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3. The international debt securities market

Fund-raising activity by euro area financial institutions in the international market surged in the first quarter of 2003. As a result, aggregate net issuance of international debt securities reached $352 billion (Table 3.1), almost double

Main features of net issuance in international debt securities markets

In billions of US dollars

	2001	2002	2002				2003	Stocks at end-Mar 2003
	Year	Year	Q1	Q2	Q3	Q4	Q1	
Total net issues	1,347.6	1,016.0	308.4	342.3	181.6	183.7	351.8	9,698.7
Money market instruments[1]	–78.9	2.3	–7.8	8.3	11.8	–10.0	54.7	500.5
Commercial paper	*26.9*	*23.7*	*5.5*	*1.8*	*19.3*	*–3.0*	*46.7*	*344.2*
Bonds and notes[1]	1,426.5	1,013.7	316.2	334.0	169.8	193.7	297.1	9,198.1
Floating rate issues	*391.4*	*201.1*	*59.7*	*74.1*	*27.5*	*39.8*	*–41.9*	*2,191.5*
Straight fixed rate issues	*996.0*	*801.0*	*253.3*	*246.4*	*145.4*	*155.9*	*338.7*	*6,690.2*
Equity-related issues	*39.1*	*11.6*	*3.2*	*13.5*	*–3.1*	*–2.0*	*0.3*	*316.4*
Developed countries	1,260.6	950.4	284.4	325.9	166.7	173.3	327.1	8,571.7
United States	*597.0*	*337.2*	*137.3*	*115.7*	*35.7*	*48.5*	*59.7*	*2,813.8*
Euro area	*551.0*	*473.0*	*128.4*	*153.6*	*91.4*	*99.6*	*212.2*	*3,904.4*
Japan	*–10.1*	*–21.4*	*–10.2*	*3.2*	*–4.2*	*–10.2*	*–4.0*	*255.8*
Offshore centres	28.2	8.3	4.4	0.3	–1.1	4.7	2.3	113.8
Developing countries	42.6	36.5	11.6	9.3	6.8	8.7	13.2	561.6
Financial institutions	1,038.3	837.8	236.0	278.9	153.9	169.0	269.8	6,991.3
Private	*956.6*	*717.4*	*215.8*	*242.3*	*118.1*	*141.3*	*199.7*	*5,956.6*
Public	*81.7*	*120.5*	*20.2*	*36.6*	*35.8*	*27.8*	*70.1*	*1,034.7*
Corporate issuers	207.6	58.1	13.0	40.9	1.0	3.2	16.3	1,301.3
Private	*171.2*	*56.2*	*19.2*	*40.7*	*–1.5*	*–2.2*	*10.6*	*1,074.1*
Public	*36.4*	*2.0*	*–6.2*	*0.3*	*2.5*	*5.4*	*5.7*	*227.2*
Governments	85.5	99.2	51.4	15.7	17.6	14.5	56.5	954.5
International organisations	16.3	20.9	8.0	6.8	9.1	–3.0	9.2	451.6
Memo: Domestic CP[2]	*–142.5*	*–105.6*	*–69.6*	*–69.6*	*6.8*	*26.8*	*–23.8*	*1,880.3*
of which: US	*–161.2*	*–98.0*	*–63.3*	*–57.0*	*0.2*	*22.1*	*–16.6*	*1,326.3*

[1] Excluding notes issued by non-residents in the domestic market. [2] Data for the first quarter of 2003 are partly estimated.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; national authorities; BIS. Table 3.1

