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The Euromarket in the Face of Change

by Wolfgang Gerhardt, Frankfurt am Main*

Financial innovations are currently displacing traditional methods of Euro-currency financing, while in Germany and Japan there is talk of establishing international free banking zones along American lines. What are the reasons for these developments and how are they affecting the Euromarket?

The Euro-currency market is currently passing through a period of profound structural change, brought about by the international debt crisis, which once again focussed attention on the creditworthiness of a country as the central criterion of international credit, and by the international trend towards the "deregulation" of national financial markets, which has even caught hold in Germany and Japan; the extent and outcome of the transformation now taking place cannot yet be assessed.

Nevertheless, in the twenty-five or more years since it has developed, the Euromarket has always shown itself quick to adapt to developments in world economic conditions and to the changed requirements of market participants. It is thanks to this flexibility and flair for innovation that the market has become an important conduit for international capital transactions.

The Euro-currency market, which is often also called the offshore market, the Euromarket or the foreign currency market, encompasses all money market and credit transactions in a currency outside the area in which it is legal tender. Hence, the banks borrow and lend funds denominated in a currency other than that of the country in which they are situated.

The Euromarket only grew to sizable proportions because commercial banks, private non-banks, monetary authorities and other state agencies needed to carry out transactions in particular currencies, but found that the institutional and other conditions in financial centres outside the country of issue of the currency allowed money and credit market transactions to be effected at lower cost and with fewer official constraints and did not impede financial innovation by the banks. Although Euro-currency transactions are carried out worldwide, the bulk of the Euromarket is

concentrated in the financial centres of countries that allow non-residents almost unrestricted freedom to carry out foreign currency transactions. Euro-currency centres have developed throughout the world, but the most important are London, Paris and Luxembourg in Europe, Bahrain, Hong Kong and Singapore in Asia and various Caribbean islands and Panama in the western hemisphere. At the end of 1984 the US dollar accounted for more than 75 % of the Euro-currency market, the Deutsche Mark for around 10 % and the Swiss franc for 5 %.

The figures themselves speak for the importance of this international financial market. According to data gathered by the Bank for International Settlements, the external foreign currency positions of banks in 25 reporting countries (which approximate to the size of the Euromarket) increased sixfold between the end of 1973 and the end of 1984, rising from US\$ 260 billion to US\$ 1,567.9 billion in the case of claims and to US\$ 1,665.2 billion in that of liabilities. Euro-currency transactions account for the greater part of the total external positions of banks in these countries. At the end of 1984, 72.8 % of claims totalling US\$ 2,153.5 billion consisted of Euro-currency transactions, 18.7 % traditional foreign lending (i.e. loans to foreign borrowers in the currency of the country in which the bank is situated) and 8.5 % transactions in the context of International Banking Facilities in the USA. Among liabilities amounting to US\$ 2,116.5 billion, the dominance of the Euromarket was even more pronounced, at 78.4 %, compared with 13.4 % and 8.2 % for the other two items.

Until 1981 the Euro-currency market expanded by an average of well over 20 % a year. As a result of the international debt crisis, which first struck the Eastern European countries and then spread to more than two dozen developing and newly industrialising countries (NICs), new lending to the problem countries shrank to a minimum; at the same time, credit demand from

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industrial countries slackened for cyclical reasons and as a result of a more cautious borrowing policy. The growth of the Euro-currency market therefore slowed down to well under 10 % between 1982 and 1984 and the market volume even contracted slightly in the third quarter of 1984.

Competition for Prime Names

The international debt crisis brought a fundamental change in the structure of the Euro-currency market. A split market developed, with one segment for borrowers from highly indebted countries and another for prime names from industrial countries. In the late seventies many Eurobanks had tended to give preference to lending to developing countries and NICs, because such loans promised higher returns than the spread on loans to first-class borrowers, which was already very small. Since then, the word "risk" has again loomed large. The Eurobanks are now waging a fierce battle for business from prime names by offering a succession of new instruments that aim to reduce the cost of borrowing and which can be adapted as flexibly as possible to the financial needs of a borrowing firm, government or international organisation.

However, the borrower's interest in cheap and longer-term credit clashes with the investor's desire for high-yielding, short-term forms of finance. Given the different conceptions of creditors and debtors, market instruments developed that bridged the gap between the short-term supply of funds and the long-term demand and kept the banks' crucial margin between deposit and lending rates as narrow as possible.

