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Highlights of international banking and financial market activity[1]

The BIS, in cooperation with central banks and monetary authorities worldwide, compiles and disseminates several datasets on activity in international banking and financial markets. The following paragraphs draw on these data to highlight significant market developments. The latest available data on the international banking market refer to the first quarter of 2006. The discussion of the international debt securities market and exchange-traded derivatives markets draws on data for the second quarter of 2006.

The international banking market

Rapid expansion of international banking activity in the first quarter of 2006

Activity in the international banking market continued to expand at a rapid pace in the first quarter of 2006. Interbank and inter-office flows accounted for much of the increase in cross-border claims, although they seemed in turn to be driven by a pickup in corporate borrowing. Indeed, the rapid pace of cross-border activity coincided with strong growth in domestic lending to US and European firms, with capital spending and mergers and acquisitions helping to boost corporate demand for bank credit. Banks also reported a large increase in their cross-border claims on emerging markets, including substantial purchases of local currency debt securities. Emerging markets nevertheless experienced continued net outflows as a result of sizeable deposit placements with BIS reporting banks, most notably by Russian residents.

Locational banking statistics

The total cross-border claims of BIS reporting banks expanded by a record $1.4 trillion in the first quarter of 2006. The 18% yearly increase pushed the total stock of cross-border claims to $22.8 trillion. This surge mainly reflected an increase in new loans extended by banks located in the euro area and the United Kingdom. The growth of bank loans over the quarter interrupted the sustained decline of their share in total cross-border bank claims.[2] Since 1996,

[1] Queries concerning the locational banking statistics should be addressed to Goetz von Peter, those concerning the consolidated banking statistics and international debt securities statistics to Philip Wooldridge, and those regarding the derivatives statistics to Christian Upper.

[2] Cross-border claims comprise bank loans and holdings of debt and equity securities.

the loan share has declined by 15 percentage points in favour of securities holdings and currently stands at 72% (Graph 1, left-hand panel).

Large interbank and inter-office flows

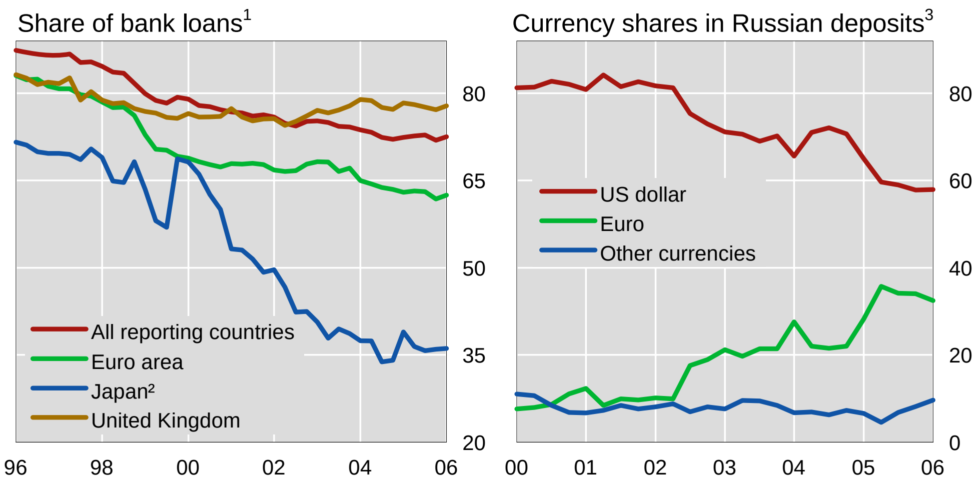
Interbank and inter-office activity explains a substantial part of the expansion in cross-border bank claims over the quarter, with much of the remainder accounted for by credit to corporates and other non-bank borrowers in the euro area and the United States. With the increase of $896 billion in claims on banks, 37% of which were inter-office transfers, claims on banks currently stand at 64% of total cross-border claims. However, the overall expansion in interbank lending concealed a $66 billion drop in claims on banks in Japan, which coincided with an $81 billion drop in banks' overall yen-denominated claims. At the same time, cross-border credits to euro area non-banks swelled by $137 billion, extended mostly by banks in the region; non-banks in the United States received $119 billion, granted mostly by banks in the United Kingdom.