Gross issuance in the international bond and note markets

In billions of US dollars

	2001	2002	2002				2003
	Year	Year	Q1	Q2	Q3	Q4	Q1
Total announced issues	2,306.1	2,104.6	606.2	570.2	437.4	490.8	774.3
Bond issues	1,349.5	1,169.2	375.1	314.9	212.6	266.6	452.9
Note issues	956.5	935.4	231.1	255.3	224.8	224.3	321.4
Floating rate issues	643.4	605.4	142.0	160.2	146.3	157.0	130.1
Straight fixed rate issues	1,590.4	1,455.4	454.8	389.0	286.1	325.6	627.2
Equity-related issues[1]	72.2	43.8	9.5	21.0	5.0	8.2	17.0
US dollar	1,131.6	987.1	310.2	257.5	200.6	218.9	335.0
Euro	841.6	807.1	228.8	229.3	164.1	185.0	342.5
Yen	125.3	90.4	16.3	25.9	23.7	24.6	23.6
Other currencies	207.5	219.9	50.9	57.5	49.1	62.4	73.2
Financial institutions	1,708.9	1,635.3	447.9	430.3	355.1	401.9	592.6
Private	*1,472.8*	*1,378.7*	*390.9*	*362.9*	*295.7*	*329.1*	*469.8*
Public	*236.1*	*256.6*	*57.0*	*67.4*	*59.4*	*72.8*	*122.8*
Corporate issuers	348.2	212.1	63.7	74.5	34.0	39.9	55.0
of which: telecoms	*135.6*	*45.8*	*12.0*	*16.1*	*7.8*	*10.0*	*23.0*
Private	*287.1*	*187.5*	*57.1*	*70.9*	*28.4*	*31.1*	*39.6*
Public	*61.1*	*24.6*	*6.6*	*3.6*	*5.6*	*8.7*	*15.4*
Governments	174.2	173.0	68.6	44.9	28.3	31.2	87.0
International organisations	74.8	84.3	26.0	20.5	20.0	17.9	39.8
Completed issues	2,305.8	2,105.5	587.9	577.8	443.8	496.0	713.4
Memo: Repayments	*879.3*	*1,091.8*	*271.7*	*243.8*	*274.0*	*302.3*	*416.3*

[1] Convertible bonds and bonds with equity warrants.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS. Table 3.2

the previous quarter's amount. Gross issuance rose by 58% to an all-time high of $774 billion, boosting net issuance in the face of a record amount of repayments (Table 3.2). Corporate borrowing outside the United States recovered somewhat from very low levels.

Demand engenders supply

The rebound in net issuance during the first quarter of 2003 was accompanied by a fall in long-term government yields in January and February. As discussed in the Overview, the declines in default-free interest rates whetted the appetite of global investors for higher-yielding assets, pushing credit and sovereign spreads lower. The greater demand for credit products engendered an increased supply. Net issuance of straight fixed rate bonds and notes soared, as financial institutions and corporate issuers moved to lock in low borrowing costs, in part because of concerns that such costs would rise once war broke out in Iraq. Emerging market borrowers also took advantage of lower funding costs, brought about in part by increased investor demand for higher-yielding assets, and stepped up their net issuance for the second quarter in a row.

Fund-raising by financial institutions leads to a surge in straight fixed rate issuance

The upsurge in net borrowing through the international debt securities market between the fourth quarter of 2002 and the first quarter of 2003 can be traced mainly to the activities of financial institutions. Net issuance by these institutions increased by 60% to $270 billion. There was a particularly sharp rise in fund-raising by euro area financial institutions that helped push net euro-denominated issuance to an all-time high.

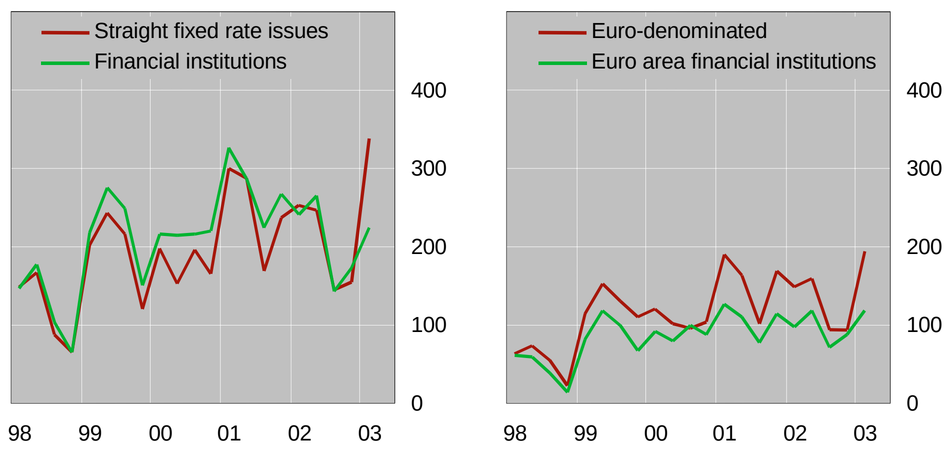
Straight fixed rate issuance surges ...