The first step in this direction was taken at the beginning of the seventies with the introduction of the roll-over technique, which is now used for the majority of Eurocredits. A roll-over credit is granted by a bank or syndicate of banks for a period of several years, but the rate of interest is adjusted regularly to the prevailing money market rate, usually at intervals of three or six months. The interest cost for the borrower consists of a selected money market interest rate – usually the London interbank offered rate (Libor) – plus a premium, which is agreed in advance for the entire period of the loan and depends on the standing of the borrower and the general state of the market. For prime names, the margin frequently fell below 0.5 %, whereas developing

countries occasionally had to pay more than 2 %. The roll-over technique passes the risk of interest rate changes onto the borrower and enables the banks to refinance a loan repeatedly at short term.

In this situation, the Euro-bond market led a wallflower existence for many years. The Euro-bond market, which is the market in bonds placed simultaneously in several countries, rivals the Euro-credit market proper in some respects, but since it handled only "straight" fixed-interest bonds it was not an attractive alternative to borrowers with impeccable credentials who, unlike the developing countries and NICs, also have access to the capital market. Its fortunes changed with the arrival of new instruments, in particular floating rate notes (FRN), on which the interest rate is linked to money market rates in the same way as that on roll-over credits. The volume of FRNs expanded strongly in 1983 and 1984, when certain borrowers were even able to obtain a margin of only 1/8 % over Libor.¹ Such terms are nonetheless attractive to investors as well, as the banks act only as broker in the issue of the securities, so that there is a direct credit relationship between the subscriber and the bond issuer and the entire interest goes to the creditor. By contrast, money deposited with banks usually earns interest at rates that at best equal the lower money market bid rate.

Unlike roll-over credits, however, floating rate notes do not allow for varying the amount of credit drawn during the lifetime of the loan.

The Advance of the Euronote

The development of Euronotes,² which combine the favourable terms for securities with the possibility of varying the amount drawn, was therefore virtually predestined. Under a Euronote facility a syndicate of banks grants a borrower an agreed credit line (stand-by or back-up line) for an agreed period of time. Within these limits, the borrower can raise funds as and when he needs them by issuing Euronotes, which are unlisted securities with maturities of between one and six months. When the Euronotes fall due, the borrower must decide whether to replace them or let them mature. He can draw on an available credit line at any time by issuing notes until the final maturity of the line has been reached. Similarly, the banks place each batch of notes with investors; if they are unable to do so, they take them into their own securities portfolios or grant the borrower a cash credit.

Euronotes were first issued in 1980 in connection with a loan to New Zealand. According to banking data, by 1983 20 % of all new Eurocredits were already being

¹ Cf. Ekkehard Störck: Neue Instrumente im Euromarkt, in: Die Bank, November 1984, p. 504.

² With regard to Euronotes, see *ibid.*, pp. 505-507; anon.: Euronotes. Ruffing Out a Eurocommercial Paper Market?, in: The Banker, Vol. 135, January 1985, pp. 48-51; David Shirreff: The Euronote Explosion, in: Euromoney, December 1984, pp. 31-41.

disbursed via Euronotes and by 1984 the figure had risen to just over half. Sweden, for example, raised US \$ 4 billion by this means.

Euronotes have still not been standardised despite this strong expansion, and new variants are frequently developed. In the case of "traditional" Euronotes, underwriters receive securities for placement in proportion to their quota in the credit. To prevent difficulties in selling the notes through banks with a weak market position, "revolving underwriting facilities" (RUFs) were created, whereby a prestigious issuing house makes the placing as "sole placing agency" (SPA); the remaining underwriting banks bear only the placing risk. In the case of "note issuance facilities" (NIFs), which have now become the most widespread variant, a "tender panel" of selected banks is invited to tender to underwrite Euronotes; if too few tenders are obtained at auction or if a pre-arranged upper interest rate limit is exceeded, the underwriters are called upon to intervene.

The banks can earn income essentially only from fees for participation in syndicates and from the placing of Euronotes. Earnings are slim, but the credits do not affect the banks' balance sheets, provided the notes are sold without difficulty at each placing deadline. They risk having to disburse the credit themselves, at least temporarily, if the creditworthiness of the borrower or the general tone of the market deteriorate during the lifetime of the loan.

Finally, the issue of Euronotes blurs the dividing line between the money and capital markets. Euronotes are securities, but the banks' involvement is not confined to the pure broking function typical of bond issues, so that new opportunities and risks are opened up for banks, investors and borrowers.

