs (which come in the form of less-efficient use of resources and possibly slower growth). Within the bounds of such necessary regulatory constraints, industrial restructuring and shifting forms of business organization in the banking and financial services sector should be driven mainly by the economic fundamentals.

Indeed, competitive restructuring in the financial services sector is conceptually no different from restructuring in the industrial sector. Market forces may dictate vertical positioning somewhere on the spectrum from the ultimate consumer to the wholesale financial markets, or horizontal positioning ranging in breadth from the financial specialist to *Allfinanz* or *bankassurance*—the respective German and French terms for providing the full range of financial services under one roof. As in other industries, the functions to be performed and the underlying demand and supply characteristics in a highly competitive market tend to dictate the sizes and forms of the organizations that compete in the marketplace. The penalties for having suboptimum organizational structures may be very severe indeed.

Summary

The discussion presented in this chapter is centered around a commonsense approach to strategic positioning in financial services. Put simply, it's all a matter of doing the right thing. This invariably requires an astute assessment of the prospective competitive battlefield, in terms of both market prospects and competitive structures, which has to be based on a number of suppositions reflecting a well-argued consensus among those creating the strategy. If important suppositions turn out to be wrong, key parts of the strategy will be wrong, too.

Once a judgment has been reached as to key client groups, geographic areas, and product portfolios that may promise to generate acceptable risk-adjusted returns to shareholders, a strategic configuration has to be devised for the institution that can extract significant scale and scope economies and that can be managed effectively to achieve strong operating economies. Such an optimum configuration may be termed "strategic integrity." It forms what the Germans call a "soll-Zustand" (what *ought to be*). This has to be compared with the "aist-Zustand" (what *is*): How does the institution currently stack up against all competitors, traditional and nontraditional, in the cold light of day, and what will be required to compete

effectively in the future in terms of capital, human and managerial resources, and organizational changes.

Realistically comparing reality to strategic objectives in the presence of a critical time element usually produces a number of show-stoppers. Rejecting losers among strategic options is just as important as selecting winners—and is often much more difficult, especially when opportunistic moves beckon and time is short. Failure to reject losers probably results in a disproportionate number of what turn out to be strategic errors in the financial services sector, often at great expense to shareholders.

Finally comes strategic implementation: marshaling resources, controlling costs, getting the troops on board, building a high-performance "superculture" over what inevitably will be a number of often very different "subcultures," getting the right people, and then providing effective leadership. This is the subject of chapter 15. The devil is always in the details.

If a strategic direction taken by the management of a financial firm in the euro-zone does not exploit every source of potential value for shareholders, then what is the purpose? Avoiding an acquisition attempt from a better-managed suitor who will pay a premium price does not seem nearly as unacceptable today as it may have been in the past. In a world of more open and efficient markets for shares in financial institutions, shareholders increasingly tend to have the final say about the future of their enterprises.

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Competitive Implementation, Organization, and Management

Few industries have ever benefited, as the wholesale banking sector did, from the almost continuous economic and financial tailwind that occurred from 1982 through 2000. At a time when world and U.S. GDP rose at a compound (nominal) rate of 7%, U.S. and world equity market capitalization and trading volume all increased at about twice that rate. The worldwide volume of new issues of equity securities rose annually by 19% and debt securities by 25%. The volume of worldwide mergers and acquisitions also rose by more than 25% per annum during the period. During this time also, commercial banks, under pressure from bad loans and mismanagement and subject to intense competition, gave up vast amounts of deposits and assets to the securities market in a massive display of disintermediation.

In such buoyant market conditions, it would seem to be difficult for any of the handful of investment banks that specialized in capital market services to do poorly. In fact, however, the burden of managing such rapid growth effectively was a great one, and not all firms fared well. Indeed, for many once-great firms, the opposite was true. Drexel Burnham went bankrupt and Kidder Peabody was subject to a distress sale. So was First Boston, a casualty of bridge loans in the late 1980s that had to be reclaimed by its principal stockholder, the Crédit Suisse Group. Lehman Brothers and Smith Barney, then ailing, were sold and reshuffled several times (in Lehman's case, back to the public in 1994). Salomon Brothers, wounded from its illegal actions in the Treasury bond auction market in 1990, never fully recovered and was sold to a division of the Travelers Group. A number of other U.S. firms that were generally thought unable to keep up with com-

petition, including Dillon Read, Chase Manhattan, J.P. Morgan, and Paine Webber, found merger with a stronger partner (although at a decent price) the best strategic alternative. And in Britain almost all of the brokers, dealers, and merchant banks were purchased by larger, more capable players in the industry, or were closed down or spun off.

A Changed Environment

With all the financial market expansion resulting from disintermediation, deregulation, globalization, and new technology, there was also an avalanche of competition. For those who could make the most of the new environment and compete effectively, opportunities for growth and enrichment appeared limitless. For all others in the financial services industry, however, the times presented as much turmoil, confusion, and distress as any similar period they had ever experienced. During this time, it was almost impossible to direct and manage investment banking businesses as they had been managed during the preceding 20 years. So much was changing so fast that every firm in the industry had to reconsider its essential strategy for growth and survival.

