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Monetary and Economic Department

INTERNATIONAL BANKING AND FINANCIAL MARKET DEVELOPMENTS

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C O N T E N T S*

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I

OVERVIEW OF RECENT INTERNATIONAL BANKING AND FINANCIAL MARKET DEVELOPMENTS

Following some easing of market tensions in Asia in the earlier part of the year, there was renewed financial turbulence in the second quarter of 1998. Nervousness about economic and financial conditions in Japan accentuated the coolness towards yen-denominated assets. At the same time, problems of policy credibility in several Asian countries led to renewed pressures on currencies in the region, with particular attention being paid to the risk of a devaluation of the Chinese yuan. These events, together with the weakness of commodity prices and, in some cases, political uncertainty initiated a new wave of contagion to other emerging market economies, triggering a flight towards the perceived safe-haven markets of the United States and Europe. Thus, long-term bond yields in the United States and continental Europe resumed their downward trend, helped in the latter case by improved confidence in the process of establishing monetary union. Interestingly, upward movements in equity indices pointed to investors' greater preference for continental European assets, reflecting growing perceptions of the strength of the European economic recovery.

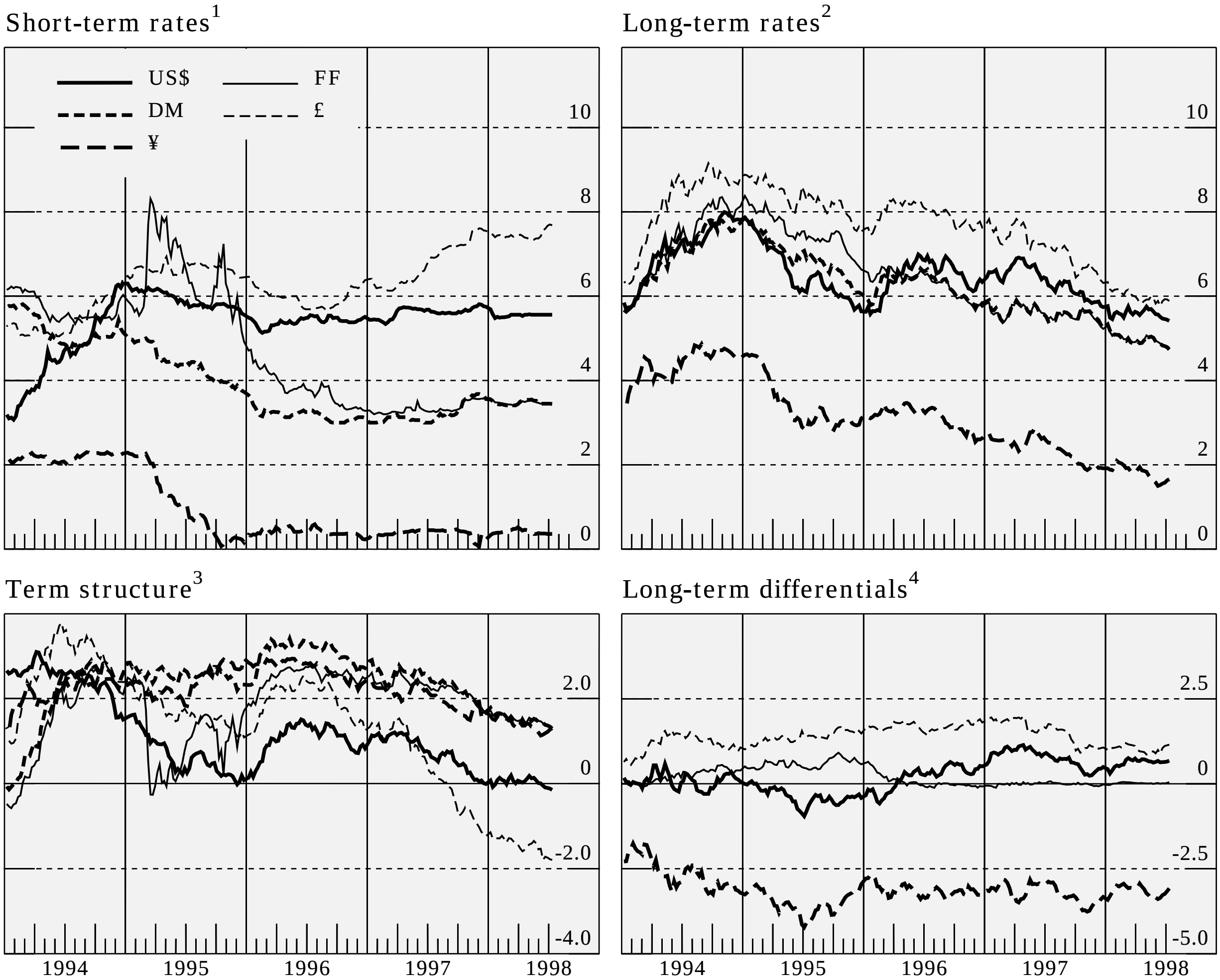
In this unsettled environment, announcements of international debt securities in the second quarter of 1998 receded from the all-time record of the first quarter. Although in part a natural slowdown after the hectic pace of issuance seen in the previous quarter, activity nevertheless remained fairly well sustained, suggesting that positive factors remained sufficiently strong to offset heightened concerns about risk. Prime among these supportive elements were the ongoing diversification of international financing, the search for higher returns, the wave of mergers and acquisitions and the development of a pan-European securities market. At the same time, the distinction between domestic and international securities continued to blur. In particular, fiscal consolidation in the industrial world has opened new windows of opportunity for a wide spectrum of highly rated names through instruments crossing over market segments. Increased awareness of country and counterparty risks was reflected in a rise in the risk premia attached to syndicated bank loans and securities issued by emerging market names. Simultaneously, credit derivatives were increasingly used for adjusting exposures, as an alternative to secondary market sales, contributing to progress in the area of credit risk management.

Meanwhile, the comprehensive BIS banking statistics now available for the first quarter of 1998 show that the unprecedented expansion seen in international bank lending during the fourth quarter of last year was not sustained. The turnaround reflected Japanese banks' retreat from both interbank and final lending business, masking the continuing buoyancy in the activity of EU banks. The expansion recorded by the latter group was largely driven by intra-European transactions, reflecting both some redirection of activity back to Europe in the wake of the Asian crisis and positive perceptions concerning EMU. Banks' growing involvement in securities trading (in particular through repos) seems to have been another contributing factor, although this may also have exacerbated short-term swings in the lending aggregates. In contrast, and notwithstanding the ample supply of loanable funds worldwide, reporting banks sharply reduced their exposure to Asia. This appears to have only marginally benefited other regions in the developing world, with special factors sustaining lending activity in a small number of countries. In turn, the reluctance of international banks to provide additional funds to emerging economies raised the vulnerability of certain countries to a new deterioration of market conditions.

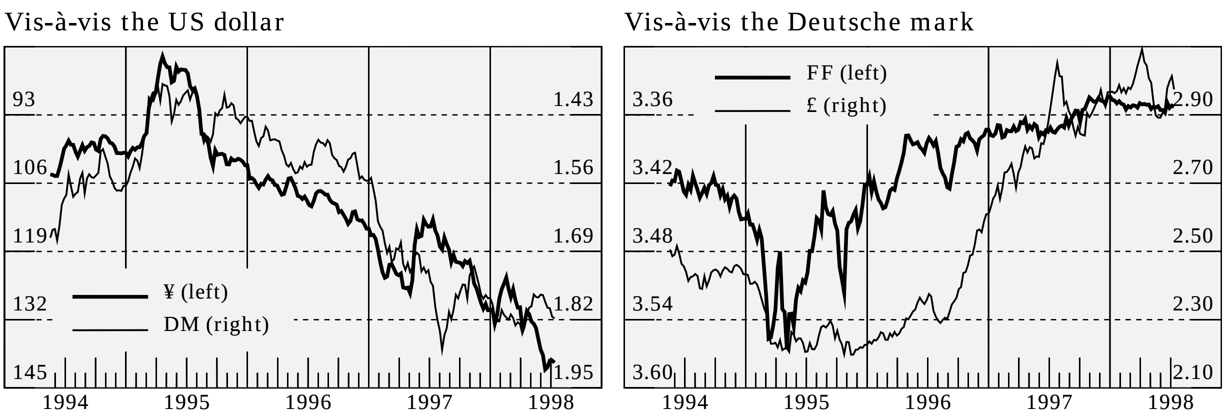
The resurgence of financial turbulence in the second quarter of 1998 lent a new sense of urgency to addressing the issues of crisis prevention and resolution. Despite the numerous initiatives that have been spurred by the Asian crisis, national and international authorities continue to face several dilemmas, such as reconciling domestic and external constraints and reducing the risk of moral hazard through an appropriate sharing of the financial costs of crises. Recent events have also underlined the need to adapt the "architecture of the world financial system, which is increasingly

International short and long-term interest rates

Weekly averages, in percentages and percentage points



Bilateral exchange rates



[1] Three-month euromarket interest rates. [2] Yields in annual terms on the basis of ten-year benchmark government bonds. [3] Long-term rates minus short-term rates. [4] Vis-à-vis German long-term rates.

Sources: Datastream, national data and BIS.

Estimated net financing in international markets[1]

In billions of US dollars

Components of net International financing	1996	1997				1998		Stocks at end-March 1998
	Year	Year	Q2	Q3	Q4	Q1	Q2	
Total international[2] bank claims[3]	604.1	1,190.5	224.9	140.9	451.1	-0.4	..	10,246.8
minus: interbank redepositing	184.1	720.5	109.9	45.9	381.1	-55.4	..	4,976.8
A = Net international bank lending[3]	**420.0**	**470.0**	**115.0**	**95.0**	**70.0**	**55.0**	..	**5,270.0**
B = Net money market instruments	**41.1**	**19.8**	**5.3**	**9.8**	**-2.4**	**10.7**	**1.4**	**193.2**
Total completed bond and note issues	860.5	1,016.6	252.7	279.2	231.9	294.0	293.5	
minus: redemptions and repurchases	364.0	461.2	99.9	115.3	137.6	124.3	89.8	
C = Net bond and note financing	**496.5**	**555.4**	**152.8**	**164.0**	**94.3**	**169.6**	**203.7**	**3,465.8**
D = Total international financing[4]	**957.6**	**1,045.2**	**273.1**	**268.8**	**161.8**	**235.3**	..	**8,928.9**
minus: double-counting[5]	187.6	155.2	23.1	73.8	11.8	75.3	..	1,293.9
E = Total net international financing	**770.0**	**890.0**	**250.0**	**195.0**	**150.0**	**160.0**	..	**7,635.0**

[1] Changes in amounts outstanding excluding exchange rate valuation effects for banking data and euronote placements; flow data for bond financing. [2] Cross-border claims in all currencies plus local claims in foreign currency. [3] See notes to Table 1 of the statistical annex. [4] A + B + C. [5] International bonds purchased or issued by the reporting banks, to the extent that they are taken into account in item A.

beyond the reach of national regulatory powers.[1] This highlights the need for improved international cooperation between supervisors.[2] Other recent developments, such as the wave of mega-mergers and alliances in the financial industry and the restructuring currently taking place in derivatives markets (as described in Part IV of this commentary) are also likely to lead to a broader reconsideration of supervision and regulation. Compounding these challenges are the pressing issues related to the advent of the euro, which has contributed to the process of global financial consolidation, and the transition to the next millennium. [3] All these developments will test the ability of the various groups of actors, in both the private and public sectors, to cope with the greater interdependence of global financial markets.

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[1] See the proposals included in the communiqué issued by the Group of Seven finance ministers following their meeting in London on 9th May 1998.

[2] The considerable swings displayed by short-term international banking flows since the eruption of the Asian crisis have already led to suggestions that supervisory measures may be required. See the comments made by the Chairman of the US Federal Reserve System in his speech at the 34th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago on 7th May 1998.

[3] On 19th May 1998, the BIS issued a press release providing details on the missions and projects of the “Joint Year 2000 Council” set up by the Basle Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors and the International Organization of Securities Commissions. Information on the Council’s objectives and activities can be found on http://www.bis.org.

II

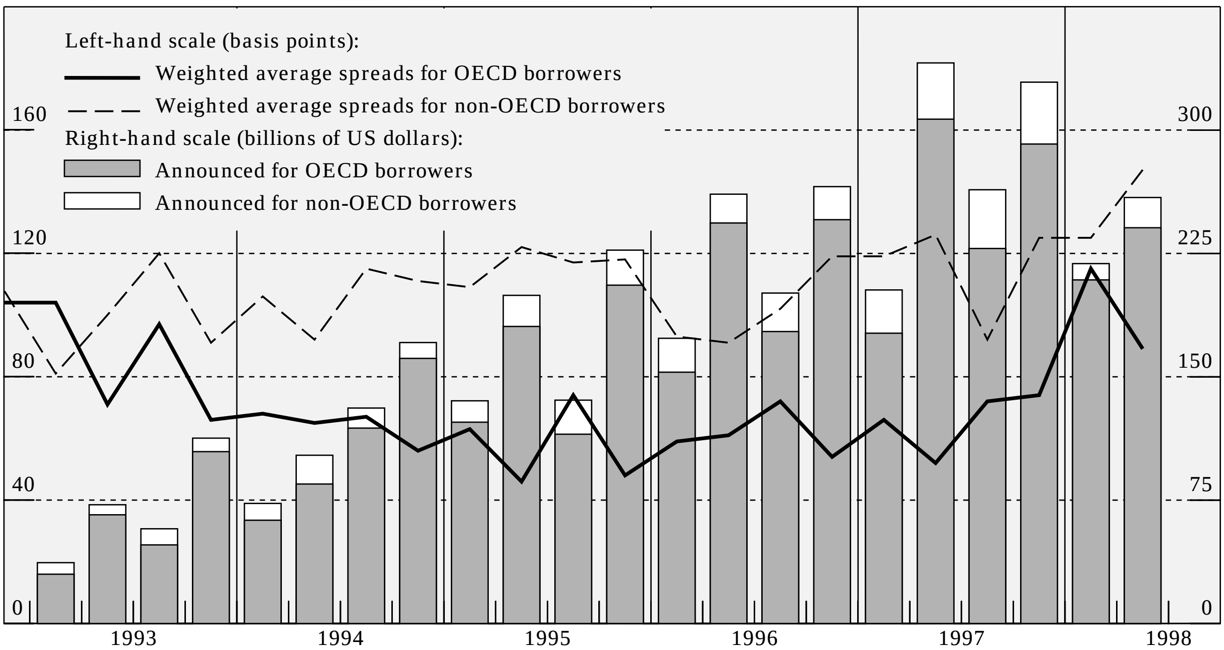
THE INTERNATIONAL BANKING MARKET

Overview

Activity in the international syndicated loan market rebounded in the *second quarter of 1998* owing primarily to the arrangement of exceptionally large deals. The overall volume of transactions rose by 18% relative to the revised total for the first quarter of the year, to $259 billion. There was some recovery in commitments to emerging market countries, but overall lending to this part of the world remained subdued. The consolidation taking place in the banking industry, the retreat of Japanese and other Asian banking groups from the syndicated loan market and the new wave of financial turbulence in the emerging market world led to a further tightening of lending conditions for lower-rated entities. This encouraged borrowers to seek alternative financing in bond markets. While the growing involvement of non-bank lenders often compensated for the reduced participation of commercial banks, the active disposal of assets by some intermediaries was associated with pricing uncertainty in the primary market. US investment banks continued to expand their activities in the loan market, using their expertise in leveraged and sub-investment-grade financing to position themselves as one-stop suppliers of financial services to large corporations. Their growing influence was also reflected in a number of practices that are bringing the loan market closer to securities markets, such as the right of arrangers to modify the pricing of transactions after syndication has begun and the incorporation of clauses providing for the transferability of participations. At the same time, the growing use of credit derivatives (default swaps in particular) provided greater scope for adjusting credit exposures. Such techniques are increasingly used as an alternative to secondary market sales, allowing the preservation of customer relations (since the consent of original borrowers is not required) and the offering of ancillary services.

Detailed data on international banking positions now available for the *first quarter of 1998* show that the unprecedented expansion in outstanding claims recorded in the final quarter of last

Announced facilities in the international syndicated credit market and weighted average spreads*



* Spreads over LIBOR on US dollar credits.

Sources: Euromoney and BIS.