Credit to emerging Europe and Asia-Pacific surges …

Cross-border claims on emerging market economies grew by a record amount of $99 billion in the first quarter of 2006. More than 60% of the increase reached non-banks, primarily in emerging Europe and Asia-Pacific.[3] A comparison across regions reveals that the expansion of total credit from BIS reporting banks was largest in emerging Europe ($46 billion), where it flowed mainly to Russia and Turkey, followed by Hungary, Poland and Cyprus. Notably, cross-border credit to Turkey increased by more than $10 billion for a second consecutive quarter. Cross-border claims on Asia-Pacific residents rose by $27 billion, mainly vis-à-vis non-bank borrowers in India and bank borrowers in China. The $13.7 billion of new credit to Latin America was

Locational banking data

Instrument and currency shares



[1] As a percentage of total cross-border claims, by reporting country. Bank loans include inter-office transfers and reverse repos. [2] Series contains a structural break in 1999 due to a change in banks' reporting of debt securities. [3] As a percentage of total cross-border deposits. The shares are adjusted for valuation effects using constant 2006 Q1 exchange rates. Graph 1

[3] More generally, emerging Europe and Asia-Pacific have been at the centre of the expansion of international credit to emerging markets since 2002; see "The international banking market", *BIS Quarterly Review*, June 2006.

extended almost entirely to borrowers in Brazil. Most of these flows originated in the United Kingdom and offshore centres, two major hubs in the international banking market.[4]

… and includes more local currency debt …

Purchases of debt securities accounted for almost one third of the increase in cross-border claims on emerging markets. As much as 40% of these new purchases are estimated to be denominated in local currencies, twice the corresponding share for cross-border holdings of emerging market securities.[5] This brought reporting banks' local currency bond holdings to $46 billion, primarily bonds from emerging Europe (especially Poland, Hungary, Russia and Turkey) and from Asia-Pacific (especially India, Malaysia, Korea and China). These cross-border holdings of local currency bonds suggest that foreign investors are increasing their participation in local currency markets as these are being developed.

… yet emerging markets see continued net outflows

Cross-border deposits by oil-exporting countries and Latin American residents outweighed the strong growth of cross-border claims on emerging markets. As a result, these markets experienced, on aggregate, a fourth consecutive quarter of net outflows, which adds up to a year-on-year net outflow of $113 billion. More than 40% of the $110 billion in new deposits by emerging market economies flowed out of Russia, and were placed predominantly in the euro area and the United Kingdom.[6] At the same time, the US dollar share in Russia's cross-border deposits continued to fall and now stands at 59%, down from 84% in mid-2001 (Graph 1, right-hand panel). Deposits by other oil-exporting countries, mainly Libya and Kuwait, as well as South Africa, drove a $22 billion net outflow from the Africa-Middle East region. Funds flowed out of Latin America as well, by a net amount of $12 billion, mainly as a result of new deposits by residents of Brazil. By contrast, large deposit withdrawals were made by residents of China, who withdrew $15 billion primarily from banks in Hong Kong, the United States and Singapore.

Consolidated international banking statistics on an immediate borrower basis

Expansion driven by European banks

The consolidated banking statistics, which are based on the nationality of the reporting bank and net out inter-office positions, indicate that the expansion in international banking activity in the first quarter of 2006 was driven mainly by European banks. Admittedly, the role of European banks is inflated by the large amount of cross-border activity within the euro area. Yet even excluding euro area banks' international claims on euro area residents, European banks

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[4] Banks in the United Kingdom and offshore centres currently intermediate 47% of worldwide cross-border banking flows, transforming deposit placements into international loans and securities holdings.