The process for doing this, under intense pressure, was often quickly cobbled together. But the firms knew that while they were in danger of being marginalized by competitors, for those who succeeded there were also opportunities for great rewards. By "success" most firms would say they meant preserving their essential culture, customer franchise, and ways of doing business—but this would turn out to be impossible. Much of these traditional ways of doing business had to change in order for firms to be able to compete effectively. And competitive results were measured chiefly along two important axes: market share and profitability. They had to either reorganize themselves to be able to perform well under these difficult conditions or save what they could of their investments by selling their firms or taking their chances in a subspecialized niche.

The 1980s were watershed years for investment banks. This was the decade of the savings and loan crisis (which created a sudden need for securitization of mortgages), burgeoning U.S. government deficits (which greatly expanded Treasury securities markets), and the largest mergers and acquisitions boom in the century. It was a decade in which financial markets were also being affected by widespread deregulation, new technologies, and rapid international expansion.

These developments pushed investment banks into a major transformation. The leading players became "integrated" investment banks that brought all of their capabilities together into a core that could service clients on an immediate basis. The concept of "block trading" with institutional customers was transferred from the secondary markets to the underwriting business with the introduction of the "bought deal" and the "bridge loan"

to facilitate client transactions. "Capital market groups" would scour the earth for innovative or low-cost financing opportunities to be presented immediately to a dozen or more existing clients or prospects. Execution could occur at once, on the phone. Merger teams, too, would combine the skills of top securities analysts and arbitrageurs with deal experts to offer clients all they could ever want in the way of transactional expertise. Relationship managers scurried to be sure that no service a client might need was overlooked. These managers, teams, and groups saw no need to confine their efforts to serving existing clients. They went after the clients of other firms as well, and the clients were ready to pick the best deal and the best price rather than rely on traditional relationships.

By the end of the 1980s, firms like Merrill Lynch, Goldman Sachs, Salomon, and Drexel had increased their market shares (especially in the United States) at the expense of the more conservative, less adaptive old guard.[1] They were very focused on perfecting the quality of their services and the aggressive marketing that needed to promote them. All survived the stock market crash of 1987, but criminal misconduct in the junk bond business finished off Drexel in 1990. It also caused the collapse of the junk bond market that Drexel dominated, thereby ending the takeover boom (which was by then in its last, overpriced stages anyway) and the ability to refinance large bridge loan positions taken on by First Boston and several other firms to accommodate leveraged buyout clients.[2] The market slump that followed in 1990 forced investment banks into sudden layoffs and retrenchments. This was the first year since the 1930s in which all New York Stock Exchange member firms would report a combined loss.

Financial markets recovered the following year, and a series of continuous "booms" began that lasted throughout the decade. There was an extended international boom—beginning with the refinancing of a very large amount of Third World debt through the issuance of "Brady Bonds," followed by widespread privatization of state-owned businesses all over Europe, Asia, and Latin America. Next was a flurry of interest in emerging-market debt and equities that carried investment bankers throughout the world. Pervading all this was a powerful new merger and acquisition boom that appeared around 1990 in the newly deregulated and reorganized European Union, which became the "euro-zone" after adopting the single currency in 1999. In the United States another merger boom had also begun, fueled by rising stock prices. So had a technology and Internet boom in the late 1990s. The various booms drove revenues sharply upward at most of the major wholesale firms, but many investment banks used the 1990s to diversify into different businesses. Many thought that pure investment banking involved more market risk than their shareholders were comfortable with. To offset that risk, most created some kind of large, fee-based asset-management organization that sought to manage pension fund assets, mutual funds, and private investments for the world's rich people. Some firms decided to extend their reach for clients further into the retail sector. Some began to offer lending and other commercial banking services

to corporate and wealthy individual clients. And many firms, after tasting the returns from leveraged buyouts in the 1980s, invested significant amounts of their own capital in high-risk, high-return "private equity" transactions (venture capital, real estate equities, leveraged buyouts, and other speculative nontraded investments acquired as private placements).

The 1990s, however, presented considerable difficulties for investment banks to overcome. The insider trading and junk bond market scandals of the late 1980s had cast a pall on the integrity of the industry, heightening the attention of regulators and class action litigants in the United States and around the world. Kidder Peabody misreported earnings due to its failure to understand the actions of its star government bond trader in 1993, and later reported large trading losses in CMOs, forcing its owner, GE Capital to discard the firm (by selling most of it to PaineWebber) as a lost cause. Goldman Sachs and Lehman Brothers were forced to settle with regulators and plaintiffs in the United Kingdom over their roles in Robert Maxwell's looting of his public company's pension fund in 1994. Baring Brothers failed in Singapore in 1995, and several of its top managers were accused of covering up what they knew. Bankers Trust infuriated its regulators, stockholders, and clients by its conduct in the derivatives market in 1995, after which management was changed and the bank was reorganized, then sold. Merrill Lynch had to face angry litigants and the SEC regarding its advice to, and trades with, Orange County, California, in 1996. CSFB was raided in 1999 by regulatory authorities in Japan for misreporting its actions there, and in 2001 it was sanctioned in India and forced into a $100 million settlement with the U.S. SEC for alleged malfeasance related to the IPO market. Later that year Merrill Lynch made a similar settlement related to conduct by stock market analysts.