The great expansion in the volume of Euronotes in a short space of time should be seen as an indication of widespread interest in this financial innovation. However, Euronotes will further accentuate the split into a two-class debtor society, for numerous borrowers – in particular from developing countries and NICs – will continue to be unable to use the capital market and will therefore be obliged to raise conventional roll-over credits. On the other hand, Euronotes might largely displace floating rate notes. Before that happens, however, the wide range of differing forms now present must give way to a small number of standard types of note.

Much will also depend on the eventual assessment of the new types of risk. Many banks still seem to be

extremely cautious about notes. The more the credit institutions themselves classify Euronotes as credit risks or the supervisory authorities require them to do so, the less satisfactory will be the present level of earnings from this type of business. In those circumstances, the continued growth of the market would depend on an improvement in terms.

Euromarket Centres in the Country of Issue of the Currency

The traditional distinctions are also becoming blurred in another field. The international free banking zones³ that have existed in the USA since December 1981 and which are now being discussed in Germany and Japan are nothing less than Euromarket centres in the country of issue of the currency concerned, for credit institutions operating from such zones can carry out money market and credit transactions with non-residents on better terms than can be offered elsewhere in the country.

Given the leading position of the Euro-currency centres, free banking zones are only competitive if they enjoy conditions and concessions comparable to those obtaining in the Euromarket. Besides providing political and economic stability, the Euromarket centres meet three criteria:

- ☐ *Freedom from minimum reserve requirements.* The reserve requirements that exist in many countries act like a tax on banking business. This is the most important cost advantage enjoyed by the Euro-currency market and it is all the greater the higher the level of interest rates and reserve requirements.
- ☐ *Banking supervision.* There are no notable restrictions on operations in the Euro-currency market, either as regards the type and volume of transactions or the determination of interest rates. There are only certain low requirements regarding the level of the Eurobanks' own funds and their liquidity.
- ☐ *Taxes and other costs.* As a rule, tax rates are low, either because they are generally low in the country in question or because special concessions are granted for the Euro-currency market. Some countries levy only licence fees. Withholding taxes do not exist.

There is only one essential difference between international free banking zones and Euromarket centres: in the zones, non-residents may deposit or

³ With regard to IBFs, see Sydney J. Key: *International Banking Facilities as a Free Economic Zone*, in: *Außenwirtschaft*, Vol. 39, 1984, pp. 57-74; Henry S. Terrell, Rodney H. Mills: *International Banking Facilities and the Eurodollar Market*, Board of Governors of the Federal Reserve System, Staff Studies 124, Washington 1983; K. Alec Chrystal: *International Banking Facilities*, in: *The Federal Reserve Bank of St. Louis Review*, Vol. 66, April 1984, pp. 5-11.

borrow funds in any currency they like, whereas in the Euromarket centres transactions in the national currency are not eligible for the concessions accorded to foreign currency transactions. As the existing International Banking Facilities in the USA have shown, free banking zones in Japan and Germany would undoubtedly conduct the bulk of their business in the national currency.

By October 1983, less than two years from the opening-up of the US financial market in December 1981, around 480 banks in 18 states had established IBFs. By the end of 1984 the volume of business of the IBFs amounted to claims of US\$ 188.6 billion and liabilities of US\$ 174.0 billion, second only to London among the traditional Euro-currency centres. The IBFs' transactions are almost exclusively in US dollars. More than three-quarters of their business is transacted in New York; the only other centres of any importance are San Francisco and Chicago.

IBFs are not independent subsidiaries of banks located in a geographically defined area. IBFs are opened when interested banks notify the Federal Reserve System that zone transactions are booked separately and declare their willingness to make certain returns and submit to appropriate examination. Transactions are granted exemption from reserve requirements, interest rate ceilings, the insurance premiums (and protection) of the Federal Deposit Insurance Corporation and certain taxes.

It is much more difficult – compared to countries with Euromarket centres – to prevent interpenetration between the domestic market and a free banking zone because of the use of the same currency in both markets. For that reason, only non-residents may make deposits with or borrow from IBFs in the USA and only for their non-American business. The only exceptions are an IBF's transactions with its parent bank or with other IBFs. Transactions with private non-banks must be for a minimum maturity of two days and a minimum amount of US\$ 100,000. Furthermore, IBFs may not issue negotiable instruments, as they may find their way into the possession of US residents.

Japan intends to follow America's example in authorising free banking zones. After years of discussion, the Japanese Ministry of Finance set up a working party in the spring of 1985 to draft the necessary reforms. The strict regulation of the Japanese market

that currently prevents the establishment of free banking zones includes minimum reserve requirements, deposit rate regulations and withholding tax on interest received by non-residents. However, it is possible that the first free zone transactions can be effected as early as 1986.