Greater borrowing by financial institutions was also associated with a surge in the net issuance of straight fixed rate bonds and notes. Because a high proportion of net issuance by financial institutions is in the form of straight fixed rate bonds and notes, it is perhaps not surprising that net issuance of these instruments increased. However, the magnitude of the rise is greater than might have been expected (Graph 3.1). Issuance more than doubled between the fourth quarter of 2002 and the first quarter of 2003 to $339 billion, a record amount, whereas the estimated elasticity of 0.88 would have predicted an increase of only 25%. Apparently, financial institutions were trying to lock in low borrowing costs by issuing relatively more straight fixed rate securities than would have been expected on the basis of their historical behaviour. A rise in net issuance of straight fixed rate securities by non-financial corporates also played a role (see below). Early repayments by financial institutions rose from $7 billion to $17 billion between the fourth quarter of 2002 and the first quarter of 2003, suggesting that at least some of the new funds raised were used to pay off existing, and presumably more costly, debt. Total repayments by financial institutions surged from $232 billion to $323 billion, helping to bring total repayments of bonds and notes to a record $416 billion.

Net issuance by euro area financial institutions was particularly strong. It grew by 66% to $145 billion between the fourth quarter of 2002 and the first quarter of 2003, while that of North American financial institutions increased by

Net issuance in the international bond and note markets

In billions of US dollars



Sources: Dealogic; Euroclear; Thomson Financial Securities Data; BIS. Graph 3.1

only 27% to $60 billion. For the euro area as a whole, the expansion was the result of more net borrowing by both public and private financial institutions. In the case of the latter, net issuance rose by 63% to $109 billion. Private financial institutions in Germany stepped up their net borrowing the most, by about $20 billion. Amongst the largest issues by euro area financial institutions in the first quarter of 2003 was a €4 billion bond from the German DEPFA ACS Bank. The increase in net borrowing by public financial institutions was also concentrated in Germany. Both the Landesbanken and the Kreditanstalt für Wiederaufbau showed record levels of borrowing through the international debt securities market. Part of the increase in the net borrowing of financial institutions was the result of an upsurge in the issuance of Pfandbriefe placed in the international market. In the first quarter of 2003, spreads on these products declined, causing issuance to rise from €10 billion in the fourth quarter of 2002 to €27 billion in the first quarter of 2003. Eurohypo AG and Banco Bilbao Vizcaya Argentaria SA were among the largest issuers, with €3 billion each.

… as does net issuance by euro area financial institutions

Rising issuance by euro area financial institutions helped to push net issuance of euro-denominated debt securities to a record $226 billion, more than doubling the previous quarter's amount (Table 3.3). This reflects in part the tendency of euro area financial institutions to issue in their home currency (Graph 3.1). Yet the magnitude of the rise is larger than would be expected on the basis of past behaviour. Net issuance of euro-denominated bonds and

Net euro-denominated issuance more than doubles

Net issuance of international debt securities by region and currency[1]

In billions of US dollars

Region/currency		2001	2002	2002				2003
		Year	Year	Q1	Q2	Q3	Q4	Q1
North America	US dollar	524.9	304.0	125.6	93.5	35.7	49.3	39.7
	Euro	65.1	40.0	18.3	14.7	7.3	–0.4	15.9
	Yen	19.1	–7.2	–4.1	1.0	–1.5	–2.5	0.0
	Other currencies	7.2	12.5	3.5	6.0	–0.8	3.8	2.5
Europe	US dollar	56.3	73.7	6.6	43.6	4.8	18.8	39.1
	Euro	520.1	468.9	137.4	134.1	101.5	96.0	206.2
	Yen	–2.9	–26.1	–12.6	–4.0	–7.0	–2.5	–3.9
	Other currencies	72.4	89.0	17.0	31.3	23.9	16.8	26.5
Others	US dollar	70.6	44.0	23.0	11.5	4.6	5.0	16.8
	Euro	12.0	14.4	3.1	7.1	5.5	–1.2	4.3
	Yen	0.5	–8.3	–12.5	6.0	2.1	–3.9	–2.2
	Other currencies	2.2	11.0	3.2	–2.3	5.5	4.6	6.9
Total	US dollar	651.9	421.8	155.1	148.5	45.1	73.0	95.6
	Euro	597.3	523.4	158.8	155.9	114.3	94.4	226.3
	Yen	16.7	–41.6	–29.3	3.0	–6.4	–8.9	–6.0
	Other currencies	81.8	112.5	23.7	35.0	28.6	25.2	35.9

[1] Based on the nationality of the borrower.