Compared to prior periods, the 1990s had become quite dangerous for financial services firms. Not only were regulators more focused and motivated, they were better informed and better supported technically. Also, the penalties for criminal misconduct had been raised (loss of licenses and large fines and penalties are to be expected; jail time is possible), and the exposures to large adverse judgments from class-action litigation in a finding of civil misconduct are potentially enormous. Today, firms are exposed to potentially severe penalties from even technical, noncriminal violations. Such exposures have placed a heavy, expensive burden on the firms to ensure flawless internal compliance and control of nontrading activities. The securities industry has become one of the most intensively scrutinized and regulated industries in the world.

During this period, the Glass-Steagall Act, which kept commercial banks separate from investment banking since 1933, was gradually eroded and then finally repealed after years of effort to do so. At the end, there was very little support for keeping banks out of the securities business because the banks were thought to need access to these businesses to remain competitive. However only a few banks—around a dozen in the United States—expected to participate in a significant way. Indeed, only two (out

of more than 9,000 in 1990) elected to transform themselves into serious investment banks—J.P. Morgan and Bankers Trust. But neither was to survive as an independent company.

Misconduct and regulatory change were only part of the story of the decade of the 1990s. The trading markets offered their own considerable challenges. First, bond market volatility suddenly exploded in 1990, then did so again in 1994 (after a series of unexpected interest rate rises by the Federal Reserve), and financial markets were roiled. As a group, the large investment banks had a negative return on equity in 1994, an event that rattled many of their principal investors. Then in 1998, the Russian default and emerging-market crises appeared, flattening markets and forcing a famous hedge fund (Long Term Capital Management) into insolvency. And the bear markets of 2001–2002 were still ahead. Despite the apparent good times, every four years had brought a crisis in the financial and foreign exchange markets, and each crisis had hammered the returns and the stock prices of the major securities firms. Although investment banks have a good record of weathering market storms, and of seeing their share prices rebound, in aggregate these market crises began to show up in declining profit margins of Wall Street firms during the 1990s. Over the 20-year period ending in 2000, aggregate investment banking revenues increased approximately 14 times, but the average profit margin of the "large investment banks" for the period 1990–2000 (7.4%) had declined to less than half of what it had been in the 1980s.

The pressure on margins was coming from increased competition that was shifting the value-added in investment banking from the manufacturers of financial products to the users. Integrated investment banks were increasingly being required to stand up for clients in profitless trades and commodity-like transactions in which fees or commissions had been eroded by competition. The remedy for this reduction in margins, the banks thought, was to shift business into areas with greater profit potential. Proprietary trading was one such area that appealed to some firms, but the increased market risk and the massive doses of capital required for it was worrying. If Long Term Capital Management, thought to be the best in this sort of business, failed, why would a more constrained, less-talented investment bank do better? Increased efforts in asset management, where market volatility was not a factor, seemed a reasonable offset to exposures in corporate finance and investing services, although most of the assets under management had to be acquired in the market at relatively high prices—on which expected returns were not high. A few firms also placed greater emphasis on developing international business. This would diversify a firm's geographic exposures and also enable it to enter into markets that were somewhat underserved by effective, U.S.-style investment banking know-how, but overseas expansion was expensive and risky—witness Barings—and progress was inevitably slow.

Finally, firms could increase their investments in private equities and real estate transactions. Such investments of the firms' own capital had

three benefits. They could sell participations in the investment funds to clients as hedge-fund shares (for which the firm would receive a management fee and a healthy 20% share of profits). The investments might result in significant returns, shoring up profits that were weakening in other areas. And they could become a captive source of lucrative IPO underwriting and merger, recapitalization, and advisory fees. Despite these efforts, pre-tax profit margins of large investment banks—there were only six or seven in 2000—still declined considerably. The decline in profitability motivated the firms to do all they could to lower costs and use new technologies to their greatest advantage. The best way to lower costs was to reduce the number of employees. In 1980, Wall Street large investment banks totaled 16,800. In 2000, despite a 15-fold increase in total revenues, the headcount was only 3 times greater, at 50,000.[3]

Strategic Choices

During the period from 1980 to 2000 almost all of the firms went public or merged with firms that were public, usually at a substantial premium to book value.[4] But as public firms, their roles were changed. They were not just in business for themselves. They had to think about their new public stockholders and outside directors, potential predators, and investment analysts who publish recommendations to investors. They had to worry also about the effects of a rising and falling stock price on their key managers and employees. They had to learn how to articulate a long-range strategy to the market and explain short-term actions that appeared to deviate from it. But mainly they were charged with keeping up with the breathless pace of action of those years, while protecting and enhancing shareholder value. This was a formidable task. In retrospect, four basic strategies were pursued by investment banks in the 1980–2000 period to accomplish this goal.

Growth through Market Dominance

The first approach was based on using a firm's dominant expertise in certain product areas to expand into adjacent product and client groups and to propel the firm upward on the acknowledged strength of its momentum. Merrill Lynch used this technique in the 1970s to leverage its ability to distribute stocks to propel it into the upper tiers of investment banking, a big step for a firm previously seen only as a retail broker. Salomon tried this, too—emphasizing government bonds, bank securities, corporate debt, and CMOs. Drexel adopted the strategy to support its dominance in junk bonds, and some others tried to do the same in their own areas of expertise—Bankers Trust (derivatives), Baring Brothers (Japanese securities), and Kidder Peabody (fixed income). The strategy suffered from a serious flaw, however: the trading environment conditioned by the firm had to become so aggressive that the firm itself might not be able to control or govern it.