Main features of international lending by BIS reporting banks[1]

In billions of US dollars

Components of international bank lending	1996	1997					1998	Stocks at end-March 1998
	Year	Year	Q1	Q2	Q3	Q4	Q1	
Claims on outside-area countries	**141.4**	**98.9**	**41.9**	**34.0**	**25.8**	**-2.7**	**-2.0**	**1,200.7**
Claims on inside-area countries	**446.2**	**1,100.0**	**312.7**	**172.9**	**148.8**	**465.6**	**0.9**	**8,814.0**
Claims on non-banks	302.2	247.4	81.8	54.9	80.0	30.7	39.9	2,770.0
Banks' borrowing for local onlending[2]	-40.1	132.2	47.3	8.1	22.9	53.9	16.4	1,067.3
Interbank redepositing	184.1	720.5	183.6	109.9	45.9	381.1	-55.4	4,976.8
Unallocated	**16.4**	**-8.5**	**19.1**	**18.0**	**-33.6**	**-11.9**	**0.7**	**232.0**
Gross international bank lending	**604.1**	**1,190.5**	**373.6**	**224.9**	**140.9**	**451.1**	**-0.4**	**10,246.8**
Net international bank lending[3]	**420.0**	**470.0**	**190.0**	**115.0**	**95.0**	**70.0**	**55.0**	**5,270.0**
Memorandum item: Syndicated credits[4]	**900.9**	**1,136.3**	**202.7**	**340.8**	**263.7**	**329.1**	**218.8**	**..**

[1] Changes in amounts outstanding excluding exchange rate valuation effects. [2] Estimates of international borrowing by reporting banks, either directly in domestic currency or in foreign currency, for the purpose of local onlending in domestic currency (see also notes to Table 1 of the statistical annex). [3] Defined as total international claims of reporting banks minus interbank redepositing. [4] Announced new facilities.

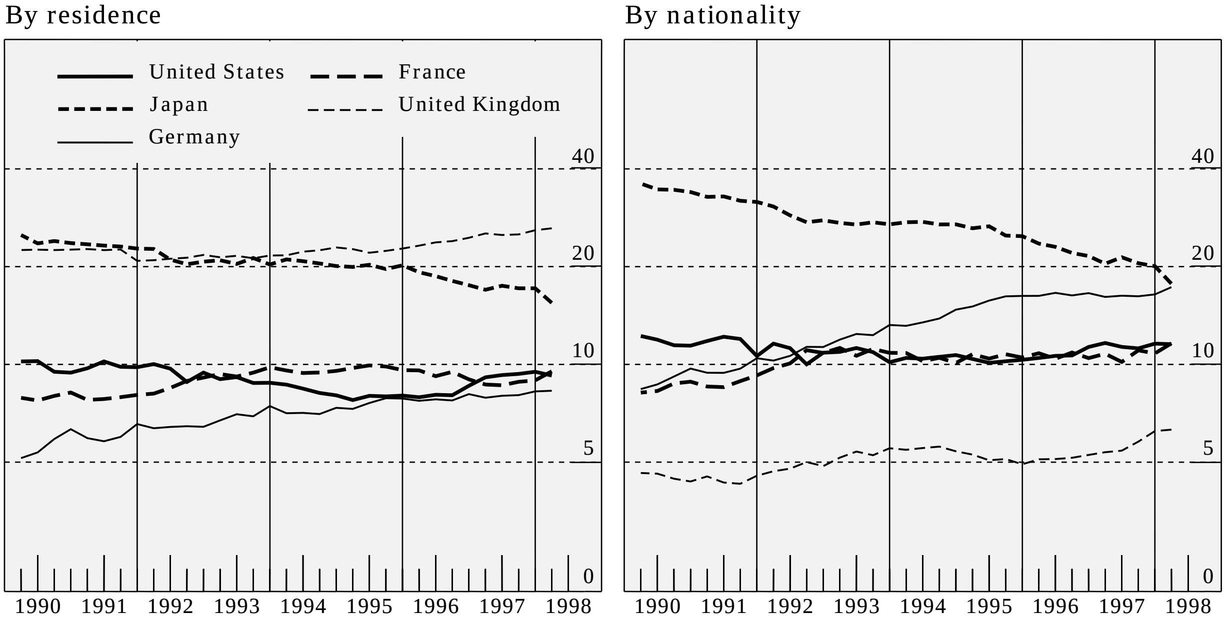
year ($451 billion) was not sustained (with a decline of $0.4 billion). The most important single factor behind the turnaround was the cutback in Japanese banks' foreign assets. In the closing months of 1997, these banks had supplied large amounts of liquidity to their foreign affiliates in response to the tightening of lending conditions in the international interbank market. The pull-back by Japanese banks in the period under review amounted to a record $244 billion, with the trimming of balance sheets affecting both their domestic and foreign books, most notably those held in the Hong Kong Special Administrative Region of China. Although they remained the largest international lending group among reporting banks at the end of March 1998 (see the graph on the next page and Annex Table 7A), the proportion of Japanese bank loans in total claims outstanding has slipped from a peak of one-third at the beginning of the decade to less than 20%. The market share of Japanese banks has now fallen back to the level of the early 1980s.

However, excluding the positions of Japanese banks, international banking activity expanded at a sustained pace in the first quarter of 1998 (by some $230 billion, according to rough estimates). The most important supporting factor was the strong growth recorded in the "international assets" of EU banks. Such business includes a large volume of intra-European transactions and, in particular, local credits denominated in European currencies and ECUs, which will be redefined as domestic lending with the advent of the euro. While the phasing-in of European economic and monetary union (EMU) continued to act as a catalyst for the expansion of transactions in European currencies between and within European financial centres, the Asian crisis may also have contributed to bringing business back to Europe (see "Business with countries inside the reporting area" below).

At the same time, and also partly reflecting the behaviour of Japanese banks, the decline in reporting banks' exposure to emerging economies in Asia intensified in the first quarter. This also seems to have been accompanied by some shift in the focus of activity in favour of Latin America and Eastern Europe. However, the movement was more apparent than real, since the upswing in both regions was due primarily to specific factors affecting two countries only, namely Brazil and Russia. Admittedly, the general easing of risk premia on the outstanding debt securities of Latin American borrowers suggests that, in the main, contagion was contained in the first quarter. Nevertheless, the growing reluctance of international lenders and investors to provide additional funds to emerging market economies has undoubtedly heightened the vulnerability of these countries should there be a

International bank lending by residence and nationality of reporting banks*

Percentage shares, at end of quarter; semi-logarithmic scale



* Cross-border claims and local claims in foreign currency of banks located in industrial reporting countries.
Source: BIS.

new wave of disturbances or a reappraisal of market conditions (see the box at the end of the section for developments in the second quarter).

Business with countries inside the reporting area

Whereas the United States had been the major recipient of the funds channelled through the international banking market in the fourth quarter of 1997, developments in the first three months of this year show a clear movement in favour of Europe (see Annex Tables 5A and B). The flight to quality in the wake of the Asian crisis may have helped accentuate the reduction in risk premia within the European Union. Interestingly, Italian entities were by far the main borrowers, followed by those located in Germany, France and the Netherlands. While reporting banks purchased a high volume of Italian securities, they also responded to strong borrowing demand in lire. Unfortunately, the available data do not permit a distinction between short-term trading and long-term investment strategies. In particular, an increase in repo activity involving Italian Treasury paper may have inflated the actual flows of funds. A similar interpretation can be given to the strong parallel expansion recorded in banks’ assets denominated in Deutsche marks and the group of “unallocated” currencies (possibly under the influence of peseta transactions in the latter case).

It should be stressed, moreover, that the use of European currencies in banking activity outside their country of issue continues to be limited in the main to European entities. Thus, while 85% of the stock of dollar deposits held outside the United States by non-bank entities is accounted for by non-US residents, the proportion of deposits in EU currencies held by non-EU entities is only 17%. However, some rebalancing may be expected following the advent of the euro.

Business with countries outside the reporting area

The detailed BIS quarterly international banking statistics available for the first quarter of 1998 provide a measure of the reduction which took place in international banks’ exposure to Asia during this period of renewed market turbulence ($34 billion). The data also seem to support earlier anecdotal evidence of uneven contagion elsewhere. There was an acceleration in banking flows in favour of Latin America ($16 billion) and, to a lesser extent, Eastern Europe ($7 billion). However,

Currency composition of international bank lending[1]

In billions of US dollars

Currencies	1996	1997					1998	Stocks at end-March 1998
	Year	Year	Q1	Q2	Q3	Q4	Q1	
Banks in industrial reporting countries	**556.1**	**1,039.4**	**312.0**	**148.6**	**145.2**	**433.6**	**108.9**	**8,335.9**
US dollar	133.0	460.8	133.6	79.5	32.8	214.8	-60.4	3,739.8
Deutsche mark	109.8	123.3	32.5	-14.9	42.3	63.5	51.0	1,150.7
Japanese yen	61.2	174.6	7.3	9.9	23.3	134.1	-116.3	831.9
Italian lira	101.1	71.3	12.3	22.6	25.3	11.1	74.0	446.9
Pound sterling	32.2	84.2	37.3	12.0	1.9	33.1	19.9	428.3
French franc	0.4	31.7	8.0	32.2	-15.8	7.3	21.8	344.4
Swiss franc	14.8	27.9	11.4	8.2	0.8	7.6	15.1	287.1
ECU	-26.4	-11.9	-5.0	-12.3	0.1	5.4	9.7	141.2
Other and unallocated[2]	129.9	77.4	74.8	11.4	34.5	-43.3	94.2	965.5
Banks in other reporting countries[3]	**48.0**	**151.2**	**61.6**	**76.3**	**-4.2**	**17.6**	**-109.3**	**1,910.9**

[1] Changes in amounts outstanding excluding exchange rate valuation effects. [2] Including all non-dollar positions of banks in the United States, for which no currency breakdown is available. [3] No currency breakdown is available.

activity in these two regions was heavily weighted towards Brazil and Russia on account of a specific set of influences, whereas lending to most Latin American countries outside Brazil slackened. New credit to the Middle East came to an abrupt halt, possibly reflecting the weakening in the financial position of countries largely dependent upon oil revenues. Lastly, a large proportion of outside-area lending was made on a collateralised basis. Although this development is not new, its scale seems to have increased in recent quarters. While such secured lending may have alleviated the drying-up of funds in the initial stages of the Asian crisis, the sharp unwinding of these positions thereafter may have aggravated the liquidity squeeze. Indeed, this may have added to the volatility of financial flows in the second quarter, when the new bout of financial turbulence in Asia had profound repercussions on emerging market economies (see the box at the end of this section). It also underlines the importance of having information on the maturity structure of international bank lending (which relies on a different statistical framework – see Part V of this commentary).

The fall in reporting banks' outstanding exposure to Asia was broadly spread among the major debtor countries excluding China (see Annex Table 5A), but it was most dramatic in Korea ($16.3 billion), followed by Thailand ($8.5 billion) and Indonesia ($5 billion). The banks' retreat from Korea was mitigated by the exchange of some $22 billion of short-term claims on Korean banks into longer-term loans guaranteed by the Government. In all three countries, a sharp contraction in trade credit and the unwinding of collateralised short-term loans granted earlier were possibly the most important influences. The decline would have been larger had it not been for the accumulation of arrears, including by institutions taken over by the authorities pending restructuring. In view of these developments, China has become the largest bank debtor in Asia, with the local banking system being by far the main channel for such external financing. However, the country's external banking debt, at $90 billion, also needs to be seen in relation to the $70 billion of deposits held by Chinese resident entities with reporting banks (which includes a proportion of the country's $140 billion foreign exchange reserves).[4]

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[4] Nonetheless, it is not generally appropriate to net out assets and liabilities in assessing a country's vulnerability to external debt, since the two sides are not fully comparable. To the extent that deposits held by residents abroad (and

Banks' business with countries outside the reporting area*

In billions of US dollars

Outside-area country groups	1996	1997					1998	Stocks at end-March 1998
	Year	**Year**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	
Total assets	**141.4**	**98.9**	**41.9**	**34.0**	**25.8**	**-2.7**	**-2.0**	**1,200.7**
Developed countries	22.8	25.2	4.2	8.8	7.8	4.4	9.6	219.5
Eastern Europe	10.8	18.5	4.4	3.3	8.3	2.6	6.5	110.7
Developing countries	107.9	55.2	33.3	21.9	9.7	-9.7	-18.0	870.6
Latin America	28.5	34.6	7.8	5.8	10.7	10.2	15.6	320.9
Middle East	-0.1	10.5	3.6	-0.6	0.3	7.2	-0.9	79.3
Africa	-0.4	2.7	0.8	0.9	0.7	0.3	1.0	58.2
Asia	79.8	7.5	21.1	15.8	-2.0	-27.5	-33.7	412.2
Total liabilities	**101.8**	**77.9**	**32.1**	**27.9**	**8.8**	**9.1**	**25.6**	**1,067.4**
Developed countries	23.2	18.2	6.2	8.5	5.1	-1.5	-0.9	194.8
Eastern Europe	2.9	9.4	4.2	4.2	4.3	-3.3	-2.7	52.5
Developing countries	75.8	50.3	21.8	15.2	-0.6	13.9	29.3	820.2
Latin America	26.9	24.3	6.2	19.2	1.5	-2.5	17.6	267.8
Middle East	17.1	-5.9	5.6	-6.0	-5.6	0.2	2.9	212.3
Africa	2.9	7.1	2.7	3.4	2.0	-1.1	1.2	55.4
Asia	28.9	24.8	7.3	-1.4	1.5	17.4	7.4	284.6

* Changes in amounts outstanding excluding exchange rate valuation effects.

The acceleration in the pace of new lending to Latin America in the first quarter of 1998, from $10 billion in the fourth quarter of 1997 to $16 billion, suggests some shift of activity in the wake of the Asian crisis. However, the bulk of the funds (a record $10 billion) went to Brazil, largely reflecting record high interest rates and regulatory arbitrage opportunities. Thus, official regulations originally aimed at encouraging the foreign financing of rural development were used as a means of investing in high-yielding dollar-indexed government securities (the rules were more recently amended to close this loophole). Although the inflows allowed Brazil to build up official reserves (which are largely redeposited in the international banking market) in the first quarter, adverse developments in Asia and Russia in the second quarter were associated with a renewed loss of reserves by the country. In the absence of any improvement in the country's fiscal and current account deficits, the unprecedented inflows of banking funds to Brazil in the first quarter of this year may have raised the vulnerability of the country to an abrupt reversal of market sentiment. According to the BIS consolidated international banking statistics, 64% of the international banking debt of Brazil at the end of 1997 was for less than one year.[5] This may explain the restrictions imposed by the Brazilian authorities on short-term borrowing.[6] In contrast, actual lending to the other major debtor countries in the region (Argentina and Mexico, as well as Chile), slackened from the rapid pace of the preceding quarter. The downturn occurred in spite of the fact that these countries were at that time still perceived by the market to be less vulnerable to contagion from Asia than Brazil.

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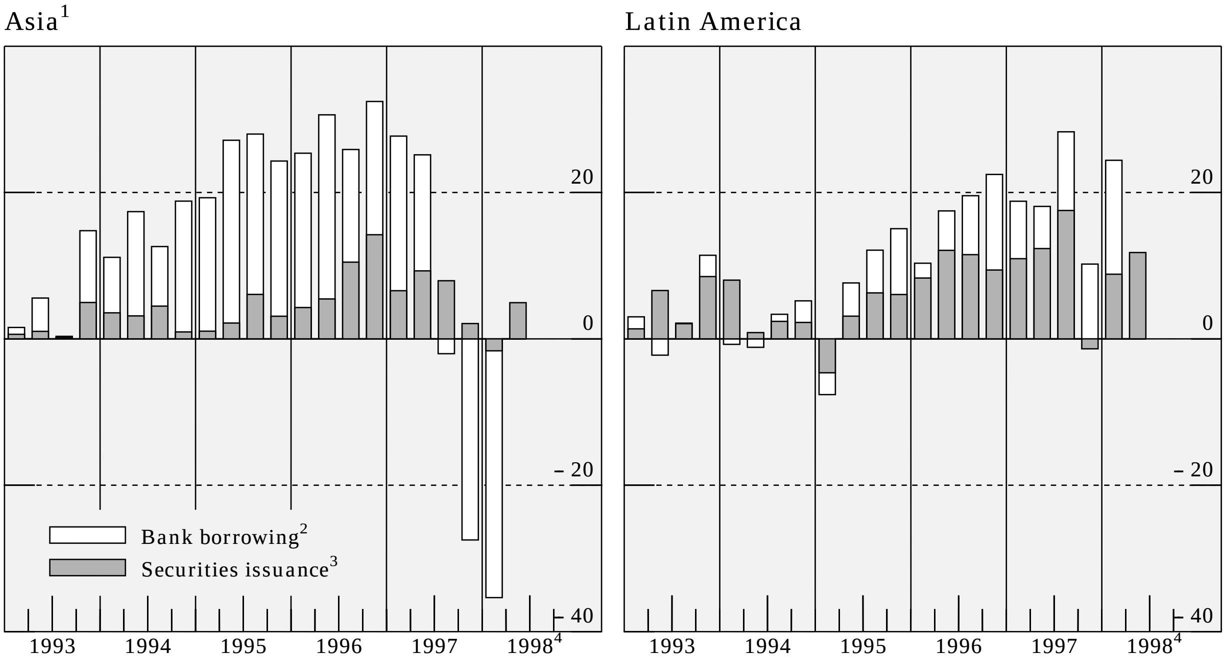
recorded as reporting banks' liabilities to the country concerned) include a large volume of official reserves, these can act as a buffer against sharp swings in external financing. However, this role can be compromised if such external deposits also include flight capital, over which the authorities have little control.