[5] These claims were reported in currencies other than the main international currencies, and exclude the domestic currency of reporting banks.

[6] The deposit liabilities vis-à-vis Russia may, in part, be attributed to the placement of official reserves. IMF data indicate that Russia's official reserves placed with banks outside the country rose by $12 billion during the first quarter of 2006. See "The international banking market", *BIS Quarterly Review,* September 2004, for a discussion of the long-term co-movement of Russian foreign exchange reserves and deposit liabilities of BIS reporting banks to Russia.

remained the most active creditors in the international banking market in the first quarter. UK and Swiss banks were largely responsible for the expansion of international claims on US residents, German banks for claims on UK residents, and UK banks for claims on emerging markets.[7]

Acceleration in corporate borrowing

An acceleration in corporate borrowing appeared to lie behind the increase in international banking activity. For example, in the first quarter of 2006, syndicated lending for mergers and acquisitions and leveraged buyouts was well above 2005 levels. In the euro area, such lending contributed to a rise in claims on the non-bank private sector from 56% of international claims on all non-bank borrowers at end-December 2005 to 59% at end-March 2006 (Graph 2, left-hand panel). In the United States, the non-bank private sector's share rose from 79% to 81% over the same period. Corporate demand for credit in turn generated substantial interbank flows, as banks turned to the interbank market to meet part of their funding commitments.

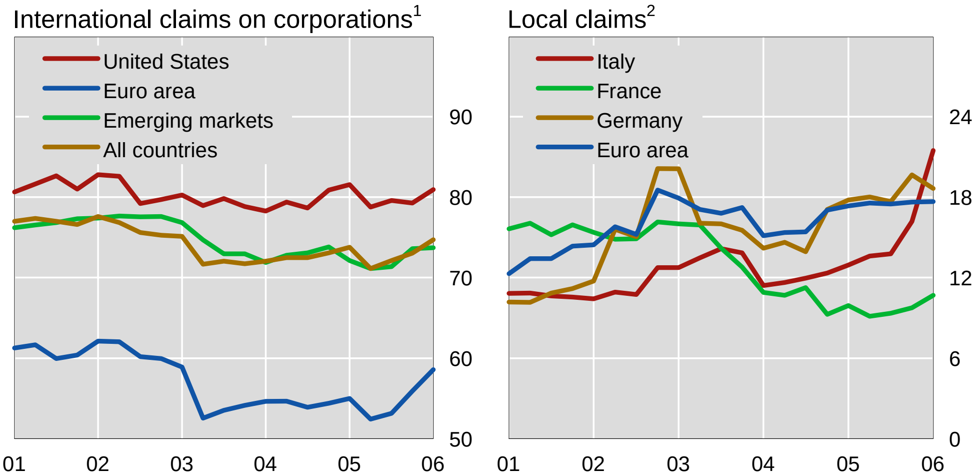
In emerging markets, the rise in banks' claims in the first quarter was broadly distributed across sectors and maturities. Credit to the public sector kept pace with credit to the non-bank private sector, leaving the latter unchanged as a share of international claims on all non-bank borrowers (Graph 2, left-hand panel). The proportion of international claims on emerging markets maturing within one year was also unchanged at 48%.

Mergers boost local claims on Italy

Local claims in local currency kept pace with international claims, expanding by about 20% between end-March 2005 and end-March 2006 after adjusting for currency movements. In some countries, mergers contributed to the increase in local claims. Local claims had until recently accounted for an

Distribution of the consolidated claims of BIS reporting banks

By residency of immediate borrower



[1] Claims on the non-bank private sector as a percentage of claims on non-banks (public plus private). [2] Claims booked by reporting banks' foreign offices on residents of the country in which the foreign office is located and denominated in local currencies; as a percentage of foreign claims (international plus local).