Consequently, many of the spectacular failures in the industry in the 1990s were really the result of having adopted a business strategy that could only be described as dangerous.

Growth by Continuous Acquisition

The second strategy involved continuous acquisition of competitors for the purpose of absorbing their customers, while simultaneously reducing operating costs, especially fixed costs and staff overhead. The master of this strategy was Sanford Weill of Citigroup. Weill combined a dozen or so small or distressed organizations to create a firm then called Shearson Loeb Rhodes that was capable of attracting, first American Express (to buy it in 1981)[5] and then the once powerful, elegant house of Lehman Brothers (to sell to it in 1984).[6] Lehman was experiencing hard times then and looking to be sold to an upscale investment bank. Weill left American Express in 1985, uncomfortable in a second-fiddle position, and the Shearson-Lehman-American Express (and E. F. Hutton, acquired later) investment banking conglomerate began to fall apart. American Express decided to sell the brokerage part of the to a new company that Weill had created after his departure.[7] This company (a consolidation of Commercial Credit Corp. and Primerica, a financial holding company) owned Smith Barney Harris Upham, a second-tier retail broker with an old investment banking name. After the Shearson Lehman Hutton brokerage business, Weill's company would subsequently acquire (in order) Travelers Insurance, Salomon Brothers, Citicorp, Schroders (a leading U.K. merchant bank), Associates First Capital (a large finance company) acquired in 2000, and Banamex-Accival (Mexico's second-largest financial group, acquired in 2000). The acquisition of European American Bank (a Long Island–based retail bank) was announced in February 2001, and of Bank Handlowy (a major Polish bank) was announced in May 2001. Citigroup, as the new firm is called, is the world's largest financial services company by market capitalization, and America's first true "universal bank" that includes banking, insurance, asset management, and investment banking under one central operating company. Part of the appeal of the strategy is to be in continuous motion, with acquisition following acquisition, after the market has been convinced that the firm knows how to take on the customers while spitting out the costs. No one has managed this strategy of continuous aggressive acquisition as successfully as Weill, but the strategy nonetheless has all the disadvantages of haphazard conglomeration and organizational confusion. And because of the size of this particular conglomerate, there is always the danger of becoming unusually unwieldy and unresponsive.

Two other investment banking organizations have followed similar continuous-acquisition strategies. One is Swiss Bank Corp., which first acquired the O'Connor Group (derivatives), then a seriously wounded S. G. Warburg, the Brinson Group (investment managers), Dillon Read, then its ultimate rival, Union Bank of Switzerland (also seriously wounded when

acquired), the GAM fund management firm, and most recently Paine-Webber. The surviving enterprise is now called UBS, AG.

The last of the superacquisitive organizations is the entity once known as Chemical Bank. It began with the acquisition of a seriously troubled Manufacturers Hanover, then of a much larger but harried Chase Manhattan, followed by a bevy of investment banking niche players Hambrecht & Quist, the Beacon Group, and Robert Fleming (U.K.), and then the faded rose of Wall Street, J.P. Morgan. However, in neither this (now called J.P. Morgan Chase), nor the UBS case has the stock market believed that Sandy Weill's essential magic touch was present. Citigroup's stock price significantly outperformed the others and stayed even with an index of broker-dealer stocks from 1997 to 2000. In all three cases, however, the wholesale banking portions of the groups have found their way into the top 10 global wholesale rankings by market share (see table 15-1)—Citigroup ranked first in 2001; J.P. Morgan Chase was second and UBS was seventh.

One consequence of this strategy of growth by continuous acquisition is that the acquiring business is interested only in the customers being acquired and some of the top talent. Thus the acquired employees are dispensable, and they know it. This creates organizational uncertainty and management problems of its own. Even Weill's most senior associates—and even the most loyal among them—have often not lasted long in their jobs. Moreover, the strategy depends on feeding the market with a continuous supply of new acquisitions, which means that bigger and bigger additions must be contemplated for the future. It also means that new and recent deals obscure the ability of analysts to determine how well prior acquisitions have fared. This was a condition experienced by the industrial conglomerates in the 1960s and 1970s, most of which fell apart after a good run in the market and have since been broken up.

Truly "Strategic" Mergers

There have been four significant instances of one-time "strategic" mergers that are so important to the firms involved that they change them irrevocably. They have almost always been transactions that were thought to be so unusual as to surprise the market when they were announced.

The first of these was the partial ownership arrangement between First Boston and Crédit Suisse's London investment bank, CSFB. However, the uneven relationship First Boston had with its Swiss partners was forever troubled, if occasionally helpful to each side. The partnership was unwound in 1990 after some mishaps and financial difficulties at First Boston in the United States. Everything was merged into the parent company to give it greater control. It is hard to see how Crédit Suisse could have made much money from its investment in First Boston. But today after further major acquisitions in Switzerland of a retail bank and an insurance company, and of Donaldson Lufkin & Jenrette, Crédit Suisse has assembled a powerful European universal bank that ranks sixth in the 2000 global banking mar-

Table 15-1 *Global Wholesale Banking Rankings 2001 Full Credit to Book Running Manager Only ($ million)*