5 While comparable to the proportion of the heavily indebted countries in Asia, this figure is some 13 percentage points above the average for other Latin American countries.

6 In addition to restrictions on foreign borrowing to purchase dollar-indexed securities, the authorities also extended in March the minimum maturity for other foreign liabilities.

International bank and securities financing in Asia and Latin America

In billions of US dollars



[1] Excluding Hong Kong, Japan and Singapore. [2] Exchange-rate-adjusted changes in BIS reporting banks' claims vis-à-vis Asian and Latin American countries. [3] Net issues of international money market instruments, bonds and notes. [4] Data on bank borrowing are not yet available for the second quarter of 1998.

Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA, national data and BIS.

Similarly, the expansion in reporting banks' lending to Eastern Europe in the first quarter of 1998 (from \$3 billion in the fourth quarter to \$7 billion) mainly reflected their activity in Russia. The renewed tightening of Russia's monetary conditions in February encouraged a reflow of foreign funds into the Treasury bill market, in which some reporting banks are particularly active.[7] Elsewhere in the region, fresh supplies of new credit to Hungary, Poland and the Slovak Republic suggest that the beneficial effects of their close ties with Western Europe outweighed concerns raised by developments in Asia and Russia. Meanwhile, the decline recorded vis-à-vis the Czech Republic may have reflected the unwinding of short-term credit lines extended in the preceding quarter. However, there was no apparent impact on the Czech koruna, which recovered in the first quarter.

Structural and regulatory developments

In April, the Basle Committee on Banking Supervision released two short statements relating to the Basle Capital Accord. The first is a formal amendment which reduces the counterparty risk weighting of regulated securities firms incorporated in OECD countries from 100% to 20%. In its second statement, the Basle Committee invited comments by the end of June 1998 on principles governing on-balance-sheet netting. The Basle Accord of July 1988 made explicit reference only to bilateral netting of off-balance-sheet assets and liabilities.[8] Acknowledging the development of

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7 The growing dependence of the country on foreign participation in this market was illustrated in May, when the sharp loss of confidence of foreign investors in the face of Asian developments, weak oil prices and scepticism about Russian fiscal consolidation forced the central bank to raise interest rates (causing three-month Treasury bill rates to rise to 120%). Thereafter, financial pressures eased somewhat on prospects of a large international financial package.

8 The netting of off-balance-sheet items was recognised only in cases where it was supported by a novation agreement (whereby a single net amount is contractually substituted for the previous individual gross sums owed between two

methods of on-balance-sheet netting, the Committee proposes to accept novation as a means of reducing gross exposures to a single net amount in applying the Capital Accord. In addition, it has decided to permit other forms of on-balance-sheet netting, subject to certain conditions. At present, the Committee is inclined to restrict the scope for on-balance-sheet netting to loans and deposits, but it may be prepared to consider a broader approach in calculating capital adequacy requirements.

Following rapid progress in the area of credit risk modelling, a task force set up by the US Federal Reserve System released in May a report considering how models could eventually be used to set banks' capital requirements for certain types of asset.[9] According to the report, technological and financial innovation has exposed shortcomings in the Basle framework. In the authors' view, the most significant flaws are that the measures of capital embodied in the numerator of capital ratios may not accurately represent a bank's capacity to absorb expected or unexpected credit losses and that their denominator is not an accurate measure of total credit risk. Moreover, such ratios do not reflect certain other risks such as interest rate and operating risks, ignore critical differences in credit risk among financial instruments, and do not account for differences across banks in diversification, hedging and quality of risk management systems. While these various shortcomings have created substantial opportunities for regulatory capital arbitrage, they have also heightened the importance of judgmental factors in the assessment of bank capital. As traditional techniques for assessing capital adequacy are becoming less appropriate, banks' internal risk measurement systems could provide valuable information for prudential oversight. However, the report also said that several issues needed to be addressed before internal models could be substituted for the standardised capital framework for credit risk.[10]

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parties). This approach was subsequently widened to encompass other forms of legally sound bilateral netting arrangements.

9 See "Credit Risk Models at Major US Banking Institutions: Current State of the Art and Implications for Assessments of Capital Adequacy", Federal Reserve System Task Force on Internal Credit Models, Washington DC, May 1998.

10 These include the appropriate conceptual framework for measuring credit losses, the calibration of key model parameters and the need for more systematic approaches to model validation.

The Asian crisis in the second quarter of 1998

Despite measures to strengthen financial systems in Thailand and Korea (which were, with Indonesia, at the centre of the Asian crisis),* a new round of turbulence erupted in Asia in the second quarter of 1998. Lingering strains in Indonesia, notwithstanding the signing in late June of a new accord with the IMF, triggered another downward spiral of local asset values and exchange rates. In some instances, social instability added to investors' reluctance to return to the region. At the same time, the deterioration of economic conditions in Japan and the greater awareness of financial difficulties in that country were associated with a renewed weakening of the yen. These developments had broad regional ramifications, affecting currency and equity markets in the whole Pacific basin and raising fears of a devaluation of the Chinese currency (and in turn a further round of competitive devaluations). Whereas concerted US and Japanese intervention in mid-June succeeded, at least initially, in reversing sentiment on the foreign exchange market, the situation of debtor countries in Asia remained worrisome.

At the same time, the repercussions outside Asia were more profound than in the first episode of contagion, amplified by concerns about the situation in Russia and in other countries suffering from macroeconomic imbalances and/or the weakness of commodity prices (oil in particular). Thus, in May, a number of non-Asian emerging market economies were forced to further tighten fiscal and monetary policies. Correspondingly, risk premia on emerging market securities, which had eased somewhat towards year-end from their peaks of October 1997, edged up again. In spite of a better differentiation of country risk by international investors, Latin American debt was, at the end of the quarter, still trading at a significant discount compared with prices prevailing in mid-1997.

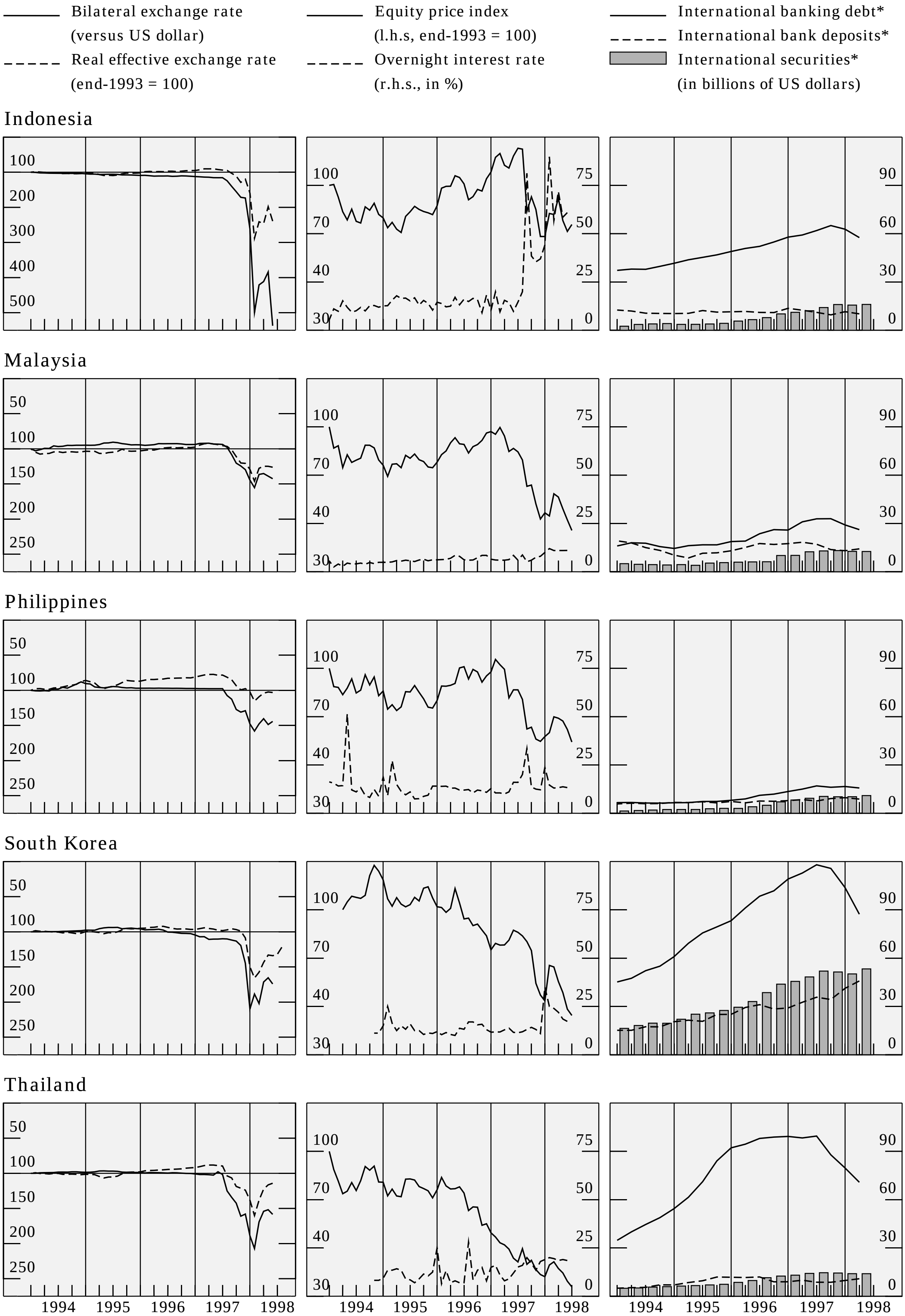
The ongoing nature of the crisis has given urgency to the debate about both crisis prevention and management. With respect to the former, a consensus seems to be developing on the need for improved information, sound domestic micro- and macroeconomic infrastructures, reduced reliance on short-term capital and an appropriate sequencing of capital account liberalisation. But these conditions may not prove sufficient to prevent crises and will, in any event, take some time to be implemented. As for crisis management, questions have been raised concerning the international response to recent events. In view of the extent of domestic financial weakness, the size of short-term private sector debt and the deep-seated problems of governance at all levels of local economies, the rescue packages per se could not have been expected to stabilise markets. The failure of the authorities to rapidly adopt the necessary adjustment measures was a crucial factor behind the severity of the crises. Indeed, such a commitment thereafter represented an important turning-point in many cases. Unfortunately, it does not yet appear to be forthcoming in some countries. Also pending is the question of the appropriate sharing of the costs involved between public and private lenders, and between creditors and debtors.

While the debate on these issues is continuing,** the authorities in Asia are faced with the difficult dilemma of reconciling the short-term challenge of restoring market confidence and the longer-term needs of restructuring their economies. Instances of early relaxation have only served to prompt further exchange rate instability; yet deflationary policies in already depressed economies have had negative effects on both the banking system and the economy. Such offsetting considerations have created a need for flexibility in the policy mix as events unfold. Thus, IMF fiscal targets have already been adjusted to allow for larger deficits, but the ultimate public cost of bank restructuring remains unknown. Similarly, a rapid easing of monetary conditions may be required in order to improve the financial situation of both the banking and corporate sectors, as well as the public sector. However, this can only be done once the authorities have re-established their credibility. On top of these domestic dilemmas, Asian countries, as a group, are faced with a less favourable external environment requiring strong policy commitment. Resolving the Asian crisis will therefore be an important test of the ability of national and international authorities to cope with the global interdependence of markets.

* For instance, in Thailand, following an announcement in March that assets of the 56 closed financial companies and of the four banks taken over by the central bank would be sold this year through auction sales, the central bank tightened the standards for loan classification and provisioning in April. In Korea, the closing of non-performing banks and the removal of restrictions on foreign purchases, which were part of the package arranged by the IMF in December 1997, were accompanied by the decision to bring certain banks under government control.

** See, for instance, Chapter VII of the 68th BIS Annual Report of June 1998.

Selected Asian financial indicators



* Stocks outstanding.

Sources: Bank of England, Bloomberg, Datastream, Euroclear, Euromoney, IFR, IMF, ISMA, national data and BIS.

III

THE INTERNATIONAL SECURITIES MARKETS

Overview

Following a record volume of gross international debt issuance in the first quarter of 1998, there was a pronounced contraction of activity in the second quarter (see the table on page 16). The slowdown was not entirely unexpected since part of the first quarter's issuance reflected business that had been delayed by the onset of the financial crisis in Asia at the end of 1997. Furthermore, the gross volume of issuance in the period under review remained larger than the average for 1997, and with the sharp drop in repayments net issuance was higher than in the previous quarter (see the table below).

Nevertheless, issuing conditions proved to be somewhat mixed. On the one hand, markets were repeatedly buffeted by a number of negative elements, including the financial crisis in Japan, the trend depreciation of the yen, the weakness of the asset markets of other Asian countries and the deterioration in the fiscal position and external balance of Russia. As a result, there was a resumption of the flight to the safety of highly rated and liquid securities, and a widening of risk premia on a broad range of assets. On the other hand, rapid monetary growth in the major countries, subdued inflationary pressures, further declines in the yield and the volatility of long-term benchmarks and flattening yield curves all combined to provide a favourable background. Other positive influences included the steady growth of institutional investors and their continuing search for higher returns, the ongoing diversification of issuers' funding sources (particularly through the repackaging of assets), the refinancing of more costly debt, the funding of mergers and acquisitions and the development of a

Main features of international debt securities issues[1]

In billions of US dollars

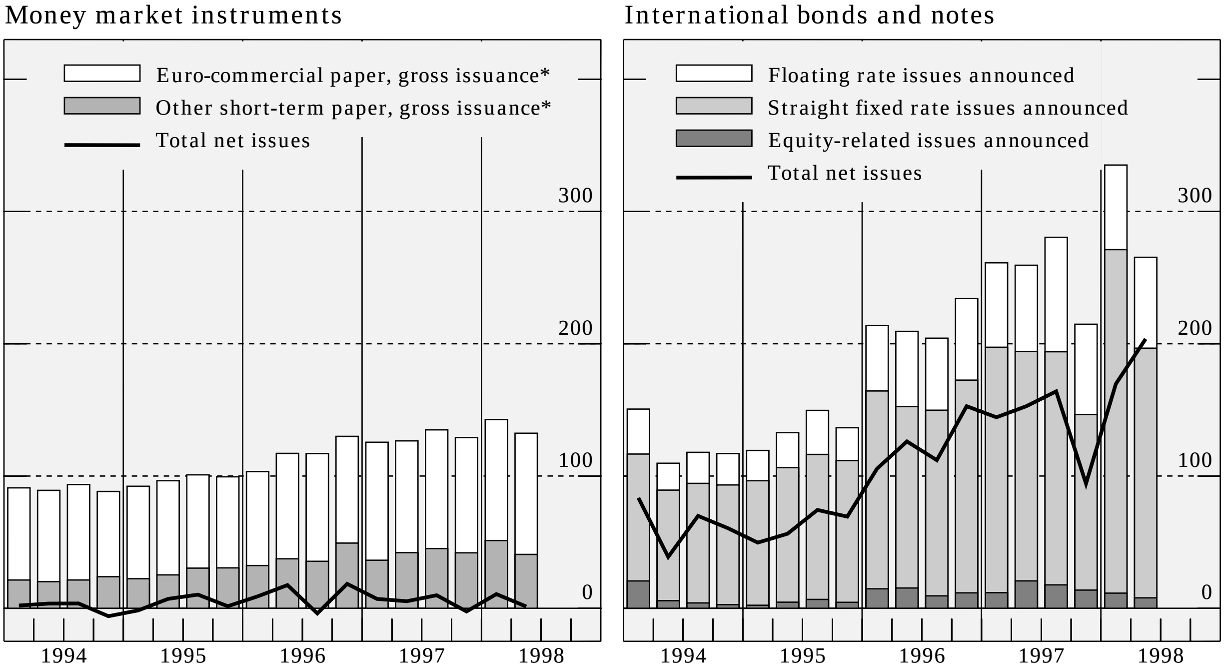
Instruments, currencies, nationality and type of issuer	1996	1997				1998		Stocks at end-June 1998
	Year	Year	Q2	Q3	Q4	Q1	Q2	
Total net issues	**537.6**	**575.2**	**158.1**	**173.8**	**91.8**	**180.3**	**205.1**	**3,851.5**
Money market instruments[2]	41.1	19.8	5.3	9.8	-2.4	10.7	1.4	194.2
Bonds and notes[2]	496.5	555.4	152.8	164.0	94.3	169.6	203.7	3,657.3
Developed countries	411.2	450.5	114.5	132.9	83.0	145.6	161.4	3,098.8
Europe[3]	*243.8*	*257.4*	*61.2*	*68.1*	*52.4*	*93.6*	*87.7*	*1,834.4*
Japan	*16.1*	*-0.8*	*-1.4*	*6.8*	*-9.0*	*-6.4*	*-9.7*	*290.9*
United States	*131.8*	*177.5*	*45.7*	*54.7*	*43.9*	*49.3*	*75.3*	*675.5*
Canada	*8.8*	*10.1*	*4.8*	*2.2*	*-0.8*	*6.0*	*7.1*	*195.5*
Offshore centres	16.6	14.9	5.1	5.3	0.2	1.7	4.3	55.1
Other countries	88.0	89.2	30.9	33.6	5.2	8.9	28.1	363.8
International institutions	21.8	20.7	7.6	2.0	3.4	24.2	11.2	333.9
US dollar	262.0	333.1	98.0	109.0	57.9	103.2	118.2	1,786.0
Yen	85.0	34.1	11.9	7.5	-1.2	-7.7	-9.3	415.0
EMU currencies	136.0	139.9	29.3	39.2	34.1	62.2	67.2	1,003.7
Other currencies	54.5	68.1	18.9	18.2	1.1	22.7	28.9	646.8
Financial institutions[4]	348.5	360.3	85.6	102.9	76.1	109.6	106.4	1,790.9
Public sector[5]	118.2	89.0	35.4	27.6	-5.3	54.0	56.2	1,143.2
Corporate issuers	70.9	125.9	37.1	43.4	21.1	16.7	42.5	917.4

[1] Flow data for international bonds; for money market instruments and notes, changes in amounts outstanding excluding exchange rate valuation effects. [2] Excluding notes issued by non-residents in the domestic market. [3] Excluding Eastern Europe. [4] Commercial banks and other financial institutions. [5] Governments, state agencies and international institutions.

Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA and BIS.

The international debt securities markets

In billions of US dollars



* Excludes issues redeemed in the same quarter.

Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA and BIS.

market for euro-denominated debt. This nuanced picture shows that the international bond market has achieved considerable maturity in recent years. The expansion of the investor and issuer bases and the wide range of structures on offer enable the market to function fairly smoothly even in conditions that are often less than optimal.

Money market instruments

In the market for euro-commercial paper (ECP) and other short-term euronotes, net issuance was marginal, with the stock outstanding rising by $1 billion, to $194 billion. This subdued pattern of activity contrasts sharply with the very rapid expansion continuing to take place in the US market (see the graph on page 15). Net borrowing in US dollars was largely offset by declines in the Australian dollar, yen and Swiss franc segments. In the developed country area, net issuance by UK and US names was more than offset by the cutbacks made by Australian, French and Japanese borrowers. In the emerging market world, the slight increase in net funding resulted largely from a swing to positive flows by Indian and Korean entities. One notable development during the quarter was the arrangement by European banks of several special-purpose vehicles (SPVs) for the issuance of asset-backed notes. The SPVs will use the proceeds of programmes to invest in a variety of asset-backed securities.

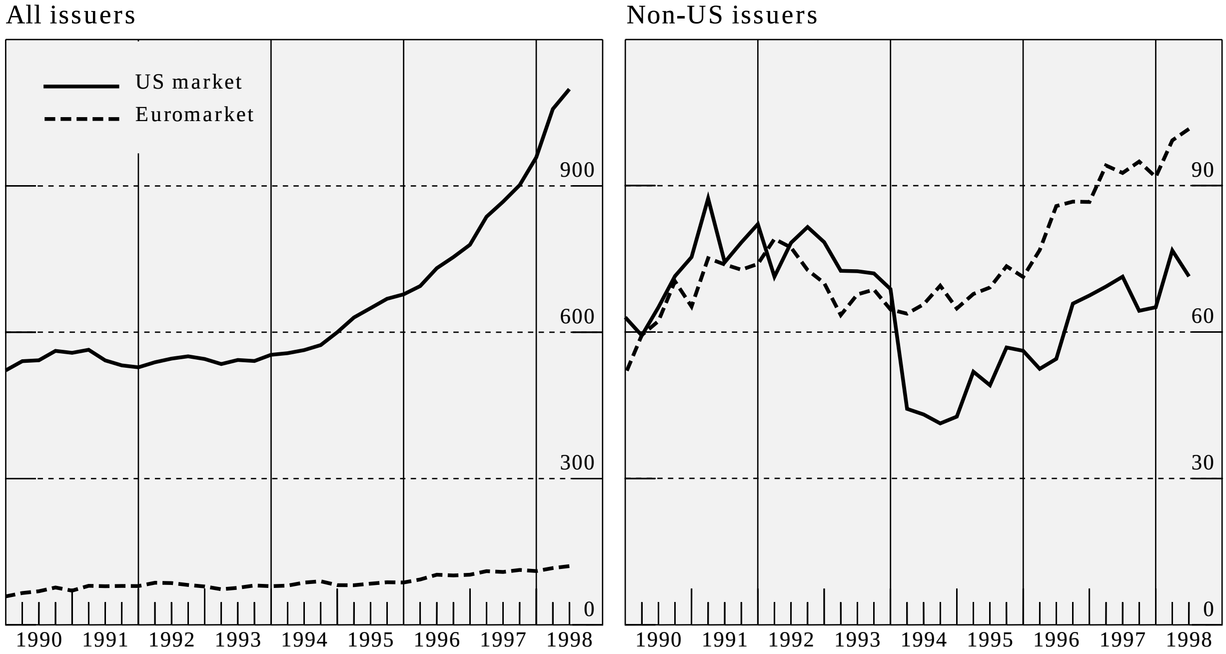
Longer-term international securities

In the longer-term segment of the international securities market, the reduction in the volume of repayments (to $90 billion from $124 billion) meant that announcements and net issuance followed diverging paths (down by 21%, to $265 billion, and up by 20%, to $204 billion). However, whether in gross or net terms, activity continued to be buoyant by historical standards.

The impact of the second wave of the Asian crisis was not as clear-cut as in earlier periods of market turbulence for most aspects of activity. First, despite the flight to quality, lower-rated borrowers from industrial countries and emerging markets were still able at times to find

Commercial paper outstanding

In billions of US dollars



Sources: Federal Reserve Board, Euroclear and BIS.

acceptance from certain groups of investors. This was even true of entities in countries most affected by the turmoil (such as Korea and Russia). Correspondingly, while the US dollar and core European currencies continued to play a predominant role, the market saw transactions denominated in emerging market currencies as well as the appearance of new issuing currencies (the Estonian kroon, the Turkish lira and the Israeli shekel). Secondly, investors' concerns about a possible rise in interest rates in the early part of the quarter did not prevent sovereigns from the developed world from launching long-term fixed rate issues. Moreover, the average maturity of issues by developing country entities rebounded from the low levels seen in the first quarter. Thirdly, the average size of fixed rate issues declined somewhat from the record seen in the first quarter (see the graph on page 18), but the bias of investors towards large and liquid securities continued to be reflected in the arrangement of sizable transactions.

Currency of issuance. There was some decline in announcements denominated in US dollars in the second quarter (to $137 billion from $155 billion), but the US currency remained the preferred issuing vehicle (with an increase in market share, to 51% of announcements). However, not all of this business represented "true" eurodollar or Yankee activity since a significant proportion of the global bonds issued by US securitisation vehicles continued to be marketed to US residents. As mentioned above, the lower volume of activity reflected the slowdown that followed the catching-up effect seen in the first quarter, as well as the heavy stock of dollar inventories and early-quarter concerns about a possible increase in US official rates. Otherwise, activity continued to be supported by attractive swap opportunities, the window created by reduced issuance of US Treasury paper, low interest rate volatility and the flight to the quality of US dollar paper.

Activity in the currencies scheduled to form European monetary union declined from the record seen in the first quarter (to $76 billion from $105 billion), with such business accounting for 29% of total announcements. Contrasting influences meant that transactions denominated in Deutsche marks declined by 14%. In the early part of the quarter, faster than expected growth in the core European countries fostered anticipations of increases in official rates, while the uncertainty related to the presidency of the European Central Bank and the choice of participating currencies made investors reluctant to commit their funds. However, the resolution of EMU-related uncertainty in May and the

Main features of the international bond and note markets

In billions of US dollars

Instruments, currencies and type of issuer	1996	1997				1998	
	Year	Year	Q2	Q3	Q4	Q1	Q2
Announced issues	**861.5**	**1,015.8**	**259.3**	**280.5**	**214.7**	**335.1**	**265.4**
Floating rate issues	222.5	283.8	65.2	86.5	68.2	63.9	68.7
Straight fixed rate issues	587.9	668.0	173.4	176.3	132.8	259.7	188.8
Equity-related issues[1]	51.1	63.9	20.7	17.7	13.7	11.5	7.9
US dollar	391.8	517.4	140.1	150.5	109.4	154.6	136.6
Yen	134.9	129.8	31.5	35.4	26.6	19.7	12.8
EMU currencies	212.2	221.8	51.6	59.7	51.8	105.2	76.2
Other currencies	122.6	146.8	36.1	34.9	26.9	55.5	39.8
Financial institutions[2]	453.7	539.1	128.2	153.9	118.3	168.6	132.9
Public sector[3]	211.8	225.2	62.3	55.5	41.2	109.2	70.7
Corporate issuers	196.0	251.5	68.8	71.0	55.2	57.3	61.7
Completed issues	**860.5**	**1,016.6**	**252.7**	**279.2**	**231.9**	**294.0**	**293.5**
Repayments	**364.0**	**461.2**	**99.9**	**115.3**	**137.6**	**124.3**	**89.8**

[1] Convertible bonds and bonds with equity warrants. [2] Commercial banks and other financial institutions. [3] Governments, state agencies and international institutions.

Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA and BIS.

flight of investors to German government bonds combined to exert a more positive influence. One striking development was the sharp increase in the issuance of DM-denominated bonds by well-known US corporate borrowers. This reflected as much the appetite of European investors for corporate risk as the pivotal role assumed by the Deutsche mark in continental Europe. The more pronounced decline in activity seen in several other core European currencies would seem to confirm the hypothesis of a shift in portfolio allocation in favour of the German currency. A similar development also appears to have occurred in the sector for euro-fungible debt, where the residual risk represented by the conversion to the euro at the beginning of 1999 tipped the balance away from ECU/euro issues. In the absence of a sufficiently large investor base in euros, issuance has reportedly been driven more by strategic considerations than by actual cost-effectiveness.[11] However, the introduction of the euro and the development of liquid European benchmarks will act to improve that segment's competitiveness.[12]

At the same time, there was a sharp drop in sterling-denominated issuance (from $33 billion to $19 billion). While the currency was supported in the early part of the quarter by its refuge status ahead of EMU and the high level of interest rates, the announcement of the countries participating in monetary union and indications of stronger growth in continental Europe altered the market's favourable perception of sterling. Opposite developments took place in the Greek drachma segment, with issues rising to a record of almost $2 billion. Following a devaluation in the first quarter of the year, the drachma recovered on the basis of the Greek authorities' strong commitment to meeting the financial criteria attached to EMU and indirectly from the difficulties affecting emerging markets. Meanwhile, gross issuance in yen declined for the third consecutive quarter (to $13 billion from $20 billion). Concerns about the state of the Japanese economy and financial system, the record low level of interest rates, renewed downward pressures on the currency (to an eight-year low against

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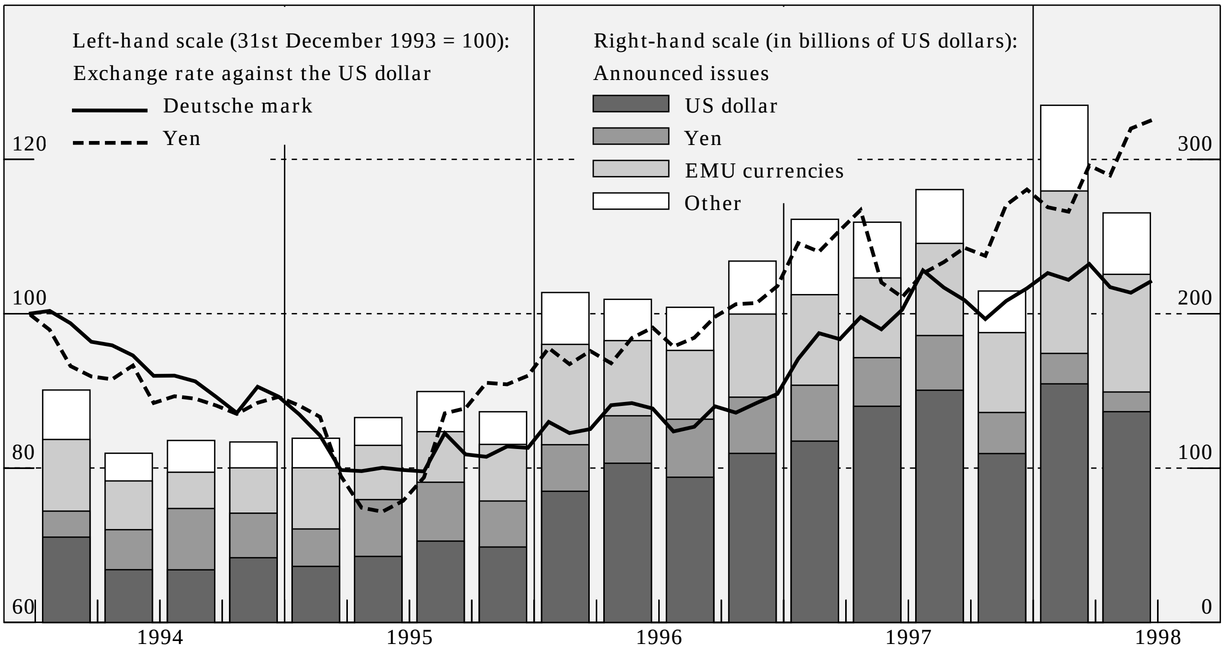
[11] Such considerations include the demonstration by sovereign and para-public issuers of a commitment to currency union and the establishment of market presence ahead of EMU.

[12] For example, in April the French Treasury offered to exchange ECU 17 billion of ECU-denominated bonds for new euro-fungible benchmarks, while in June the European Investment Bank announced the planned exchange of outstanding bonds in ECUs and other European currencies into a small number of euro-denominated securities. Lastly, the Austrian debt office announced that it would switch its funding from Austrian schillings to Deutsche marks.

International bond and note issuance and the US dollar exchange rate



Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA and BIS.