Sources: Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; BIS.

Table 3.3

notes more than doubled to $194 billion while the estimated elasticity between euro-denominated net issuance and that of euro area financial institutions of 1.18 would have predicted an increase of only 43%. A rise in euro-denominated issuance by North American nationals, from –$0.4 billion in the fourth quarter of 2002 to $15.9 billion in the first quarter of 2003, also played a role. The two largest issues in this category were a €4 billion note floated by Freddie Mac and a €1.75 billion note from General Electric Capital Corporation.

Rising issuance by euro area financial institutions also helped to push net issuance of commercial paper (CP) in the international debt securities market to a record $47 billion in the first quarter of 2003. However, this increase in short-term borrowing through the international market did not carry over to the much larger domestic CP market. The stock of domestic CP contracted by $24 billion, albeit at a much slower rate than that witnessed in the first two quarters of 2002.

Corporate borrowing strengthens as equity-related issuance rises

Non-financial corporate borrowing through the international debt securities market rose somewhat during the first quarter of 2003 from very depressed levels. After two quarters of almost zero net issuance, net borrowing by these entities increased to $16 billion. The rise was almost entirely due to greater net issuance by private borrowers, which, at $11 billion, turned positive again after two quarters of negative values. Gross issuance by non-financial corporates also increased in the first quarter of 2003, to $55 billion from $40 billion in the previous quarter. Most of the issuance was by European companies, while issuance by US companies remained more or less flat. There are indications that corporate borrowers were taking advantage of lower financing costs. Some of the new borrowing was used to pay off existing floating rate obligations, as net issuance of these securities by non-financial corporates remained negative for the sixth quarter in a row. In contrast, net issuance of straight fixed rate bonds and notes by non-financial corporates rose from $10 billion to $20 billion.

European corporates are locking in low yields ...

Low borrowing costs also apparently led non-financial corporates to lengthen the maturity of their debt. The average maturity of the bonds issued by non-financial corporates increased from 9.9 years to 11.3 years. This is the highest average maturity since the first quarter of 1999. Indeed, some of the largest new issues took place at very long maturities. France Telecom, for example, raised a total of €1.5 billion with two 30-year issues, and Electricité de France raised €850 million with a similarly dated offering.

... and lengthening maturities

Convertible bond issuance rises substantially ...

Gross announcements of equity-related issues rose to $17 billion in the first quarter of 2003 from relatively low levels in the second half of 2002. Nearly all of the new equity-related issues were convertible bonds. In the first quarter of 2003, gross issuance of convertible bonds exceeded gross issuance of international equities for the first time since the third quarter of 1999. However, the issuance of international equities was very low. Furthermore, the increase in equity-related issues was not high enough to bring the total of equity-related and straight equity issuance back to the levels seen in 2000 and 2001.

For convertible bonds, credit, interest and equity risk play connected roles in the bond's intrinsic value, because investors have the option to convert the bond into a specific number of shares of equity. This optionality may make convertibles attractive to some investors in the current market conditions. The rising volatility of equity markets during the first quarter increased the value of the embedded option. Moreover, investors moving away from the depressed equity markets could buy an asset with the credit risk of a fixed income instrument and the upside potential of equities. Issuers are attracted by the lower yields usually paid on convertibles compared with normal fixed income instruments, due to the compensation for the embedded option. Finally, high demand for convertibles, mainly by hedge funds, had a downward influence on spreads, leading to increased issuance. This quarter the total sum of assets held by hedge funds using convertible bond arbitrage strategies was at its highest level.