Rank	Firm[a]	Syndicated Bank Loans	Global Debt U/W and Private Placements	Global Equity U/W and Private Placements	M&A Advisory Completed	MTNs Arranged	Total Managed Transactions	Market Share (%)
1	Citigroup—SSB (4)*	278,375	429,342	48,789	476,149	640,797	1,873,452	10.81%
2	JP Morgan Chase (7)	514,476	299,192	14,644	428,011	538,515	1,794,838	10.35%
3	Merrill Lynch (2)	37,987	367,429	61,324	597,350	608,608	1,672,698	9.65%
4	Goldman Sachs (1)	43,953	238,695	60,928	748,990	369,735	1,462,301	8.43%
5	Morgan Stanley (3)	20,060	225,691	44,446	626,839	505,256	1,422,292	8.20%
6	Crédit Suisse Group (5)	42,485	303,724	44,225	426,358	395,483	1,212,275	6.99%
7	UBS Warburg (12)	33,870	220,815	29,662	212,449	470,308	967,104	5.58%
8	Deutsche Bank (11)	83,423	206,799	16,946	119,269	491,265	917,702	5.29%
9	Lehman Brothers (8)	32,760	237,902	18,428	172,180	403,508	864,778	4.99%
10	Bank of America (10)	238,057	151,205	5,746	67,116	202,344	664,468	3.83%
11	Dresdner Klein. Wasserstein (16)	48,339	49,202	29,729	343,353	69,822	540,445	3.12%
12	Barclays (24)	58,742	72,722			281,110	412,574	2.38%
13	ABN AMRO (14)	30,869	83,018	4,824	29,173	258,323	406,207	2.34%
14	BNP Paribas (18)	28,938	49,829	4,767	36,599	264,007	384,140	2.22%
15	Bear Steams (13)	4,492	130,706	3,650	90,569	146,269	375,686	2.17%
16	HSBC (22)	30,059	46,785	476	10,576	134,719	222,615	1.28%
17	Lazard Freres (15)			15,727	161,051		176,778	1.02%
18	Nomura	1,744	24,213	6,096	9,599	133,214	174,866	1.01%
19	RBS Group	67,279	63,338			33,346	163,963	0.95%
20	Societe Generale (−)	58,666	19,306	7,636	27,924	46,792	160,324	0.92%
21	Mizuho	53,674	8,301	249	28,315	65,522	156,061	0.90%
22	Banc One	59,368	19,054	611		48,504	127,537	0.74%
23	West LB	46,252	16,099			62,759	125,110	0.72%
24	Commerzbank AG (−)	37,335	17,846	298		61,627	117,106	0.68%
25	Mitsubishi Tokyo	29,291	4,828		7,872	73,091	115,082	0.66%
Market total		2,108,964	3,368,764	428,373	4,866,020	6,565,600	17,337,721	100.00%

Source: Thomson Financial Securities Data
[a]2000 ranking in parentheses.

ket share tables. After a series of scandals its CEO, Allen Wheat, was forced out and replaced by John Mack, who had lost a power struggle at Morgan Stanley Dean Witter.

The second case was the three-way merger of a merchant bank, a stock broker, and a "jobber" (market-maker) in 1984 that created (the new) S. G. Warburg, then making an open attempt to become Britain's first integrated investment bank, similar to the major American firms. Warburg became the market leader in post–Big Bang London, but it was suddenly forced into a distress sale to UBS after serious trading losses in 1994 where it is one of several investment banking businesses that have been commingled at UBS.

The example frequently pointed to by analysts of a successful strategic merger is the combination of Morgan Stanley and Dean Witter in 1997. Morgan Stanley had been a wholesale finance specialist firm since its beginning as a spinoff from J.P. Morgan in 1933. It inherited all of the famous Morgan clients and had been the bluest of blue chip firms since its fortuitous birth. In the 1980s, Morgan Stanley changed itself into a full-service international firm and in the 1990s began aggressively to add investment management businesses. It was disappointed in its market valuation, however, and decided that its future would best be made by merging with a retail brokerage, Dean Witter, that had once been owned by Sears Roebuck and still retained its valuable Discover credit card business. The merger, which left ex-McKinsey management consultant and former Dean Witter CEO Philip Purcell in charge, represented big changes for the old Morgan Stanley people, many of whom departed. This group included John Mack, the firm's president and number 2 officer after the merger, who resigned in January 2001. Although Purcell (and Mack, as his deputy) managed the combination well, they did not integrate the firms very much. They continued to emphasize the old Morgan Stanley investment banking business while rebuilding the securities sales and trading and asset-management business around the Morgan name (Dean Witter was dropped from its name in 2001). Morgan Stanley was the world's fifth-ranking global banking firm in 2001, based on market share.

Citigroup is also an example of a strategic merger to create a newly powerful market presence. Although the continuous acquisition strategy executed by Weill arrived fortuitously at Citicorp, the resulting combination must represent a major strategic event in totally reshaping the firm. Its presence is now very strong in several service categories: Citigroup is now among the world's largest banks, broker-dealers, insurance providers, and asset-managers; it is also strongly positioned in the United States, Europe, and Japan and in emerging markets. Whether management can master the intricacies of coordinating between product and geographical lines to produce a seamless delivery of effective financial services remains to be seen, but as a strategy, the creation of Citigroup was certainly a significant event.