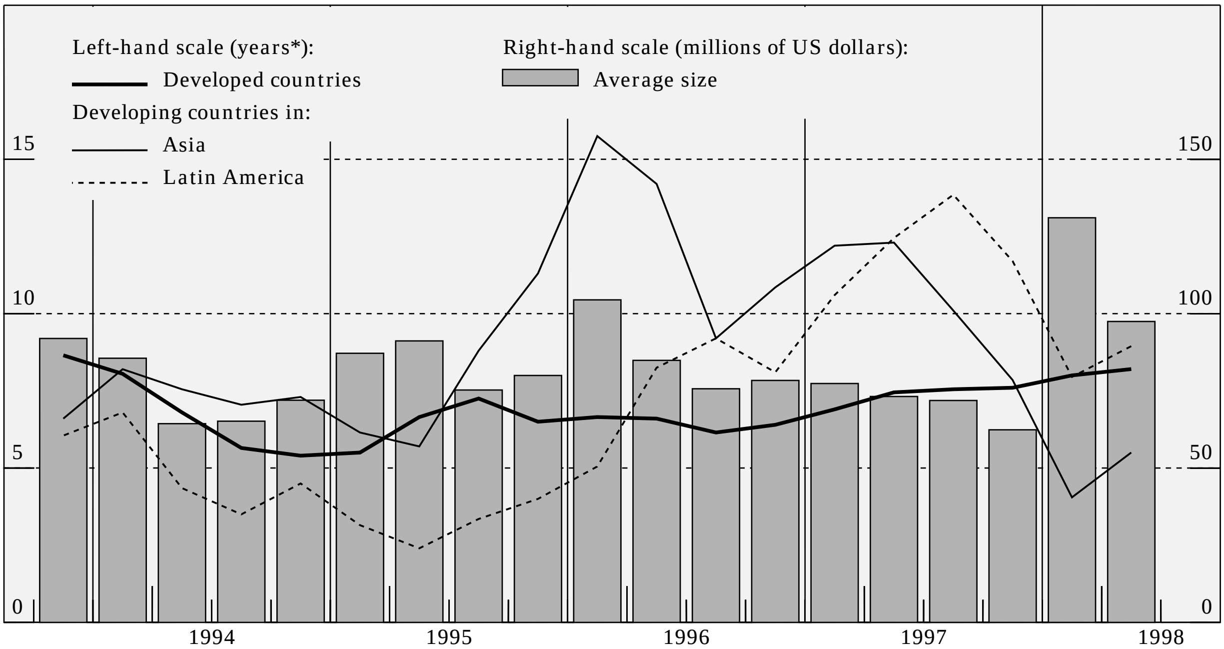
the dollar) and the introduction of measures liberalising the foreign exchange market reduced demand for yen-denominated assets.[13]

The weight of dollar-denominated issuance, the trend towards large benchmark issues and the growing importance of institutional investors continued to support the competitive position of US underwriters (with a further gain in market share to 43%). The merger of commercial and investment banks in the United States continued to subject European intermediaries to intense competitive pressures. In particular, the increase in the proportion of issues being distributed by the top lead managers (which tend to be US-based) was reported to have created difficulties for smaller retail-oriented European institutions. Nevertheless, the distribution power of the large European banks in their currencies and the forthcoming introduction of the euro could give them an opportunity to compete on a more even footing. At the same time, the low volume of Japanese-originated and yen-denominated business was reflected in the correspondingly low share of Japanese lead managers (less than 2%).

Type and nationality of issuers. Banks and central governments from the industrial world as well as supranational entities accounted for most of the reduction in issuance seen in the second quarter of 1998. Since the drop in bank issues was concentrated in countries where banking systems enjoy fairly high ratings (Germany and the Netherlands in particular), this might have reflected the waning of the highly attractive funding opportunities available to prime borrowers during the worst phase of the Asian crisis. Nevertheless, the fact that non-bank financial institutions (largely securitisation vehicles) and semi-public financing agencies (mainly from the United States) introduced a fairly steady volume of issues would suggest that investor demand for highly rated or collateralised instruments remained strong. At the same time, market participants noted that euromarket investors were becoming more favourably disposed towards corporate debt. This was most vividly illustrated by

[13] In spite of this unfavourable climate, capital market financing made further progress in Japan. The low level of yields on Japanese government bonds and lack of momentum of equity markets have generated investor interest in domestic corporate bonds and spurred issuance to record levels in the first half of the year.

Average size and maturity of announced straight fixed rate international bonds and notes



* Two-quarter moving average weighted by size.
Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA and BIS.

the expansion of high-yield ("junk") issuance, under the combined influences of investors' search for higher yields (as EMU convergence plays reached their limits), their better capacity in analysing credit risks, slowing issuance by European governments and the return of investors to the relative safety of more familiar names.[14] Intermediaries believe that in spite of the low cost of banking facilities, European mergers and corporate restructurings are increasingly likely to be financed by high-yield bonds rather than bank loans.

Looking at the geographical breakdown of business, issuance continued to be concentrated among developed country borrowers. However, the quarterly drop in new issues was particularly pronounced in the case of European commercial banks and central governments. At the same time, the economic difficulties affecting Japan were reflected in the activity of borrowers from that country, with the lowest volume of Japanese business since the second quarter of 1990. Emerging market names shrugged off the increase in secondary and primary market spreads to extend the recovery in activity seen in the first quarter (see the graphs on page 19). Latin American entities, which appear to have been somewhat less affected by the turbulence in Asia and Russia, brought the largest volume of issues. At the same time, the governments of Korea and Russia tested the market's resilience with sizable transactions. In April, Korea launched its first-ever international bonds, with a $4 billion two-tranche package. Expectations of an upgrade of the country's sovereign risk rating and of economic recovery were reflected in a favourable reception by investors. The issues had a positive impact on other emerging market borrowers, leading to a temporary improvement in risk premia. The Russian Federation launched a $1.3 billion five-year issue and a $2.5 billion 30-year deal, the largest and longest ever issued by the country. However, the margin of 650 basis points over US Treasuries on the shorter deal was about twice that on a similar issue launched in October 1997.

Type of issues. The issuance of *straight fixed rate bonds* declined by 27% in the second quarter (to $189 billion). The reduction was evident across most currency sectors but was more pronounced for currencies in the euro zone. It was also spread across all business sectors, with the exception of corporate borrowers, which actually raised slightly more funds. Highly rated US

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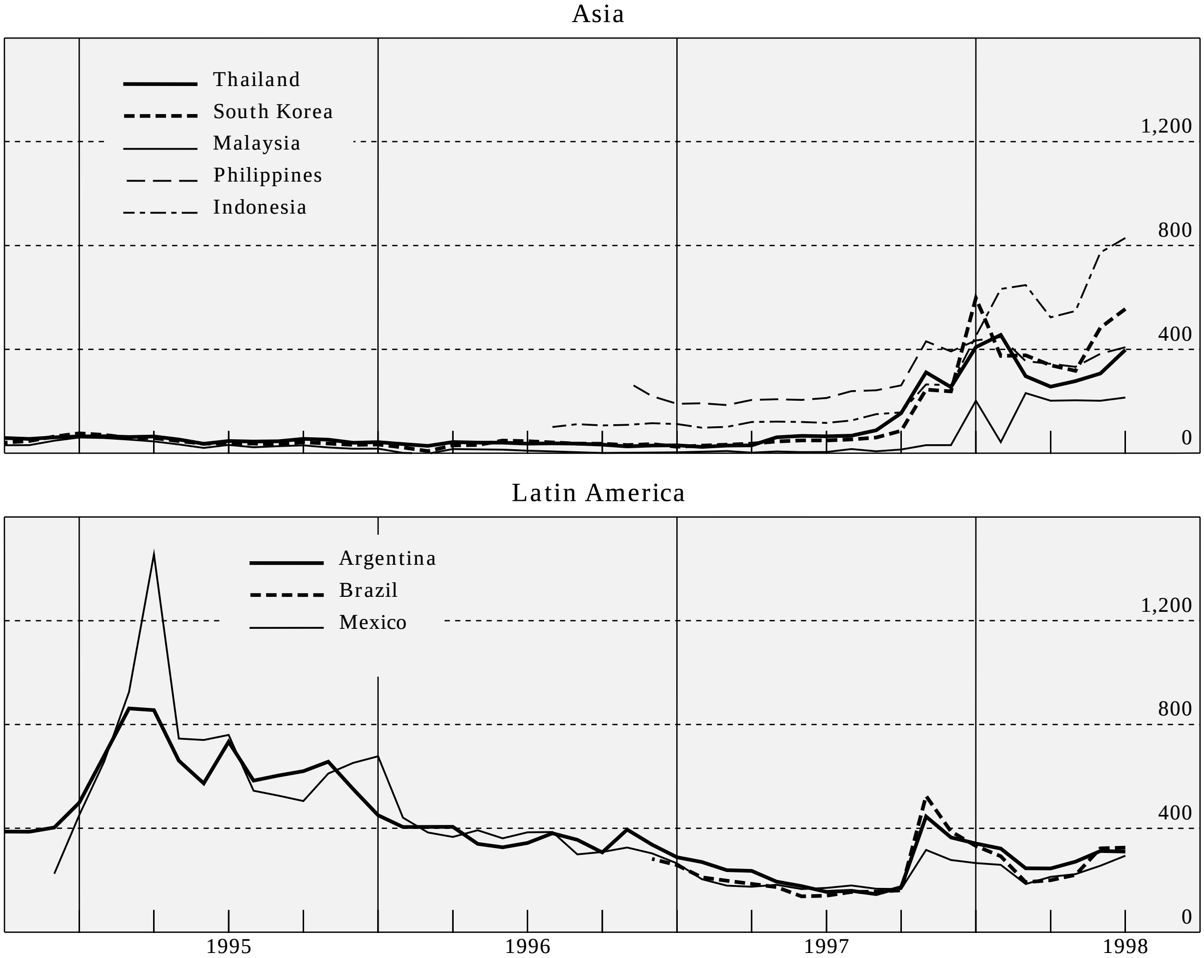
14 Such securities are rated below investment grade. Estimates of issuance in that market segment vary widely.

Average spread of US dollar sovereign international bonds over ten-year US Treasury bonds*

In basis points

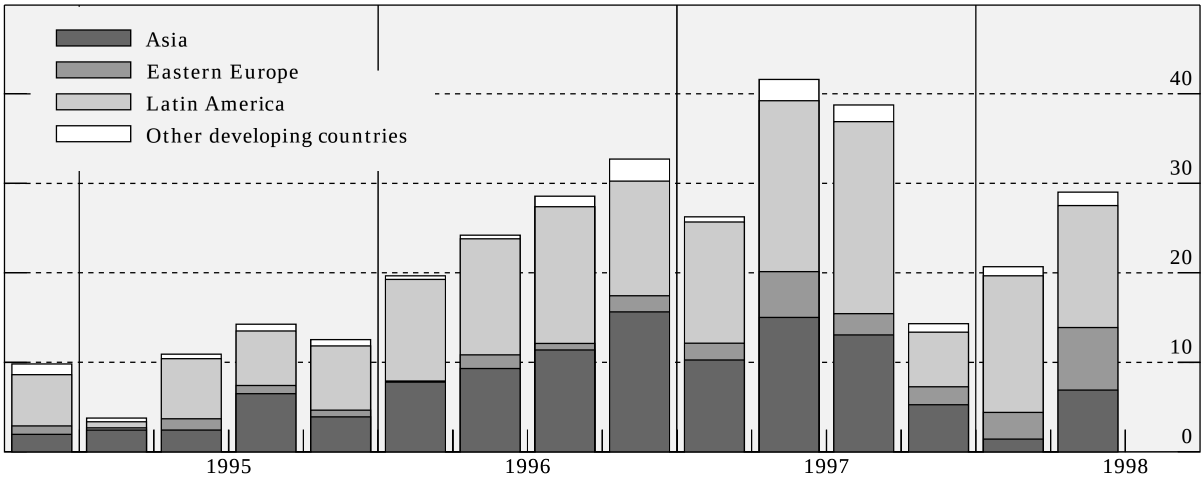


* Brady bonds for Latin American countries and the Philippines and ten-year eurobonds for other Asian countries.

Sources: Bloomberg, Datastream and BIS.

International bond and note issuance by emerging market borrowers *

In billions of US dollars



* Announced issues based on the nationality of the borrower.

Sources: Bank of England, Euroclear, Euromoney, IFR, ISMA and BIS.

industrial companies, in particular, took advantage of low interest rates and investor demand for liquidity by launching unprecedently large financing packages in dollars and Deutsche marks. Another interesting feature of the quarter was the extent of business conducted by North American semi-public financing agencies. The Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association capitalised on the limited supply of US Treasury paper to introduce several “reference notes” ranging between $3 billion and $5 billion. The notes form part of regular issuance programmes that aim at providing investors with liquid yield curves. Lastly, Canada took advantage of the rarity value of its international debt by launching a DM 4 billion global bond, while European sovereigns focused on the establishment of benchmarks ahead of EMU.[15]

In contrast to the fixed rate market, the pace of issuance of *floating rate notes* (FRNs) accelerated slightly in the second quarter of 1998 (to $69 billion from $64 billion). Concerns over the evolution of global interest rates and the volatility of asset prices in emerging markets whetted the appetite of investors for defensive instruments. The strength of demand facilitated the placement of large issues, bringing the average size of deals to the highest since 1992. The largest, a six-tranche issue amounting to £1.4 billion, was launched by a Japanese vehicle that securitised loans made to UK companies. Although the US dollar continued to account for the bulk of activity (58%), the launch of several ECU/euro-denominated issues (including for US companies) brought the share of euro zone currencies to 26%. In this context, a European bank brought the first transaction to be priced against EURIBOR. Banks also began to issue perpetual step-up “Tier 1” bonds in European currencies.[16] Such highly subordinated structures have been used extensively in the United States and are now beginning to find acceptance in the euromarkets.

Despite the strong performance of European equity markets, there was a further decline in total announcements of *equity-related issues* during the second quarter of 1998 (to $8 billion from $11 billion). The poor performance of Asian equity markets has prevented a return of Asian entities to the primary market. This has created significant financial difficulties for some Japanese companies since the failure of investors to convert into equities has forced the firms to repay issues that were launched in the early 1990s. While higher-rated entities have issued straight bonds for repayment, financing for lower-rated entities has not always been easy to secure, with the result that some issuers have defaulted. The situation was different in Europe, where the low level of interest rates and the strength of equity markets created strong demand for convertibles. This enabled issuers to bring transactions encompassing higher conversion premia than in past years.[17] As in recent quarters, European industrial restructuring and the growing emphasis on shareholder value continued to induce firms to unwind cross-shareholdings through exchangeable issues.[18] Lastly, the slow pace of primary market issuance prompted intermediaries to design synthetic issues linked to single shares, baskets of stocks or broader market indices.

In spite of strong investor demand for securities encompassing collateral backing, the issuance of mortgage and other *asset-backed securities* (ABSs) increased only slightly from that of the first quarter (to $33 billion from $31 billion). Securitisation vehicles from North America accounted for almost 60% of gross issuance, but there was growing use of such securities by European borrowers. For example, Germany, Italy and Switzerland saw their first mortgage-backed issues, and underwriters brought a number of innovative arrangements (including the first security backed by the

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[15] For example, Sweden launched a parallel euro/Swedish krona issue that will enable market participants to trade on anticipations of EMU entry, Finland was encouraged by the setting of bilateral European currency rates to join the bandwagon of euro issues, while Austria launched a “domestic” transaction in Deutsche marks.

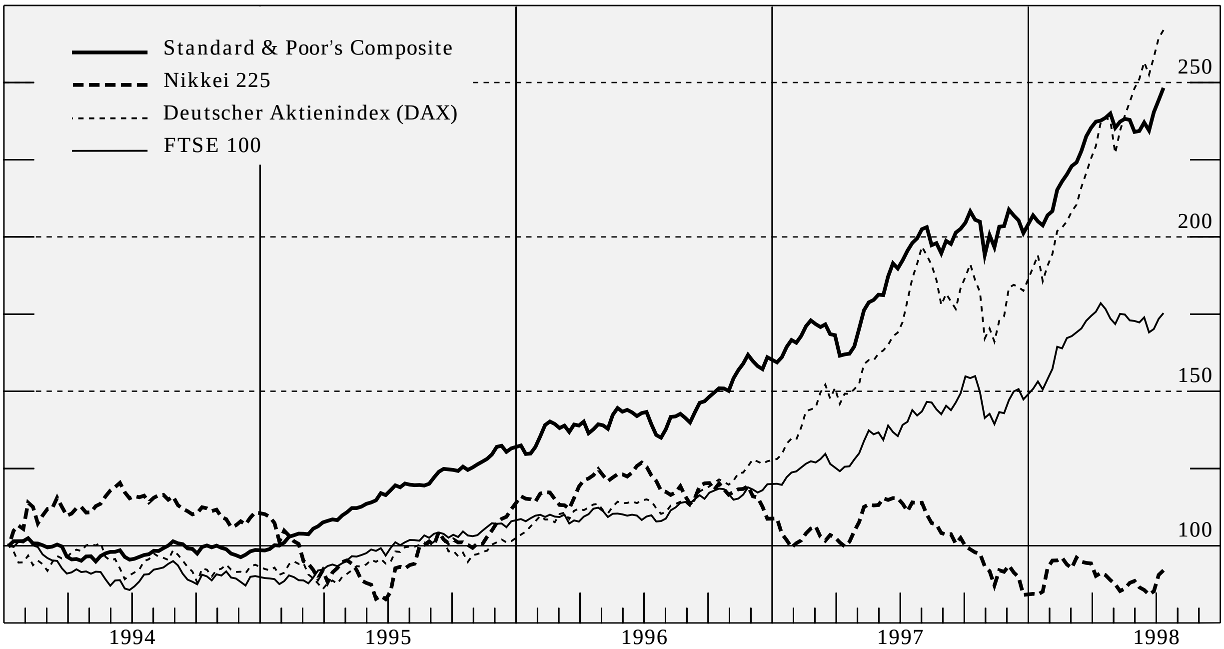
[16] If the issues are not called after ten years, the coupon is automatically adjusted upwards.

[17] The premium is the additional amount or percentage over par at which the buyer of a convertible bond is able to purchase the underlying equity.