The German financial market is far less tightly controlled; e.g. no interest rate restrictions have applied since 1967. All that would have to be done to permit American-style free banking zones would "only" be to amend the reserve requirements and lift the prohibition on many forms of business that have now become commonplace in the international market, including the "classical" roll-over credit. For years, such proposals seemed doomed to failure because of the resistance of the Deutsche Bundesbank to financial innovation.

However, a change of heart became apparent at the Conference of German Private Banks in March 1985. The President of the Bundesbank, Karl-Otto Pöhl, stated publicly for the first time that it would be "desirable if Eurocurrency business could be 'repatriated' by making certain modifications to the minimum reserve requirements".⁴ Nevertheless, he spoke out against free zones along American lines. It is still too early to predict the outcome of the discussions that are now under way.

Beware Euphoria over Growth

Free banking zones in the USA, Japan and Germany have or would have sufficient weight to hold their own against existing Euromarket centres because of the international standing of their countries' economies, currencies and banks. One has only to look at the IBFs to appreciate the prospects for such zones.

The German and Japanese banks of world importance, which have their own networks of foreign branches and subsidiaries, could reduce the cost of their establishments abroad if they could transfer a substantial part of their business back to headquarters. Decision-making would be speeded up and there would be greater opportunity for direct control and influence. Free banking zones would increase the attraction for foreign banks to be represented in these countries by branches and subsidiaries.

However, one should avoid the temptation to measure the advantages in terms of new jobs or additional tax revenue. The Euromarket is dominated by standardised transactions for vast amounts but with slim margins, which require a correspondingly small staff input and generate low returns.

⁴ Karl-Otto Pöhl: Stabilitätspolitik unter wechselnden Bedingungen, Vortrag anlässlich des XIV. Deutschen Bankentages am 26. März 1985 in Bonn, reproduced in: Deutsche Bundesbank (ed.): Auszüge aus Presseartikeln, 27th March 1985, No. 23, p. 4.

Excessive euphoria about the probable growth of the zones would be equally misplaced. After a brilliant start, the rate of growth of the IBFs in the USA quickly came into line with the general trend in international financial markets. Around one-third of the funds handled by the IBFs were previously booked through banks in the USA and around two-thirds through Euro-currency centres, mainly in the Caribbean.

German and Japanese free banking zones with their centres in Frankfurt and Tokyo would also benefit initially from the transfer of funds from banks in their respective domestic markets, but in the battle for market shares they would also have to engage in ruthless competition with the Euro-currency centres in their own region – Frankfurt competing with London, Paris and Luxembourg, and Tokyo with Hong Kong and Singapore. In contrast to the Caribbean offshore centres, where the banks are almost exclusively letter-box companies whose transactions are agreed and executed in New York, the banks have fully operational offices in the European and Asian centres. Moreover, the Euro-currency centres are preparing new types of business to ward off the expected offensive.

Tokyo's chances are better than Frankfurt's. The yen is still at the start of its international rise and the Far East is regarded as a region with good growth prospects which will probably be reflected in the demand for financial services. Neither of these factors applies to Frankfurt. In addition, London is the hub of the Euro-currency market and there is certainly little call for a second financial supermarket in Europe.

The Change in Central Bank Thinking

For many years, the monetary authorities of the leading industrial countries regarded the Euro-currency market and the circumvention of their national regulations as a significant potential threat to the beneficial development of the world economy, because in their opinion the market jeopardised the effectiveness of their national monetary policy and the stability of the banking system. Their attitude has now changed towards the Euro-currency market and the numerous financial innovations that have been made. The reason does not lie solely in the recognition that in the sixties and seventies the financial markets in the USA, Germany and Japan did not play a role commensurate with the international importance of their currencies, economies and banks and that their national markets

should not lose touch with international developments; a more important factor was their new understanding of the Euro-currency market and the mechanisms influencing it.

First, the Euromarket does not in itself affect the role of a currency as an international investment and reserve currency, as had been widely supposed. The greater business opportunities that the Euromarket offers cannot alone override the other economic and political factors that work for or against a currency. That being the case, the opposite also appears to be questionable – whether, for example, the decline in the international importance of the Deutsche Mark since the beginning of the eighties could be arrested by offering more attractive investments in DM, the introduction of which has been prevented so far in both the Euro-currency market and the domestic market by the Deutsche Bundesbank.