Steady Internal Growth

The final strategy followed by investment banks in this period was to pursue only internal growth. Such firms would continue to do what they had been doing in the past, sticking to and reinforcing what they were good at without succumbing to any of the abstract strategic ideas that were periodically presented. Such a strategy enabled firms to avoid the managerial chaos and disruptions of large mergers (especially of the "mergers-of-equals," which seem to create the most trouble) and to retain more of their experienced bankers with strong, seasoned client relationships.

Merrill Lynch has made a few acquisitions. But its acquisition of White Weld in 1978 (rescuing it from bankruptcy) was perhaps its most important as the merger gave credibility to the firm in corporate finance. Since then, Merrill has mainly acquired firms abroad to enhance its local presence in important markets in the United Kingdom (Mercury Asset Management, Smith New Court) and Japan (the retail brokerage business of Yamaichi Securities). For the most part, Merrill Lynch has relied on internal growth to maintain its significant wholesale market share (ranking third in 2001), while still developing its retail service businesses in the United States and abroad.

Goldman Sachs was left, just prior to its initial public offering in 1999, as the most unchanged firm among the major bracket players of Wall Street. Goldman Sachs was organized in 1869 as a commercial paper house. Over the next 130 years its main effort was to grow organically in the wholesale finance markets and to increase its market share and profitability. It acquired J. Aron & Co., a small commodities firm in the early 1980s, but otherwise kept to itself. The IPO ended Goldman's unique partnership structure by requiring the firm to include several hundred of its more senior employees into its coveted "ownership" status and forcing it to govern itself differently in the future. But the IPO did not force Goldman to change its central strategy. In 2000, Goldman acquired Speer Leeds & Kellogg to help it reinforce its commitment to equity trading markets, but this acquisition did not reflect a major strategy shift. It ranked fourth in the global wholesale banking tables in 2001.

Other firms sticking to their own knitting during the 1980s and 1990s included Lehman Brothers (since its re-launch in 1994), Bear Stearns, and Lazard Frères (since merged with its sister companies in London and Paris). Lehman ranked ninth in wholesale banking services in 2001, Lazard (a merger house only) was seventeenth and Bear Stearns was fifteenth. Four other important firms followed this strategy also until they sold out to others (at very good prices): Dillon Read, Donaldson Lufkin, Paine Webber, and J.P. Morgan. Of all these firms, however, only Merrill, Goldman, and J.P. Morgan (now contributing to the Chase totals) made it into the top 10 global investment banks.[8]

Strategy Changes Require Execution

One can see from these various cases that it has been possible to develop successful investment banking businesses in extremely challenging times by different strategic routes. Merrill Lynch has prospered by aggressively expanding a single product line where it had exceptional skills into a broader range of product lines. Several firms, especially Citigroup and J.P. Morgan Chase, have accomplished some of their strategic objectives by strategies of continuous acquisitions. Morgan Stanley has flourished in its larger strategic role, and so has Goldman Sachs in its traditional one. Other firms pursuing similar strategies, however, have not fared nearly as well.

If there are different strategies, what may be most important in determining their outcome is the effectiveness of their execution. Execution places a great weight on a firm's ability to make intended things happen on time, while preventing other (bad) things from happening at all. In essence, execution is about good management—which over time depends on recruitment, training, and retention of high-quality, career-oriented professionals. It requires a firm to enculturate new and acquired personnel with the firm's values and standards and to impose effective control and compliance systems to be sure that they are enforced. Effective execution means being able to evaluate performances well and to set compensation policies that work. These tasks are much more difficult to do in merger situations in which many professional employees are seen to be overlapping or redundant and when senior officers are consumed with protecting or projecting their personal power. The tasks are also difficult when high merger premiums are paid (and have to be reclaimed by extensive cost cutting), and when the firms' stock prices become volatile, depressing the value of compensation packages.

Global Banking Today

During the last two decades, probably 20 or 30 firms struggled to execute strategies that would assure their market position and profitability. They have had time and market conditions in their favor, but only a handful have achieved their objectives. Only a handful can claim to have secured significant market shares in the wholesale financial services industry.

Table 15-1 shows the 2001 market shares of the top 25 market leaders in an aggregate of global wholesale banking transactions (corporate banking, distribution of debt and equity securities, merger advisory, and medium-term notes). These services were selected because they are among the most important offered to clients in terms of transactional value. Thus they become the determinants of the market power or reputation of individual firms. To ascertain the overall impact of a firm in the principle marketplace for its services, we have taken a measure of the total volume of transactions for which an individual firm can be seen to be the originator,

or "bookrunner." Data are available on the basis of "full credit to bookrunner" for the service areas chosen (no such data are available for secondary market activity, such as trading). Wholesale markets are now so well integrated globally than an issue originating in one market usually may be sold in several others, and the skills, capabilities, and infrastructure of individual investment banks can be utilized with equal effectiveness in many parts of the world. To perform effectively and competitively in wholesale banking, firms must be more integrated and more globally connected than ever; hence, the global volumes of transactions in the areas selected have been used.

At the end of 2001, seven American firms were among the top 10 global wholesale financial services rankings. Three were banking-related entities: J.P. Morgan Chase, Citigroup, and Bank of America. Four were nonbanking-related: Merrill Lynch, Goldman Sachs, Morgan Stanley and Lehman Brothers. The other three firms in the top 10 were European universal banks, each with several mergers under its belt. The top 10 firms accounted for over 70% of all global wholesale banking transactions that were originated during the year. The top five firms accounted for 47%. The average market share of the top five firms was 9.5%; of the next five, 5.3%, and of the twenty-fifth placed firm, 0.7%.