[18] For example, a Swiss life insurance company brought the largest transaction of the quarter, a $2 billion multicurrency issue that is exchangeable into the shares of six blue-chip European firms.

Equity market developments

Weekly averages (3rd January 1994 = 100)



Sources: National data and BIS.

cash flow of forthcoming films).[19] Specialists in the area anticipate that it will take some time before the European ABS market begins to rival the vibrant US one since it remains hampered by a wide variety of regulations and conventions, the lower popularity of credit cards in continental Europe (which account for the bulk of non-mortgage securitisation in America) and the existence of competing financing channels (such as publicly guaranteed mortgage instruments). However, the greater importance of bank lending in Europe and the pressures faced by banks in boosting returns on equity could well lead to the rapid development of certain types of instrument, such as collateralised loan obligations (CLOs).[20]

By contrast, recent developments in Asia indicate that it might take longer for securitisation to develop in that region. For example, while Japanese banks have been actively disposing of less profitable assets, the origination of CLOs from that country has remained modest, with most transactions so far being secured on portfolios of foreign loans. International investors have been somewhat less receptive to Japanese ABSs owing to concerns about the quality of assets and the difficulty that vehicles have in achieving a clean sale of loans (since the originating bank must notify the underlying debtor of the sale). Issuance has also been hampered by the close correspondence between the ratings of the originating banks and the SPVs, which submits investors to a risk on the underlying as well as on the originating bank. This lack of insulation was illustrated during the quarter by the negative impact of the downgrading of certain Japanese banks on the CLOs they had issued. It is important to note, however, that the circumspection of investors also extends to other types of SPV, particularly those that are backed by pools of loans to undisclosed borrowers. Rating agencies have

19 However, given the complexities involved in structuring securities based on non-standard cash flows and the difficulty in evaluating them for trading (since cash flows are based on forecasts of earnings), it remains to be seen whether such instruments can enjoy broader market acceptance.

20 Securitisation is also becoming more popular in Latin America. For example, Petroleos de Venezuela SA launched a $1.8 billion Yankee issue that was securitised on oil export revenues. The servicing of the securities through a Cayman Islands vehicle aims at shielding investors from transfer risk, enabling the borrower to secure a higher rating than the Venezuelan state.

been facing a major challenge in evaluating securities that are structured on the basis of a large number of credits in a broad range of countries.[21]

Structural and regulatory developments

At its annual general meeting held in May, the International Securities Market Association (ISMA) said that most of the technical work required to ease the transition to the euro had already been completed. It noted that EU governments had adopted different approaches to the redenomination of government debt following the introduction of the euro.[22] Under EU rules, the only assets that must legally be redenominated in euros are outstanding government bonds. It added that uncertainty remained in certain areas such as the conventions for issues of international securities made after the introduction of the euro and the confirmation and settlement of issues straddling the transition date of 1st January 1999. The Association said that new euro-related trading conventions should not be applied to existing private sector issues because such adjustments could affect derivatives contracts and therefore cause hedging mismatches. It suggested that currency conversion be introduced only gradually, with changes being made on coupon payment dates. At the same time, it noted that market associations had agreed to adopt standard conventions on securities issues after 1st January 1999.[23]

The taxation of income from euromarket and domestic securities was also the subject of debate over the quarter. In May, the European Commission introduced a proposal that would oblige EU countries either to impose a minimum withholding tax of 20% on EU nationals' interest income on a range of assets (cash, savings deposits and bonds) or to provide information about these earnings to home country tax authorities. Banks handling the interest payments would have responsibility for establishing investors' tax status and applying any withholding tax. The proposal is part of a wider effort aimed at reducing tax evasion and eliminating fiscal competition between EU countries. Although non-EU nationals, institutional investors and certain types of instrument (such as shares) would be exempted, market participants have argued that the proposal could damage the eurobond market and could even drive it "offshore".[24] It could also create difficulties for outstanding eurobonds since such issues often carry clauses whereby coupons must be "grossed up" or the principal redeemed at par in the event of a withholding tax being imposed. While the current low level of interest rates would make it worthwhile for issuers to redeem outstanding issues, it could lead to legal challenges by investors. In May, the Japanese government said that it was considering the abolition from next April of the withholding tax paid by non-residents on interest income from Japanese securities. The issue has attracted strong interest recently because the Japanese authorities are seeking to make yen assets more attractive to foreign investors. There are concerns that simple abolition would lead to greater tax evasion since Japan does not have a comprehensive system for investor identification.

On 1st April, the Japanese Ministry of Finance abolished the 40-day seasoning period[25] for euroyen bonds issued by Japanese borrowers and their overseas affiliates.[26] The measure coincides

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21 For example, investment banks have recently set up "credit arbitrage" vehicles and EMTN programmes that invest in high-yielding instruments (ABSs, credit-linked notes and emerging market countries' local currency debt).

22 ISMA recommended that governments make the minimum denomination of converted securities no less than one euro in order to avoid the use of decimals in nominal amounts of bonds. France and the Netherlands have decided to round down to the nearest euro but most other countries will round to the nearest euro cent.

23 Countries converting to the euro have agreed to adopt ISMA's standards, which include inter alia the calculation of accrued interest on an actual/actual basis and the harmonisation of business days for settlement in euros with those of TARGET, Euroclear and Cedel.

24 Retail investors could purchase their bonds through a non-EU state, where the paying agent is not obliged to tax interest payments at source.

25 The period of time before which a euromarket security can be sold to resident investors.

26 The 90-day seasoning rule was abolished for non-resident sovereign and supranational borrowers in January 1994. The seasoning period was reduced to 40 days for Japanese borrowers and their overseas affiliates in April 1996.

with amendments to Japan's Foreign Exchange and Control Act. Whether it will generate greater activity in the euroyen bond market will depend upon market conditions and the type of confirmation procedure that will be introduced to determine the beneficiaries of withholding tax exemption. In early July, the French Minister of the Economy said that from 1st January 1999 the distinction between the domestic and euromarket segments of the French bond market would disappear.

In May, the International Organization of Securities Commissions (IOSCO) released two reports by its Technical Committee which make recommendations on the management of financial risks and on methodologies to determine the capital requirements of securities firms.[27] The first document offers guidance by providing benchmarks by which both securities firms and their supervisors can assess risk management and controls. In the second document, the Technical Committee advises supervisors that, subject to suitable safeguards, the output of value-at-risk (VAR) models could be incorporated in the calculation of regulatory capital for market risk for internationally active securities firms. The document brings IOSCO closer to the models-based methodology adopted at the beginning of the year by the Basle Committee on Banking Supervision. This should help to reduce regulatory distortions between the banking and securities markets.

[27] See "Risk Management and Control Guidance for Securities Firms and their Supervisors", IOSCO, Montreal, May 1998 and "Methodologies for Determining Minimum Capital Standards for Internationally Active Securities Firms", IOSCO, Montreal, May 1998.

IV

DERIVATIVES MARKETS

Overview

Despite the financial turbulence in Asia and Eastern Europe and the continuing flight to the quality of highly rated assets, there was some moderation in the use of exchange-traded financial derivative instruments in the second quarter of 1998 from the near record of the first quarter. Much of the overall contraction took place in the European interest rate segment, owing largely to greater confidence in the process of establishing European monetary union. Although the forthcoming introduction of the single European currency led to further adjustments in exchanges' competitive strategies, the most significant development was the inexorable advance of electronic trading facilities and exchanges. This was again to the benefit of the DTB, which recorded further gains in its market share of German government bond contracts. Moreover, exchanges as a group continued to face strong competition from the over-the-counter (OTC) market, as illustrated by new plans for the clearing of OTC products.[28] Meanwhile, off-exchange activity seemed to proceed at a steady pace following a deceleration at the end of last year. While the weakness of the yen was associated with a higher turnover of related currency contracts, the upward momentum of continental European equity markets fuelled activity in warrants. Finally, the prolonged crisis in Asia and its broader repercussions generated a great deal of interest in credit-related instruments.

Exchange-traded instruments

The aggregate turnover of exchange-traded financial contracts monitored by the BIS declined by 5% in the second quarter of 1998.[29] This outcome resulted largely from the sharp drop in interest rate instruments (10%), particularly in Europe, but to a lesser extent in Asia and North America. In spite of renewed financial turbulence in Asia and the related flight to the quality of highly rated government assets, anticipations of stable European official rates in the latter part of the quarter, the positive climate created by the announcement of countries participating in European monetary union and the further decline of long-term Japanese bond yields (to record low levels) all combined to soothe market participants' concerns about the future path of interest rates. By contrast, the increase in equity instruments (6%) may have been related to the desire of investors to seek protection in countries where equity markets were perceived to have reached a ceiling. Further retail inflows into buoyant continental European equity markets may also have been a contributing factor. Expansion in the area of currency contracts was even more pronounced (17%), but the bulk of that increase took place in Brazil.

Looking at developments on the major exchanges (in all types of products), business reached new records on the CBOT and the DTB (see the graph on page 26). Turnover on the CBOT was supported by commodity contracts and recently introduced equity instruments. At the same time, activity on the DTB grew particularly rapidly, with the exchange even overtaking LIFFE in the total turnover of contracts for the month of May. Although the DTB's turnover has been "artificially" boosted by the reduction in the size of its options contracts on individual equities (to one-fifth of the initial size), the exchange has also continued to gain market share in Bund futures (to more than 80% of total turnover in that instrument). With the declines seen in the turnover of bond contracts on LIFFE, the DTB is now the leader in the long-term segment of the European market. The DTB is reaping the rewards of its aggressive marketing strategy, which includes the installation of trading screens in Chicago and London, extended trading hours and intense competition over trading fees. LIFFE, which continues to enjoy a dominant position in European short interest rate contracts,

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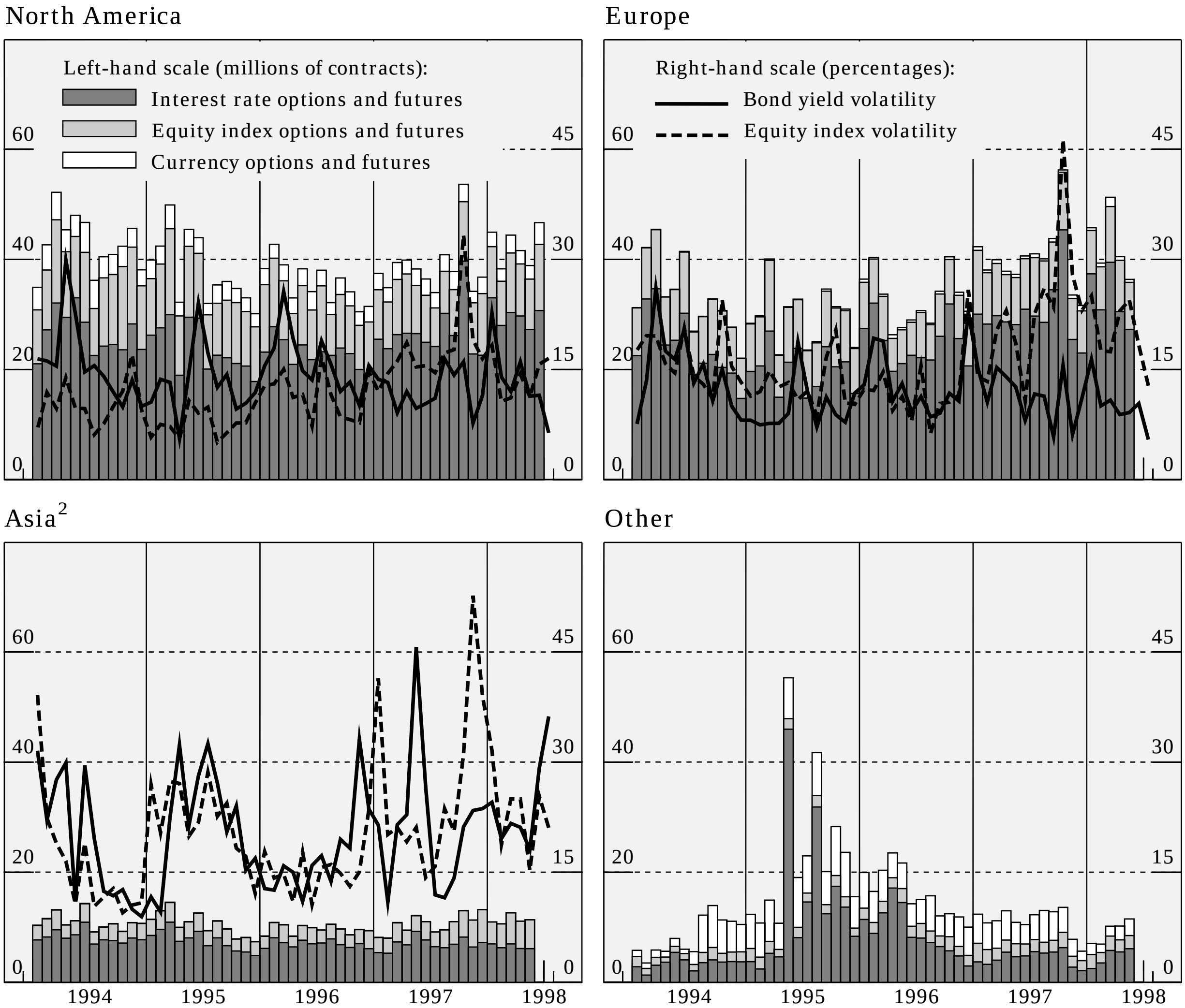
28 For example, the London Clearing House (LCH) made further progress in its bid to establish SwapClear, a facility for the clearing of plain vanilla swaps and FRAs in the major currencies. The system would remove bilateral counterparty risk for financial institutions trading in OTC instruments and thus provide that market with one of the major competitive advantages of exchange-traded markets.

29 Based on the number of contracts traded.

Turnover of derivative financial instruments traded on organised exchanges and bond yield and equity index volatilities[1]



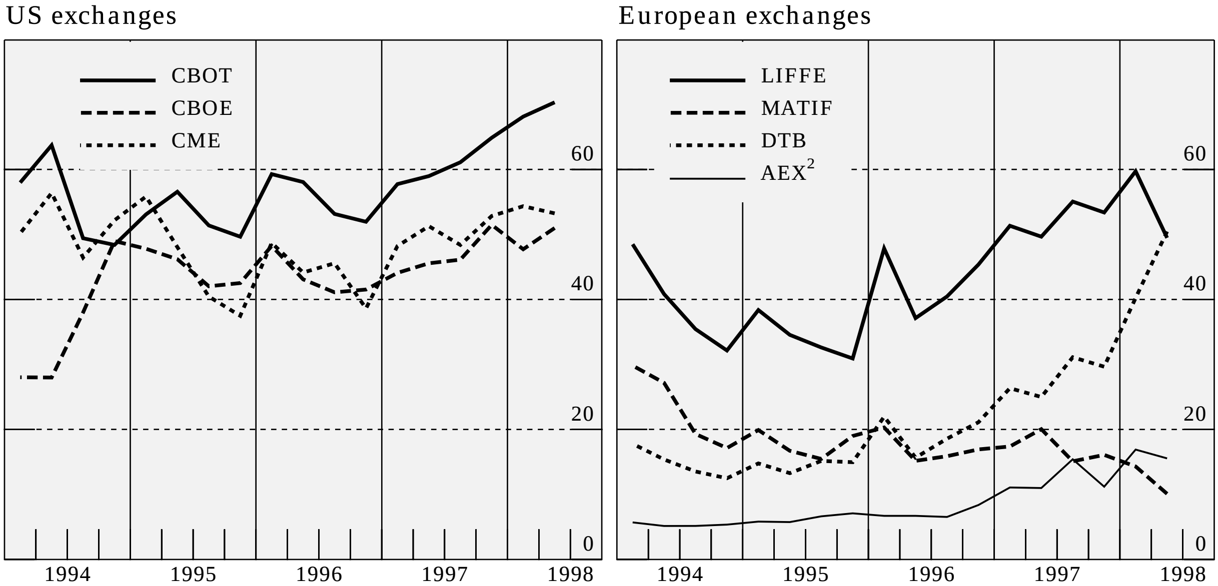
[1] Annualised standard deviation of daily percentage changes in ten-year government bond yields and equity indices of US, German and Japanese markets for North America, Europe and Asia respectively. [2] Including Australia and New Zealand.
Sources: Futures Industry Association and BIS.

has been taken somewhat by surprise by the DTB's progress. The prevailing consensus-based culture has hindered the development of new technology, and in spite of its broad range of products the exchange has failed to introduce instruments that would have been less affected by EMU-related consolidation. Meanwhile, despite strong advances in technology, the MATIF has been affected by strong competition from German government bond contracts in a context of reduced volatility between French and German government bond markets.