Graph 2

[7] International claims comprise cross-border claims in all currencies plus local claims in foreign currencies. Local claims refer to claims booked by reporting banks' foreign offices on residents of the country in which the foreign office is located.

unusually small proportion of foreign claims on Italy: 13% at end-March 2005 (Graph 2, right-hand panel). Among countries in the euro area, only in France was this proportion lower, at 10%. The takeover of two Italian banks by French and Dutch banks in late 2005 resulted in a sharp rise in foreign banks' local claims on Italian residents, and at end-March 2006 they accounted for 21% of foreign claims on Italy, slightly above the average for the euro area.

Consolidated international banking statistics on an ultimate risk basis

The consolidated banking statistics, when compiled on an ultimate risk basis, ie taking into account cross-border risk transfers, provide a comprehensive measure of banks' country risk exposures. They suggest that banks in the reporting area either maintained or increased their exposures to almost all countries in the first quarter of 2006, including a number of countries where financial markets were unusually volatile.

Market volatility has little impact on banks' exposures to Iceland …

The turmoil in Icelandic financial markets in February and March 2006 did not appear to lead foreign banks to reassess their exposures to Iceland. In late February 2006, Fitch's announcement of a negative outlook on Iceland's sovereign rating had led some foreign investors to liquidate their króna investments, resulting in a sharp depreciation of the currency. Foreign banks, however, further increased their exposures to Iceland in early 2006. Foreign claims on the country, on an ultimate risk basis, totalled $23 billion at end-March 2006, up from $19 billion at end-December 2005 and $12 billion a year earlier.[8] Unused credit commitments were more or less unchanged in the first quarter of 2006 at $3 billion, suggesting that the increase in claims was not driven by a drawdown of previously arranged lines of credit. Guarantees extended by reporting banks, including protection sold through credit derivatives, were also more or less unchanged at $3 billion. Meanwhile, volatility in foreign exchange and asset markets contributed to a 50% increase in the market value of derivatives exposures, to $1 billion. German banks were the single largest creditors, with foreign claims of $8 billion at end-March 2006. However, exposures to Icelandic borrowers were a tiny fraction of BIS reporting banks' total foreign exposures, only 0.1% on average.

… and the Gulf region

In the Middle East, too, the precipitous decline in equity prices in March 2006 had no apparent consequences for banks' exposures to the region. This is consistent with the perception that the decline was unrelated to any change in fundamentals. Foreign claims on Saudi Arabia and other countries in the Gulf Cooperation Council (GCC) increased rapidly in late 2005 and early 2006, from $67 billion at end-June 2005 to $90 billion at end-March 2006.[9] Guarantees and unused credit commitments boosted potential exposures by a further $50 billion, and derivatives contracts added $4 billion. Credit to borrowers in the United Arab Emirates (UAE) drove the increase and

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8 According to the BIS locational statistics, about 70% of outstanding cross-border claims on Iceland were denominated in euros. Therefore, fluctuations in the euro/US dollar exchange rate will have a significant impact on consolidated claims reported in US dollars.

9 The GCC comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

by end-March 2006 accounted for almost half of outstanding claims on the GCC countries. UK banks were the largest foreign bank creditors in the region, with foreign claims of $36 billion at end-March 2006, including sizeable local operations in the UAE. Euro area banks, led by French and German banks, held claims totalling $34 billion.

Large net liabilities to Lebanon

Banks' exposures to Lebanon, never large, had declined even before the breakout of hostilities in July 2006. Foreign claims totalled only $4.3 billion at end-March 2006, down from about $7 billion a year earlier. Credit commitments and guarantees added $1.5 billion. Banks' small exposures to Lebanon, however, belie the country's role in the international banking market. The locational international banking statistics suggest that Lebanon provides a sizeable amount of funding to banks, with cross-border liabilities to Lebanese residents exceeding cross-border assets by $23.6 billion at end-March 2006.