To be outside the top 10 is to be not taken very seriously as a global wholesale financial services provider. Thus a number of firms have struggled to secure positions in the top 10, quite often by acquisition. In 1991, for example, all of the top 10 firms were among the top 10 in 2000, or among those firms that were acquired by firms that were in the top 10 in 2001. Seven of those firms had been involved in at least one major strategic merger. In 2001 the top five firms had between them undergone more than 11 strategic mergers to solidify their positions. Those lower down on the ranking ladder certainly have found it difficult but not impossible to climb their way up (e.g., Deutsche Bank, BNP Paribas, UBS Warburg) even through acquisitions. The acquisitions have also reduced the dominance of American firms among the group—in 1993–1995, nine of the top 10 firms were American; in 2001 the number had dropped to seven.

Market Share and Market Value

The top firms in handling wholesale transactions tend to be the ones that enjoy the greatest profitability. They get the best assignments and can seek the highest fees. However, if a firm's position in the rankings is achieved only by merger, then the assumption of profitability may not be valid. To sustain profitability, the firm has to demonstrate superior capabilities, which newly jumbled together firms may not be able to do. Being profitable (in a time of declining margins) is good, of course, but the firm's profits have to be capitalized by the stock market at a multiple that reflects—among other things—both future prospects and the essential volatility (risk-

iness) of the firm's profit stream. So here the firm's mix of business (which establishes the overall volatility of the firm) seems to count, with apparently lower risk being associated with businesses that are better diversified. However, current market data do not appear to offer much support for the idea that financial service firms with lower betas will enjoy higher capitalization rates (price-earnings ratios).

Indeed, it is not clear that in the long run, merging one's concentrated profit stream into another profit stream that diversifies it will be the answer to the strategic requirements (for higher multiples) of investment banks. It may have been (through 2001) for Citigroup, and for Morgan Stanley, which the market considered to be well-managed, profit-driven firms. However, if in the future the market decides that today's multimarket diversified financial services firm is tomorrow's ungainly conglomerate, the market value may be discounted until the firm is worth more broken up into its respective business lines. But future investors will decide, and their message will shape the strategic actions of the players. Some investors will prefer highly diversified, very large capitalization companies in financial services in which to be able to make large long-term investments. Others investors will choose to make diversification decisions themselves, and instead prefer those investments that are "pure plays" in a particular expertise or dominant market share with room for substantial upward price movement. In the end they will look for superior profit-making capability and for strategic objectives that sensibly preserve this capability, rather than expose themselves to excessive dilution (i.e., combining promising activities with other, less profitable businesses) or excessive risk.

Some investors may also believe that firms with large market capitalizations are inevitably tempted to continue pursuing a bigger-is-better strategy, which they do by issuing shares in even larger acquisitions. Such firms may feel the pressure to follow the actions of other highly visible firms in their industry. Some companies make intriguing promises to gain support for a time for efforts that are difficult or impossible to achieve—Citigroup said it was going to increase its number of clients by 10-fold after the Travelers/Citicorp merger, to 1 billion—that is, to one-sixth of all the people on Earth. Some very big firms also simply lose to bureaucracy the ability they might have once had to manage efficiently and to react quickly. Today's corporate dinosaurs include many companies that were once, not so long ago, lean and fleet.

Back to the Future

For several years, management consultants and academics have published credible data indicating the remarkably low success rate of large mergers. In 2001 this was revealed in the financial services sector by merger-related difficulties at First Union, Bank of America, Banc One, and on the wholesale side at Crédit Suisse and Deutsche Bank. Academics also have studied

economies of scale and scope in mergers in the banking industry (especially as these relate to creating universal banks) and, after the one-time gains from initial cost cutting, they have found little of the former and almost none of the latter.[9] Citigroup may prove these studies wrong, as it claims to be cross-selling effectively. But cross-selling is not without its own often significant incremental costs, and revenues are often hard to attribute or are unverifiable. The extensive record on the limited amount of efficiency gains from bank mergers leaves to management the burden of proof that net new economic value is created in large, multiproduct merger situations.

Future profits in large banking companies are now subject as never before to fee cutting and the commoditization of once specialized, lucrative product lines. To sustain margins, firms have to take advantage of their abilities to maneuver between product lines and world markets and to make the most of their comparative advantages, their know-how, and their franchise values. But they must be nimble enough to avoid becoming committed to low-profit business lines. Morgan Stanley may worry about big banks lending to its clients, but it should be hesitant to go into that (or any) business with such low margins and significant capital requirements. It should also be reluctant, especially during market downturns, to get into low-margin lending, investing, or trading situations if difficult-to-control market exposures would have to be taken on to do so.

Firms may also have to face the reality that if profits are being squeezed or otherwise made more risky, then they will have to find ways to reorganize their business in order to pay out to employees something less than the current 50% or so of net revenues. How can employees in a commodity-like business with declining margins and high personnel turnover command such high pay scales, year after year? If the best people leave, because they want to retire at age 45 or because some other firm has made a marginally higher offer, and yet the firm still manages to get by without them, could it have been paying the employees too much in the first place? Perhaps being able to pay employees differently would work better for both the firms and the employees.