Exchanges continued to face intense competitive conditions in the second quarter of the year. This was particularly evident in Europe, where the battle for market share ahead of the introduction of monetary union took a dramatic new turn as exchanges that had been primarily based on open outcry surrendered to the relentless expansion of screen-based trading. Thus, following the introduction in early April of electronic trading in interest rate futures, the MATIF ended its open outcry sessions at the end of May and began to install remote-access screens in other centres. Trading activity had already been disrupted in the first quarter by the introduction of the new electronic trading system, but traders quickly demonstrated an unmistakable preference for such a facility for all types of contract (including those on interbank rates, for which open outcry had been assumed to represent a better trading environment). This shows how difficult it is for exchanges to maintain parallel trading;

Derivatives turnover on major US and European exchanges[1]

In millions of contracts, quarterly data



[1] Includes all types of derivative instruments traded on exchanges (i.e. including commodity products and options on single equities). [2] AEX results from a merger of exchanges in the Netherlands.

Sources: Futures Industry Association and BIS.

once a critical mass of activity moves to electronic trading, open outcry wilts rapidly. Meanwhile, LIFFE members voted overwhelmingly for the introduction of daytime electronic trading, bringing forward the introduction of screen-based trading by almost one year relative to plans mooted in early 1998.[30]

Although North American exchanges have not operated under the same constraints as those in Europe, the increasingly global nature of financial markets has meant that they have not been able to ignore the changes taking place elsewhere. The main US exchanges realise that it is only a question of time before electronic trading networks begin to encroach on their activities.[31] As a result, they are increasingly making use of such technology for order-routing and new contracts.[32] Some, such as the CBOT, are also making contingency plans that include a full-scale move to electronic trading should market participants require such a switch. In addition, US exchanges are developing a number of electronic facilities in joint ventures involving wholesale market brokers and specialised IT firms.[33] Such facilities would provide lower execution costs and a centralisation of margin and

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30 Such trading will begin in early August for most of LIFFE's bond contracts (the long-term gilt contract being the main exception) on a modified version of its APT system, in November for equity options on LIFFE Connect (the exchange's new in-house system), and in mid-1999 for other contracts. However, the technology underlying APT is less flexible than systems that have been developed more recently; it is not compatible with APT+ (the system that handles options) and it is not structured to permit remote access.

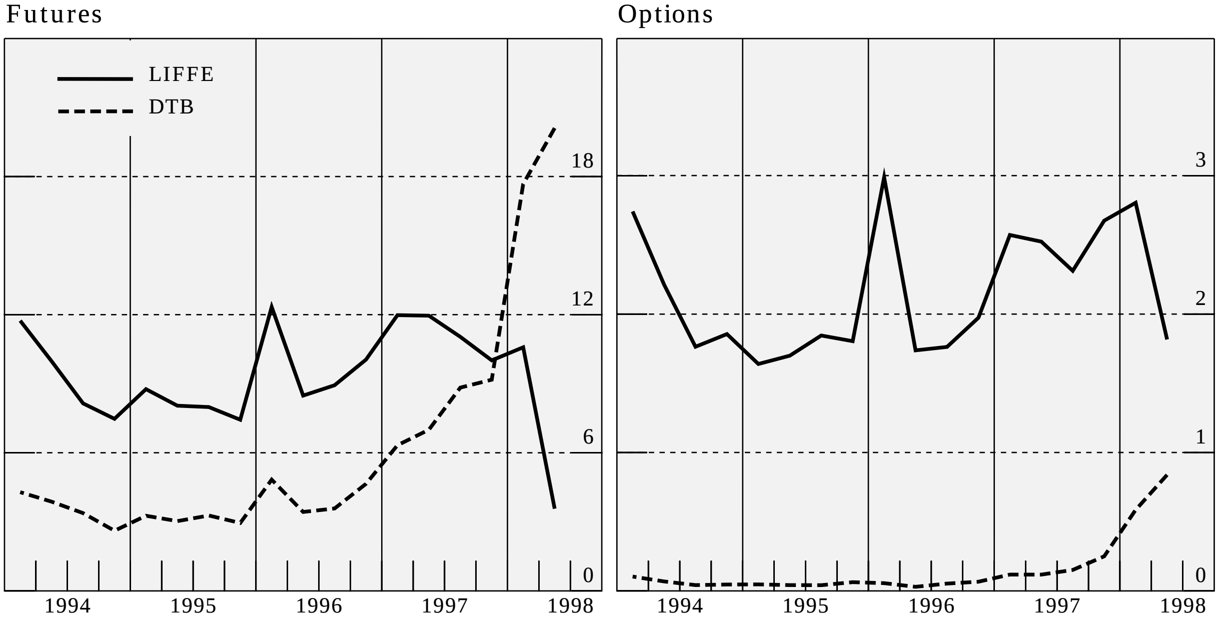
31 For example, banks have begun to offer Internet trading facilities allowing users to tap into almost any electronic and open outcry system in the world. Cheap execution costs, extended business hours and the ability of market participants to easily switch from one system to another will intensify the competitive pressures on market-places.

32 Thus, although execution on the CBOE continues to take place through the pit, about 80% of the order flow is channelled electronically. The CME has introduced contracts that are traded exclusively on its electronic system (such as the "turn") or via a combination of open outcry and screen-based facilities (such as the "e-mini" contract).

33 These include plans by the CBOT and Prebon Yamane for the launch of Chicago Bond Brokerage (CBB) to trade US government securities and repos (with, at a later stage, FRAs and interest rate swaps), and by the NYCE and Cantor Fitzgerald to establish the Cantor Financial Futures Exchange (CFFE) for the trading of US Treasuries and futures.

Bund futures and options turnover on LIFFE and the DTB

In millions of contracts, quarterly data



Sources: Futures Industry Association and BIS.

collateral requirements for cash and derivatives transactions.[34]

These developments have several implications for the competitive position of exchanges and, more fundamentally, for the global infrastructure of cash and derivatives markets. First, the battle for supremacy has now moved from the listing of new contracts to the technological arena. Secondly, the sharp expansion of screen-based trading is leading to a reshuffling of alliances to the benefit of a small number of hubs. Alliances have so far been constructed around the proprietary communications linkages of a few core exchanges, but this approach is being challenged by “new-generation” trading systems that permit the interconnection of different facilities and the channelling of orders through a variety of networks. This is likely to level the playing-field for all electronic exchanges, making it more difficult for them to differentiate themselves other than through the quality of their software products and the efficiency of their clearing systems. Thirdly, pressures from market participants (who trade simultaneously on various exchanges and on the OTC market) for lower-cost and centralised facilities are likely to lead exchanges to standardise and merge their clearing functions. Lastly, the growing importance of screen-based facilities cutting across product and institutional market segments is creating new challenges for regulators wishing to ensure the soundness and openness of such systems.

Another important development during the quarter was the refinement of European exchanges’ strategy with respect to EMU-related instruments. The three major European exchanges now have clearly defined plans for existing short-term products. Both the MATIF and the DTB have announced that their money market contracts would be indexed against EURIBOR, although the DTB said that it would continue to list its LIBOR-indexed contract in case EURIBOR failed to win market acceptance.[35] In the area of government bonds, exchanges have specified their strategies with respect to the deliverability of euro-denominated contracts. The MATIF began to trade a ten-year euro-

34 The consolidation of market-places will probably also reinforce the trend towards electronic trading. For example, the merger of AMEX and NASD (which operates a screen-based stock exchange), with the possible addition of the PHLX, is likely to lead to the computerised trading of equity options.

35 LIFFE indicated earlier that it would retain LIBOR.

denominated bond contract in June and will introduce a five-year contract in September, with both instruments being based on French government bonds. The exchange has announced that a forthcoming 30-year contract will incorporate benchmarks issued in a number of euro zone countries (including those of Italy and Spain), whereas the DTB intends to use only German government bonds for its euro-denominated bond contracts. LIFFE for its part will continue to list existing individual bond contracts for post-1999 delivery months.[36] It is not clear at this stage what type of contract design will best meet the needs of the euro-denominated bond market. A contract based on the underlying bonds of a single issuer would reduce the problems associated with basis risk and cheaper-to-deliver securities, but might be less liquid than one based on several issuers.

The struggle for European market share was also reflected in the introduction of new products during the course of the quarter. In the area of interest rate contracts, LIFFE stole a march on its competitors by launching in late April the first euro-denominated futures, a modified version of its existing short-term ECU contract. The exchange also said that it would launch in the fourth quarter of 1998 a futures based on five and ten-year euro-denominated swap rates which, if successful, would represent a radical departure in a market that has been dominated by government bond rates. EUREX (the joint venture comprising the DTB and SWX) announced the launch in July of a contract on large German mortgage bonds (jumbo Pfandbriefe). In July, the MATIF attempted to capitalise on its switch to electronic trading by introducing low-fee contracts on UK gilts. Competition was also much in evidence in European equity products. While the AEX and LIFFE began the trading in May of contracts based on the Eurotop 100 index, the Euro-Alliance (the group formed by EUREX and the SBF-MATIF) launched in June a family of narrower equity indices (Stoxx 50 and Euro Stoxx 50).[37]

US exchanges were also fairly active in listing new products. The CME was particularly busy, with the launch in April (in co-operation with MICEX) of a contract on the dollar/rouble rate, and in May of several currency contracts involving the ECU/euro.[38] It also plans to introduce contracts on euro-Canadian interest rates, Japanese government bonds and its Quarterly Bankruptcy Index. The CBOT for its part added a contract on US inflation-indexed Treasury bonds. Lastly, the TSE launched sectoral equity indices.

Over-the-counter instruments

The paucity of recent data on OTC markets once again made it difficult to assess the extent of overall activity in the second quarter of 1998.[39] Nevertheless, OTC business seems to have proceeded at a steady pace, following the deceleration seen at the end of last year. Fixed income markets in the industrial world generally remained calm but the weakness of the yen was associated with a higher turnover of related currency contracts and the upward momentum of continental European equity markets generated activity in warrants. The prolonged crisis in Asia and its repercussions in other regions of the developing world created interest in credit-related instruments. Market participants expect that the markets for equity and credit derivatives will experience the most rapid expansion over the next few years.

In the area of *interest rate products*, there was a general decline in market volatility in Europe and North America. Although the strong volume of US corporate bond issuance and the steady flow of eurodollar bonds tended to put downward pressure on US dollar swap spreads, the reduced supply of US government bonds and the global flight to quality maintained them at fairly high

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36 Euro-denominated bond futures might be introduced as early as September for parallel trading with existing bond contracts.

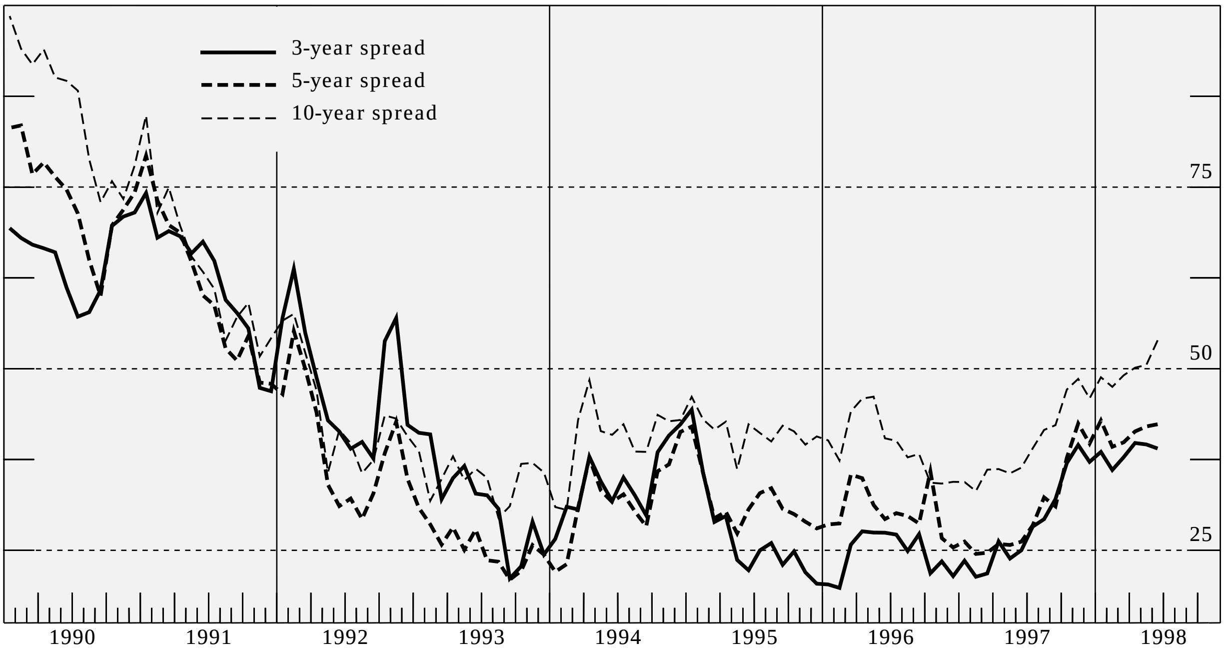
37 The announcement of an alliance between the DB and the LSE in early August could have important repercussions for the continued existence of these competing indices.

38 FINEX also introduced a contract on the ECU/euro against the US dollar.

39 As announced earlier, the BIS has recently begun a regular semi-annual survey of OTC market activity. Data on the outstanding stock of OTC contracts are being collected and the BIS intends to publish end-June 1998 data by the end of the year.

US dollar interest rate swap spreads over US Treasury yields

Monthly averages, in basis points



Source: Datastream.

levels (see the graph above). The stability of US official rates kept interest rate volatility low and the trading flow of interest rate options modest. The announcement concerning the initial participants in European monetary union in early May was followed by a flattening of the main European swap curves and a moderation of arbitrage transactions. With market participants discounting an increase in German official rates, options turnover in the core European countries was reportedly modest. European bond issuers made active use of Deutsche mark swaps and banks began quoting prices in euros for a range of interest rate contracts. There was also some activity involving the interest rates of those European countries that will not join EMU at the outset. For example, upward pressures on short and long-term sterling rates led to interbank trades in forward starting swaps, while European "convergence" trades shifted to the interest rates of Greece and Eastern European countries. With Japanese bond yields declining to new lows, activity in yen interest rate instruments remained lethargic. The turmoil in the emerging markets created some trading opportunities, but the lack of liquidity constrained transactions.

With respect to *currency-related products*, the weakness of the yen against other major currencies and the possibility of central bank action to support it pulled the volatility of related options to record levels and created active trading in US dollar calls/yen puts. The strengthening of the Deutsche mark against the other major currencies in the first half of the quarter was also reflected in active demand for short-dated dollar put/DM call options. There was a brief flurry of speculation on European currency pairs ahead of the selection of countries that would form part of European monetary union in April, but the implied volatility of the currencies that will constitute the euro dropped sharply afterwards. Intermediaries began quoting currency forwards and options denominated in euros but customers remained somewhat diffident. At the same time, dealers shifted their focus to more exotic currencies, where there was strong demand for puts (such as on certain Eastern European and Asian currencies as well as on the Brazilian real and the rand). However, the drying-up of liquidity in foreign exchange and interest rate derivatives in several of those markets made it expensive for companies to hedge their currency exposures.[40]

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40 This was compounded by restrictions imposed in some countries on derivatives market activity. For example, the Taiwanese central bank announced in April that it was tightening the supervision of non-deliverable forward contracts,

In the area of *equity derivatives*, the European warrants market was reported to have been highly active, but transactions in Asian products remained subdued. Basket warrants on European banks and Southern European companies were popular, but dealers also launched issues based on sectoral indices in a bid to facilitate the switch in asset allocation from a country to a pan-European basis. With the interest rates of European countries converging further, European retail demand for guaranteed investment products remained strong.[41] However, the high volatility of equity markets prompted dealers to close out the long-dated option positions that they had built up when offering such products.

The Asian financial crisis continued to focus the attention of market participants on *credit derivatives*. The weakness of the Japanese financial system, particularly following new disclosures of non-performing loans and the downgrading of banks, reportedly led market participants to seek active credit protection on the liabilities of Japanese banks and non-financial corporations. While some Japanese banks were also thought to have purchased short-term credit protection against their loan exposures, a large US-based insurance company was reported to have entered into a large credit event swap on Japanese sovereign instruments (rather than offloading its risks in the reinsurance market). However, the ongoing deterioration in credit quality in the Asian region meant that intermediaries continued to exhibit caution in providing hedges on lower-rated credits. In a survey of active participants in the credit derivatives market, the British Bankers Association (BBA) estimated that the outstanding stock of such derivatives amounted to $170 billion at the end of 1997 compared with $40-50 billion at the end of 1996. According to dealers, much of the growth has resulted from transactions on emerging market paper and structured securities. Lastly, the US Office of the Comptroller of the Currency released data showing that credit derivatives held by US banks amounted to $91 billion at the end of March 1998, compared with $55 billion at the end of 1997 and $19 billion in the first quarter of that year.