The international debt securities market

Strong issuance in the international bond market in the second quarter of 2006 …

Investors' retreat from higher-risk assets in May 2006 seemed not to dampen issuance in the international debt securities market in the second quarter. Gross issuance of bonds and notes totalled $1.1 trillion, close to the exceptionally strong pace recorded in the first quarter of 2006. Repayments rose slightly, and so net issuance of bonds and notes slowed to $551 billion in the second quarter from $630 billion in the first. Nevertheless, net issuance was still well above the previous year's pace.

… driven by securitisation vehicles …

Issuance in the international debt securities market in the second quarter was driven by non-bank financial institutions, including special purpose vehicles. They raised a record $536 billion in bonds and notes, up from $463 billion in the first quarter. Several of the largest transactions were securitisations. For example, the German government raised €7.5 billion through its second securitisation of pension contributions payable by the federal postal services' successor companies.

… and non-financial corporations

Borrowing by non-financial corporations remained at the elevated levels seen in the first quarter. International bond and note issuance by euro area corporations was especially strong at $45 billion, exceeding the previous peak of activity in early 2001. Mergers and acquisitions were partly responsible for the high volumes. For example, German chemical company Bayer placed three issues totalling $3.7 billion to finance its planned takeover of German pharmaceutical company Schering. An unusually large proportion of corporate issuance was at floating rates: 19% in the second quarter of 2006, compared to 11% on average over the 2004–05 period.

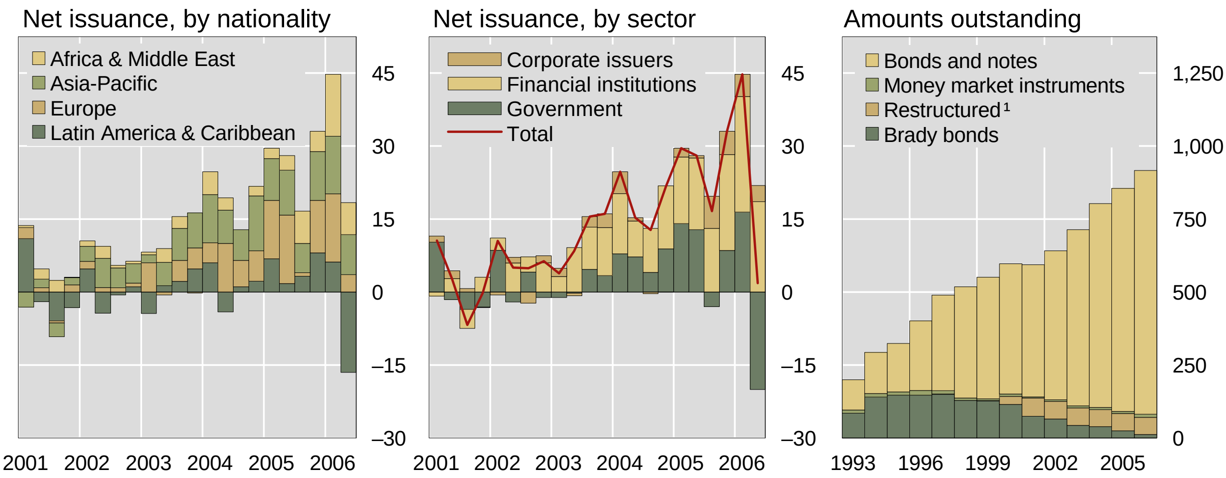
Emerging market issuance slows sharply …

In contrast to issuance by industrial country borrowers, issuance by emerging market borrowers slowed sharply in the second quarter. In particular, sovereigns were virtually absent from the international debt securities market. Gross issuance of bonds and notes totalled $31 billion, its lowest level in two years and about half the amount raised in the first quarter. Net issuance was close to zero (Graph 3).

The slowdown in emerging market issuance seemed unrelated to the deterioration in financing conditions in May 2006. In fact, issuance was

Emerging market bonds

In billions of US dollars



[1] Mainly defaulted debt restructured by Argentina and Russia.