Secondly, the Euromarket does not cut across domestic money supply control or domestic interest rate policy as though at will. A market participant's choice between the national market of a currency and the Euro-currency market hinges chiefly on the interest rate differential, which in turn is determined by the cost effects of banking regulation in the two markets, above all the reserve requirements and exchange controls. Differences in financial instruments also play some part.⁵ In the Euro-currency market itself, interest rates for comparable transactions are the same everywhere at any given time owing to efficient arbitrage. Hence, the factors that determine the level of interest rates in the domestic market also necessarily apply to the international market in that currency. The impact of monetary policy on the Euromarket of the currency in question therefore depends on its impact on the national market and the pattern of interest rate connections; in other words, it is strongly determined by the central bank.⁶

The problem of banking supervision is somewhat different. For years the supervisory authorities in the Euro-currency centres were more or less openly criticised for the supposed inadequacy of their controls. However, since almost all the Eurobanks are branches or subsidiaries of banks of international importance, the self-discipline of the parent banks themselves provides a safeguard, as they cannot allow their Euro-currency establishments to collapse without running the danger of suffering the same fate. However, for some time now the authorities of the main Euro-currency centres and other countries have been working together in the

⁵ Cf. Wolfgang Gerhardt: *Der Euro-DM-Markt. Marktteilnehmer, Zinsbildung und geldpolitische Bedeutung*, Hamburg 1984, pp. 123 ff., 188 ff.; Josef H. Käsemer: *Euromärkte und nationale Finanzmärkte: Eine Analyse ihrer Interdependenz*, Berlin 1984, pp. 62 ff.

⁶ With regard to the DM market, see Gerhardt, *op. cit.*, pp. 272 ff.

Committee on Banking Regulations and Supervisory Practices at the BIS, the Cooke Committee. One outcome of this is the agreement to introduce consolidated balance sheets, that is to say the banking authorities supervise their domestic credit institutions, including not only their domestic and foreign subsidiaries but also their Euro-currency establishments, on the basis of a consolidated balance sheet for the group as a whole. The banks' compliance with own funds and liquidity ratios is examined on the basis of this consolidated return. In Germany the legal framework was created by amending the Banking Law with effect from 1st January 1985.

Many banks found initially that supervision on a consolidated basis restricted their scope for expansion. The rapid spread of Euronotes may therefore have been stimulated by the fact that they do not affect the balance sheet. How effective the co-operation among the supervisory authorities has now become may be seen in their reaction to the expansion in Euronotes. Following

discussion in the Cooke Committee, the Bank of England classified Euronotes as potential risks at the beginning of April 1985 and instructed banks in the United Kingdom to give Euronote credit lines to non-banks half the weight of traditional credits to such borrowers and those to banks the same weight as traditional lending when calculating their risk asset ratios. The authorities of other countries will probably follow suit in the near future.

The Euro-currency market will continue to play a central role in the international financial arena, largely because of its undiminished ability to innovate, which has enabled it to be in the vanguard of numerous new developments in the past. The blurring of the traditional demarcation between the money and capital markets and between the domestic and Euro-currency markets for a particular currency may lead to closer integration of the international financial markets and strongly influence the character of the Euromarket, but it cannot jeopardise its future.

ISLAMIC BANKING

Principles, Problems and Perspectives of Islamic Banking

by Volker Nienhaus, Bochum*

Since the late 1970s, financial institutions (banks, investment companies, insurance companies) have grown up in many countries in the Moslem world with the intention of conducting their business in accordance with Islamic, or Shariah, law. Above all else, this means business involving no interest payments. The following article explains the most important principles of Islamic banking and outlines some of the problems which appear to be most central to this sphere.

Islamic financial institutions competing against, or offering an alternative to, conventional banks now exist in Egypt, Jordan, Kuwait, Guinea, Bangladesh, Malaysia and elsewhere. Saudi Arabia will shortly join this list (unless one chooses to include it already by virtue of the internationally oriented Islamic Development Bank in Jeddah – this was founded in 1975, but as a development bank does not pursue commercial aims). The governments of Pakistan and

Iran are working towards the complete Islamisation of the financial system (the former since 1979, the latter for practical purposes only since 1984), and Sudan embarked on this course at the end of 1984, but it came to a standstill after the overthrow of Numeiri. Apart from Turkey, which also counts as part of the Moslem world, the only European country which has so far granted an unrestricted banking licence to an Islamic financial institution is Denmark. In contrast, such a licence was clearly turned down at the end of 1984 by the Bank of England, whose main reservations concerned the

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