It is easy to predict (as predictions have been made in the past) that the next 20 years will involve more of the same: that is, more consolidation and flight to bigness. But this is unlikely. Financial services markets are unlikely to continue to grow at twice the real rate of economic growth. Mergers involving American wholesale banking firms will not continue at the same pace (the number of firms available for mergers has decreased substantially), and if stock prices of prospective acquiring firms continue to fall—back toward their historical means—there may be little appetite for more mergers for a while. The market price of Chase Manhattan's stock fell more than 40% in the first six weeks after the news was released on September 11, 2000, that it was acquiring J.P. Morgan for stock valued at 25% more than its market price. Unless there comes to be strong, convincing evidence of net economic gains from consolidation, the pendulum

may begin to swing the other way. Markets can punish as well as reward strategic actions.

The wholesale finance business may already have consolidated about as much as it is going to, and from now on, the trend may be to go backward in search of real value. The outcome could mean pulling the best talent out of the "big box" firms and replanting it into comfortable, flexible, performance-oriented, small partnerships that function as specialized players (for example as Goldman Sachs did in the 1960s) or as investors managing money for clients (hedge funds, arbitrageurs, LBO firms).[10] Both would begin to compete with the old firms, but initially the old firms probably would not see much threat and might even encourage the effort.

In the meantime, some of the old firms may find that they have accumulated too much on their plates to be as good in everything (as expert, as responsive) as they were when they were on their way up. In 2001, Citigroup with 180,000 employees (even before the Associates First Capital, European American Bank, Bank Handlowy, and Banamex acquisitions), J.P. Morgan Chase with 75,000, Merrill Lynch with 67,000, and Morgan Stanley with 55,000 must have some quality-control problems. They all do. And, because the firms today are almost as active as investors and investment managers as they are investment banking service providers, they cannot avoid running into their own clients in the marketplace. When they do, how do they decide the outcomes, with fees going down on one side and prospective private equity or other investment returns looking more promising on the other? If this happens often enough, the clients will feel there is an extra price to be paid for dealing with the firm and perhaps move its business elsewhere. And where might this business migrate? Perhaps to the reborn investment banks of tomorrow that will resemble the small, fleet opportunistic shops that their predecessors were 40 or 50 years ago.

Summary

The coming years will represent great challenges to most of the world's large financial service organizations. These firms will have to rethink their basic business strategies and attempt to reposition themselves to maximize their comparative advantages and minimize their weaknesses. Strategic repositioning, however, can be very difficult to execute, because the magnitude of internal change is so great. The key to succeeding in the new world financial order is adaptability.

Notes

1. In the 1960s, the "special bracket" of underwriters consisted on Morgan Stanley, Kuhn Loeb, First Boston, and Dillon Read. Morgan Stanley and First Bos-

ton had transformed themselves to accommodate for integration, but Kuhn Loeb and Dillon Read did not. By the 1980s, however, several of the "major bracket" underwriters of the 1960s and 1970s had disappeared.

2. Investment banks would offer to make the bridge loan to finance a takeover through a tender offer of a controlling position in a company, which would then force a merger on the rest of the stockholders. The company would refinance the bridge loan by a sale of junk bonds after the merger could be completed. As there were several large fees involved, investment banks pursued takeover assignments by offering to do the bridge loans. When the junk bond market broke, the bridge loans could not be refinanced and sank in value. Crédit Suisse was required to bail First Boston out of its position, and in November 1990 it recapitalized the firm to give the Swiss control of First Boston.

3. Securities Industry Association, 2001 *Fact Book*. New York, 2002.

4. Donaldson Lufkin & Jenrette was the first NYSE firm to go public (1969). It was followed by others quickly. Merrill Lynch went public in 1971, and the last major firm in the United States to go public was Goldman, Sachs & Co., which succumbed in 1999.

5. In 1981 there were two other acquisitions designed to put together a financial supermarket (by combining brokerage and insurance), Sears Roebuck and Dean Witter and Prudential and Bache. In 1985, Donaldson Lufkin was acquired by Equitable Life Assurance, which has since been acquired by AXA. All of these fell short of their goals, and all except Prudential Securities have been broken up.

6. Shearson Loeb Rhodes was sold to American Express in 1981 and became Shearson American Express, which acquired a failing Lehman Brothers in 1984, and became Shearson Lehman Brothers, which acquired the nearly bankrupt E. F. Hutton in 1997.

7. The investment banking part, now renamed Lehman Brothers, was sold to the public in 1994 and remains an independent firm.

8. In 1999, before the mergers of J.P. Morgan and Chase, and DLJ into Crédit Suisse, Goldman Sachs was ranked first in global wholesale banking transactions, followed by Merrill Lynch, Morgan Stanley, Citigroup, Crédit Suisse, Chase, J.P. Morgan, Lehman, DLJ, and Bank of America.

9. See Steven Davis, *Bank Mergers* (New York: St. Martins Press, 2001), which quotes reports from the Bank for International Settlements and the Federal Reserve Bank of New York on their studies. See also Mark Sirower, *The Synergy Trap* (New York: Free Press, 1997), and Anthony Saunders and Ingo Walter, *Universal Banking in the United States* (New York: Oxford University Press, 1994).

10. There has been a substantial migration already to very successful firms like KKR, Blackstone, Wasserstein Perrela, and other boutique investment banks. Private equity and hedge funds have also drawn much of the talent needs from Wall Street's major investment banks.

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