Sources: Bloomberg; Dealogic; Euroclear; ISMA; Thomson Financial Securities Data; national authorities; BIS. Graph 3

weakest in April, when spreads were near record lows, and strongest in May, when spreads widened. Furthermore, issuance by financial institutions and corporations remained robust throughout the quarter. Financial institutions from Kazakhstan were among the most active emerging market issuers, raising $2.6 billion in the US dollar market. Concerns about possible currency mismatches on the banks' balance sheets led the Kazakh authorities, in mid-June 2006, to announce additional measures to slow the rapid increase in Kazakh banks' foreign currency borrowing.

… because sovereigns are already well funded

The slowdown in emerging market issuance appeared to reflect the favourable financial position of many emerging market sovereigns. By the first quarter of 2006, governments had already funded a large part of their external financing requirements for 2006. The current account surpluses posted by many emerging market countries also reduced the need for external financing, including in Latin America.

Indeed, Latin American governments, long the most active emerging market borrowers, made substantial early repayments in the second quarter. Brazil exercised a call option to retire almost all of its outstanding Brady bonds. Venezuela also retired the bulk of its outstanding Brady bonds. Debt exchanges and early repayments reduced total outstanding Brady debt to $12 billion at end-June 2006, down from $150 billion at its peak in 1997 (Graph 3).

Derivatives markets

Buoyant activity in exchange-traded derivatives in the second quarter …

Trading on the international derivatives exchanges was buoyant in the second quarter. Combined turnover measured in notional amounts of interest rate, equity index and currency contracts increased by 13% to $484 trillion between

April and June 2006, following a 24% rise in the previous quarter.[10] The high rate of growth in the first quarter had been caused by a surge in activity in US money market derivatives, which reverted to a more normal pace in the following three months.[11]

… in all risk categories

Trading volumes rose in all risk categories. Activity in contracts on short-term interest rates increased by 15%, while trading in derivatives on stock price indices and on government bonds grew by a more moderate 6% and 5%, respectively. Turnover in futures and options on foreign exchange increased by 21%, outpacing activity in the other risk categories. However, with a turnover of merely $4.2 trillion, or less than 1% of total volume traded on the international derivatives exchanges, the FX segment remains of limited importance as this type of risk tends to be traded over the counter.

Anticipation of BoJ rate hike lifts trading in yen contracts …

Trading volumes in contracts on short-term yen interest rates soared ahead of the rate hike by the Bank of Japan in July, although they remain low both by historical standards and relative to activity in other currencies. Rates had remained at virtually zero for more than five years, which had contributed to a dearth of activity in derivatives on short-term Japanese interest rates (see the feature on the link between monetary policy and activity in money market derivatives on pp 65-76 of this issue). Futures turnover increased by 46% in the second quarter of 2006, while options volumes soared by 130%. However, at just below $10 trillion between April and June, of which about $1 trillion was in options, turnover in derivatives on short-term Japanese interest rates remained a fraction of the volumes recorded in other currencies. This contrasts with the mid-1990s, when contracts denominated in yen briefly accounted for over one fifth of worldwide turnover in exchange-traded money market derivatives (Graph 4).

… but volumes remain low by international standards

Activity was also buoyant in some smaller currencies but more muted in the US dollar and the euro. Rapid increases in turnover during the quarter under review were also recorded in contracts on short-term Australian interest rates (44%), followed by derivatives on rates in the New Zealand dollar (28%), pound sterling (26%) and Canadian dollar (22%). Trading volumes in futures and options on short-term US dollar and euro interest rates grew by a more moderate 13% each.