... reflecting in large part an increase in mandatory convertibles

A relatively large proportion of convertibles are currently issued as mandatory convertibles. A mandatory convertible is automatically converted into equity at a specific maturity date, thus removing the optionality for the buyer of the convertible. The transfer of risk to the buyer is usually compensated by a higher yield. Companies want to issue mandatory convertibles in order to avoid their experiences of 1999 and 2000, when many telecoms companies issued convertibles in the expectation that they would be converted into equity at the time of redemption. In most cases the conversion did not take place due to the sharp decline in equity prices, leaving them with much higher than expected debt/equity ratios. Another attractive feature for the issuer of mandatory convertibles is that they are in general not treated by the rating agencies as pure debt. The biggest mandatory convertible issues in the first quarter of 2003 were a €2.3 billion offering by Deutsche Telekom and one of ¥345 billion ($2.9 billion) by Sumitomo Mitsui Financial Group.

Developing country borrowing recovers further

Developing country borrowers tapped the international debt securities market for an increased volume of funds in the first quarter of 2003, as sovereign spreads narrowed further (see the Overview). After growing by 28% between the third and fourth quarters of 2002, net issuance by developing country nationals rose by an additional 52% to $13.2 billion in the first quarter of 2003 (Table 3.1). However, issuance is still below the $17 billion average net quarterly issuance in the three years preceding the Asian financial crisis of 1997. The largest issue to be placed in the international debt securities market by a developing country borrower in the first quarter of 2003 was a $2 billion fixed rate bond floated by the United Mexican States that had a maturity of 10 years and was priced at a spread of 246 basis points over the 10-year US Treasury yield.

Developing countries' access to capital markets improves

The rise in developing country net new financing was highly concentrated. Indeed, almost two thirds of the expansion was the result of increased Brazilian borrowing alone. Brazilian nationals took advantage of reduced risk aversion amongst global investors and the easing of political uncertainty in Brazil in the

first quarter of 2003, and borrowed heavily. Their net issuance was $1.5 billion, compared to –$1.3 billion in the previous quarter. In the main, the borrowing was at the short end of the yield curve. Net issuance of money market instruments increased to $2.3 billion in the first quarter of 2003 from $0.6 billion in the previous quarter while net issuance of bonds and notes, at –$0.9 billion, remained negative for the second quarter in a row.

Even though Turkish spreads soared in mid-March on news that a multibillion dollar financial package from the United States would be drastically reduced, a generalised easing of political uncertainty allowed issuers from Turkey to again tap the international debt securities market for new funds. After three quarters of negative net issuance, they raised $0.2 billion in net new financing in the first quarter of 2003.

Collective action clauses in bonds are an important development

A significant development concerning emerging market borrowing was the incorporation of collective action clauses (CACs) in four sovereign bonds. CACs are provisions that allow a bond restructuring with the approval of a qualified majority of bondholders instead of their unanimous consent. These provisions are viewed as an alternative to international bankruptcy proceedings for dealing with potential sovereign defaults. The issuance of bonds with these clauses followed a long debate on how to improve procedures for sovereign debt restructuring. Prior to this, issuers had initially thought that the inclusion of CACs might increase their spreads.[1] At the same time, some investors had feared that CACs might be an indication of the likelihood the issuer attached to the probability of default.

Mexico and Brazil take the lead

One Mexican bond in the first quarter of 2003 and two Mexican bonds and one Brazilian bond at the beginning of the second quarter were issued with CACs. In some jurisdictions, such as under English law, CACs are generally included. The Mexican bonds were the first emerging market bonds with CACs from a major borrower on the international capital market issued under New York State law. The Brazilian bond was the first non-investment grade bond from a major borrower with CACs. In these four cases, the inclusion of the CACs did not seem to require any additional premium.

No harmonisation of CACs yet

By issuing bonds with CACs, Mexico tried to set a new benchmark, but there are several differences in the legal documentation between the bonds issued by Mexico and Brazil and the recently announced issuance of Uruguayan bonds. For example, there was much discussion on the actual threshold for a change in payments; Mexico set the percentage of bondholders who have to consent at 75%, while some investors proposed a higher figure. Uruguay announced that the same threshold would be used for the new bonds to be issued as result of the restructuring of its debt. However, a higher threshold of 85% was adopted for the Brazilian bond.

[1] Tsatsaronis (1999) finds evidence of such an effect but one that is not systematic (see K Tsatsaronis "The effect of collective action clauses on sovereign spreads", *BIS Quarterly Review*, November 1999, pp 22–23).