Turnover in equity index derivatives reaches new high

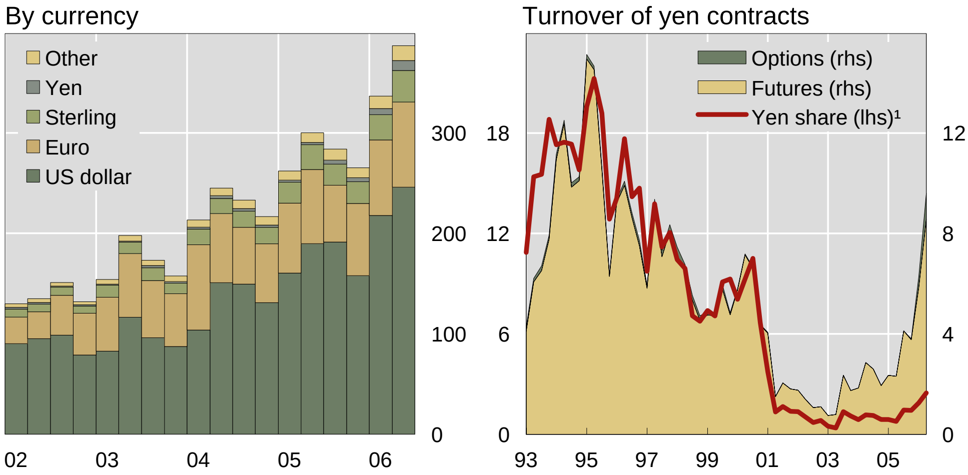
Heavy trading during the sell-off in May and June lifted turnover in stock index contracts to a new high. Turnover measured by notional amounts reached $46 trillion between April and June, 6% higher than in the first quarter of this year. In contrast to the preceding three months, the rise in activity was genuine and not merely the result of valuation effects. Turnover growth in stock index contracts was particularly strong in some English-speaking countries, above all Canada (47%), the United States, the United Kingdom and Australia (all 19%). Rapid growth was also recorded in contracts on Swedish equity indices (18%). Trading in euro-denominated contracts rose by almost one third

[10] All growth rates refer to quarter-on-quarter changes, unless otherwise stated.

[11] Data on the volume of over-the-counter derivatives are published in the June and December issues of the *BIS Quarterly Review*.

Turnover in short-term interest rate contracts

Quarterly data, in trillions of US dollars



[1] As a percentage of world total.

Sources: FOW TRADEdata; Futures Industry Association; BIS calculations. Graph 4

in terms of the number of contracts traded, but increased by only 8% in terms of notional amounts. Weaker activity was recorded in Korea, where trading in stock index contracts declined by 11% in terms of both the number of contracts and notional amounts.

FX contracts surge on dollar volatility

Sharp movements in the US exchange rate led to a 23% rise in turnover in futures and options on foreign exchange in the second quarter. Trading volumes in euro FX contracts listed on the Chicago Mercantile Exchange reached $750 billion in May alone. During the quarter as a whole, activity in this contract rose by almost one third, while turnover in yen derivatives was up 23%. Jointly, these two contracts account for more than one half of worldwide turnover in exchange-traded currency derivatives. Even more rapid growth was recorded in some emerging markets, for example in Russia (82%) and Korea (67%), even though the two currencies concerned did not experience any extraordinary volatility in the period under review. Turnover in Turkey increased by 172%, albeit from a low base. The Turkish lira was affected particularly strongly by the sell-off in May and June.

Strong trading in commodity contracts

The number of commodity contracts traded on the international derivatives exchanges (notional amounts are not available) grew by 10% in the second quarter. In the previous three months, activity had increased by 18%, mainly reflecting a 37% surge in activity in energy derivatives as oil prices had reached new highs. Trading in that product category continued to expand in the second quarter, in line with further price increases, but growth slowed to 8%. Turnover in contracts on agricultural commodities rose by 10% and that in derivatives on base metals by 7%.

Gold contracts peak during sell-off

Rapid growth (21%) was recorded in the precious metals segment of the commodity derivatives market. Turnover in futures and options on gold soared to over 6,000 contracts (measured in 100 ounce contract equivalents to account for a shift towards smaller-sized contracts) in May alone. This was more than one fifth above the previous monthly high in late 2005. In June, turnover in gold contracts declined to 4,700. The monthly pattern of turnover in gold contracts contrasts with that of contracts on silver or non-precious metals, which peaked in April and subsequently declined. This is puzzling because price developments were largely similar.