Structural and regulatory developments

The US Commodity Futures Trading Commission (CFTC), which is responsible for regulating futures and options markets, announced in May that it was engaged in a comprehensive review of its regulatory approach to OTC derivatives markets. Market participants have been concerned for several years about the potential application of the Commodity Exchange Act (CEA) to such markets. Since the CEA generally requires instruments for which it has responsibility to be traded on exchanges, the inclusion of OTC derivatives within its regulatory ambit might have the effect of making them illegal and unenforceable. Legislation introduced in 1992 attempted to address this concern by authorising the CFCT to exempt OTC derivatives from most provisions of the CEA. The CFTC’s announcement has heightened market participants’ concerns because of the possibility that the prior exemption would be changed and because of the underlying premise that OTC derivatives are subject to the CEA unless they are explicitly excluded or exempted. Neither the US Congress nor the CFTC have yet determined that OTC derivatives are subject to the CEA. The US Treasury, the Federal Reserve Board and the Securities and Exchange Commission (SEC) have taken the position that there are serious questions about the CFTC’s jurisdiction in this area and that it was not the intent of Congress to allow the CFTC to impose unilaterally a comprehensive regulatory scheme for the OTC market. They have proposed legislation that would impose a temporary moratorium on the CFTC’s ability to act in this area until Congress has an opportunity to review the issue. In a separate action, the CFTC has requested comments on the installation by non-US exchanges of electronic trading terminals in the United States. The CFTC has previously allowed the DTB to place terminals for the execution of trades from the United States without requiring that the exchange be designated as a market under the CEA, subject to certain conditions. The CFTC now intends to establish rules that would govern the treatment of foreign terminals in the United States.

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requiring daily disclosure of all trades and the immediate reporting of transactions amounting to more than $5 million (along with the identity of counterparties).

41 Guaranteed equity products offer some participation in the upward movement of equity markets, while guaranteeing the invested principal. Intermediaries guarantee the principal on such products by investing in zero coupon government securities and purchasing equity options.

In a separate development, the US Financial Accounting Standards Board (FASB) announced that it had approved final standards on derivatives and hedge accounting. The new rules, which will become effective for fiscal years beginning on 15th June 1999, will require companies to record derivatives on the balance sheet as assets or liabilities that will be measured at fair value. Companies will have to record in the income statement any changes in the value of such instruments that do not closely offset the change in the value of the underlying. The new standards have faced opposition from a number of industry participants, including the International Swaps and Derivatives Association (ISDA), which has said that such rules would produce swings in accounting profits and losses, and therefore create a disincentive for corporations and financial institutions to hedge prudently and cost-effectively against financial risk.

Lastly, ISDA launched in May the final version of its EMU protocol, a series of documents clarifying the treatment of existing transactions in the light of EMU. The protocol outlines five areas that will be affected by EMU (continuity of contracts, price sources, netting, definitions and redenomination of bond options) and defines market practices for each of those areas. By signing the protocol, firms agree to automatically amend their ISDA master agreements with all the other market participants that wish to adopt the same provisions. The aim is to reduce the legal workload relating to the transition to EMU.

V

THE BIS CONSOLIDATED INTERNATIONAL BANKING STATISTICS IN PERSPECTIVE

The Asian crisis has revived interest in the BIS international banking statistics as a key source of information on the country exposure of creditors. The BIS figures are derived from two different and fairly complex statistical reporting systems. The aim of this section is to familiarise readers with these systems and with some of their uses in assessing the size and composition of countries' indebtedness.

The detailed *quarterly locational international banking statistics*, reviewed in Part II of this commentary, (and provided in full in Annex Tables 1 through 7) measure the claims (as well as the liabilities) of commercial banks that are *residents* of the 24 countries reporting to the BIS (namely 18 industrialised countries and six other financial centres) vis-à-vis all individual countries. These banking statistics distinguish between types of borrower (banks and non-banks),[42] as well as the currencies in which the claims are denominated. This, in turn, makes it possible to estimate cross-border flows of funds which are consistent with balance-of-payments methodology.

Useful as these quarterly data are, the Mexican debt crisis of 1982 underlined the desirability of having supplementary information on the maturity and composition of banking claims, as well as on the relative importance of the various nationality groups of reporting banks in individual country exposure. For this purpose, the BIS was requested to collect *semi-annual consolidated international banking statistics*, showing the maturity and sectoral distribution of banks' country exposure according to the *country of origin* (the location of the head office), rather than the country of residence, of reporting banks. The data cover the worldwide consolidated claims on countries in the developing world and Eastern Europe, as well as on non-reporting developed countries of banks originating from 18 countries.[43] The worldwide consolidation principle means that positions between related offices are netted out.[44]

Despite their conceptual differences, both the quarterly and the semi-annual statistics were able to capture the strong increase in Asian countries' external indebtedness well before the eruption of the Asian crisis in 1997. In particular, the surge in the short-term debt of Thailand was underlined in BIS publications as early as 1994 and consistently thereafter.[45] Nevertheless, in the wake of the crisis, efforts are under way in cooperation with reporting central banks to improve further the coverage, quality and timeliness of the data. This has already been reflected in a reduction in the publication lag of the semi-annual consolidated statistics through the issue of a statistical press release, accompanied by a short covering note.[46] A more detailed analysis of these data will henceforth be included in the BIS quarterly publication.

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[42] More recently, an explicit identification of loans and deposits separate from securities held in banks' portfolios has been introduced.

[43] In the BIS terminology, the combination of developing countries, Eastern Europe and non-reporting developed countries is defined as "outside-area countries".

[44] Although the BIS semi-annual statistics were originally introduced in 1977, worldwide consolidated data were expanded from US banks to include non-US banks from end-1983, in the wake of the first Mexican crisis. A nationality breakdown was published for the first time at the end of 1993.

[45] See page 6 of "The Maturity, Sectoral and Nationality Distribution of International Bank Lending, Second Half 1993", July 1994 and subsequent issues. See also page 20 of "International Banking and Financial Market Developments", August 1995, as well as pages 143-144 of the 66th Annual Report of the BIS published in June 1996.

[46] See the BIS press release of 25th May 1998. Efforts are also under way to introduce ultimate risk reporting, include reporting countries as vis-à-vis countries and move to quarterly reporting.

This part of the commentary is divided into three sections. The first one highlights the main differences in statistical coverage between the BIS quarterly and semi-annual data in measuring the country risk exposure of internationally active banks. The second section compares such creditor-based reporting systems with the data collected by the World Bank, which are based primarily (although not exclusively, as explained below) on information provided by debtor countries. The aim of the comparison is to illustrate the information content of the BIS statistics in estimating the external debt of emerging market economies. Finally, the third section analyses long-term developments in the maturity, sectoral and nationality composition of the BIS semi-annual consolidated statistics for broad groups of emerging market economies.

The quarterly locational versus semi-annual consolidated international banking statistics

The *country of residence* of the lending bank is the key criterion of the BIS quarterly international banking data. It is therefore consistent with the balance-of-payments concept and allows measurement of *cross-border flows* between the host country and the rest of the world. In contrast, the *nationality* or *country of origin* of the lending bank constitutes the organising principle of the semi-annual reporting system, with the *worldwide consolidation* of outstanding exposures being its fundamental underlying characteristic.

Moreover, while the country-by-country breakdown of the quarterly statistics primarily aims at capturing the size and composition of international or cross-border capital flows,[47] the semi-annual consolidated statistics focus explicitly on the maturity and nationality structure of international bank exposures (together with a sectoral breakdown of claims) to entities located outside the reporting area. The latter data are drawn largely from supervisory or statistical returns in the countries where banks are headquartered, covering all (domestic and foreign) establishments of a particular bank. The inclusion of the exposures of foreign branches and subsidiaries[48] requires that all inter-office accounts be netted out in order to avoid double-counting (in contrast to the quarterly statistics).

Coverage of country exposure in the BIS international banking statistics

	Quarterly	Semi-annual
Reporting country................................	Host country (residence)	Home country (nationality)[1]
Number of countries............................	24	18
Reported claims...................................	External (cross border)	Worldwide consolidated
Inter-office netting-out........................	No	Yes
Composition of claims by:		
Currency..	Yes	No
Type	Yes[2]	No
Type of counterparty[3]......................	Yes (partial)	Yes
Maturity...	No	Yes[4]

[1] Host country for the affiliates of banks with head offices located in non-reporting countries. [2] Loans, deposits and securities. [3] Banks and non-banks for the quarterly statistics; banks, public sector and private non-banks for the half-yearly data. [4] Up to one year, between one and two years and beyond two years.

It should be stressed that in the two sets of statistics exposures are generally reported vis-à-vis all borrowers located in one particular country, regardless of the residence of the headquarters of the borrower. Therefore, in both cases, the exposures measure the *transfer risk* faced by international banks, defined here as the risk associated with capital controls or a moratorium on payments which may restrict the ability of all entities located in one particular country to service their debt to foreign

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[47] The original purpose of the quarterly statistics, which were introduced in the mid-1960s, was to cast light on the eurodollar market, reflecting concerns about its monetary policy implications.

[48] Including, in general, in the case of non-local currencies, those of affiliates to residents located in the recipient countries.

entities. However, exposure may be redefined on an *ultimate risk* basis, by identifying the country in which the ultimate guarantor resides or, for branches, in which the head office is located. Such adjustment is generally considered to provide a better measure of the *country risk* faced by creditors. When the statistics were created, the bulk of external borrowing by emerging economies was undertaken by the public sector or with its explicit or implicit guarantee. Moreover, although use was made of offshore centres by borrowing entities to channel funds from major financial centres to their home country, information on this was scant and unreliable. However, with the expansion of cross-border investment and borrowing facilities, the reduced weight of public sector borrowers (as a result of efforts towards fiscal consolidation and privatisation) and the growing use of offshore facilities for raising funds in the international market-place, the measures of transfer risk and country risk have increasingly diverged. This helps to explain current efforts to collect statistics on an ultimate risk basis (see the following section).

Although the worldwide consolidation principle is the most important difference between the two sets of statistics, not all the data reported under the semi-annual reporting system are in fact consolidated. Several reporting countries are host to a number of banks with headquarters in non-reporting countries. Excluding such establishments from the half-yearly reporting system would have considerably reduced the coverage relative to the quarterly statistics (by more than 10%). As a result, reporting countries were also requested to provide the same maturity and sectoral breakdowns of the country exposure of such establishments on an unconsolidated basis.[49] For example, the UK reporting system includes the consolidated claims of UK-owned banks, plus the non-consolidated claims of the UK affiliates of banks whose head offices are located in countries other than the other 17 BIS reporting countries (since the UK affiliates of, say, French banks are already covered by the French reporting system).

Consolidation, together with the inclusion of the non-consolidated claims of banks with headquarters in non-reporting countries and the inclusion of local lending in foreign currencies by reporting banks’ foreign branches and subsidiaries, means that the coverage of the semi-annual data tends to be broader than that of the quarterly. On the other hand, the netting-out of inter-office accounts, combined with the smaller number of reporting countries, reduces the size of the semi-annual figures relative to the quarterly data. Admittedly, the six countries reporting under the quarterly but not the semi-annual framework consist of Caribbean and Asian offshore centres where the activity of the affiliates of the 18 countries’ banks is already covered by the reporting head offices (as part of the consolidation exercise). However, they also host a number of banks from emerging market economies, which are often used for rechannelling funds from major financial centres to their home country.

As can be seen from the graphs on the next page, the relative importance of these various discrepancies differs considerably both between regions and between individual countries. Thus, whereas the increases in the two statistical series during the last few years have been fairly consistent for Korea and Indonesia, the rise in the consolidated data has lagged that of the non-consolidated data in the case of Thailand. This has been attributed to the large volume of inter-office business (which is netted out in the semi-annual statistics) conducted by Japanese banks until 1996 and not associated with onlending to local entities.[50]

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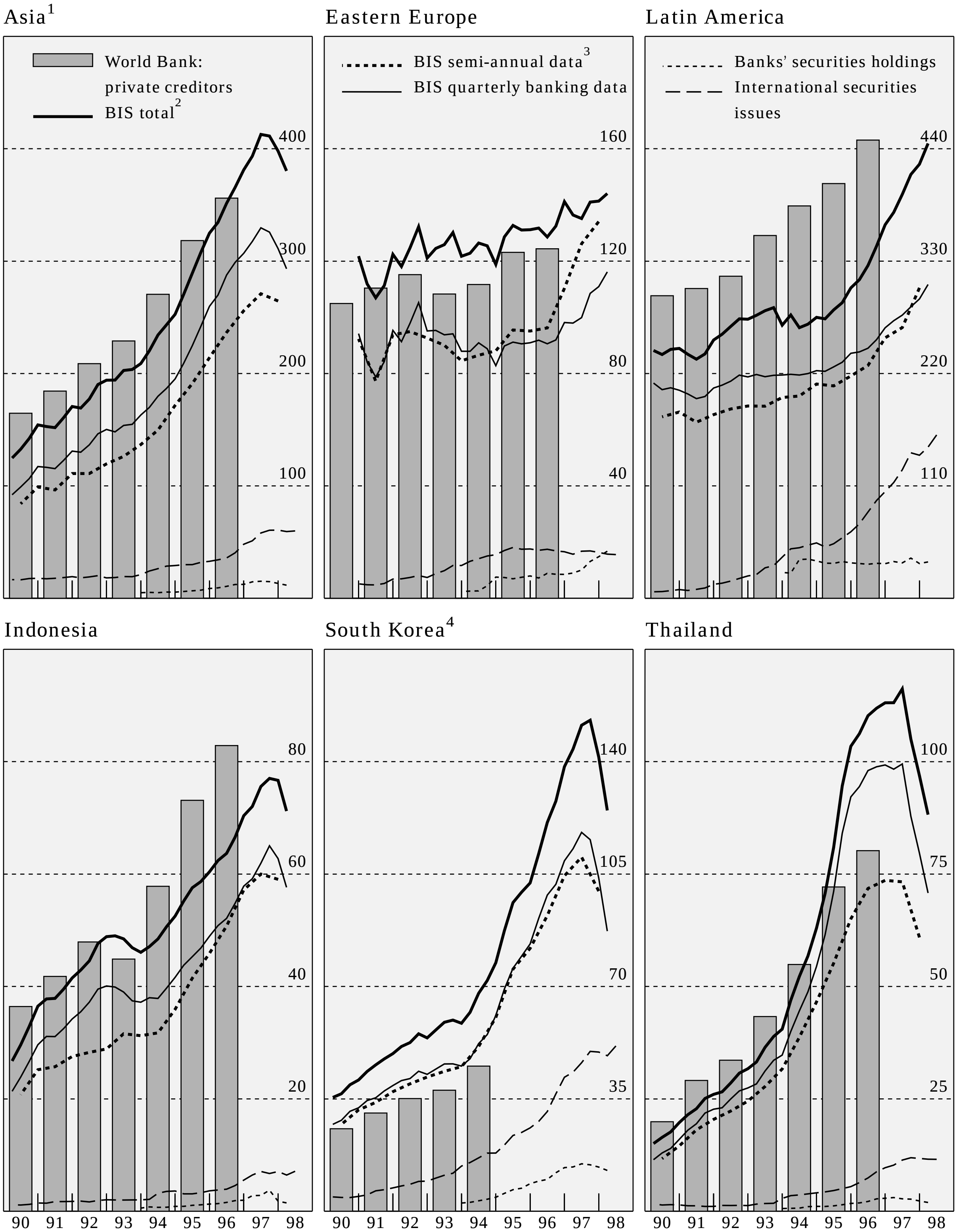
49 The application of the consolidation principle in this particular context would have resulted in netting out funds transferred to head offices without a corresponding inclusion of the ultimate use of the funds, since the positions of such head offices fall outside the scope of the reporting system.

50 The opening of the Bangkok International Banking Facilities at the beginning of 1993 was initially associated with fierce competition between Japanese banks to boost the balance sheet of their local offices in order to qualify for the limited number of new banking licences granted by the Thai authorities for operating in the country. The emergence of strains both in this country and in Japan subsequently dampened their enthusiasm for establishing a market presence in Thailand.

Measures of international debt to the private sector

Amounts outstanding in billions of US dollars



[1] Excluding Hong Kong, Japan, Singapore and South Korea. [2] BIS quarterly banking data excluding banks holdings, plus BIS international debt securities data and OECD-BIS data on guaranteed non-bank trade credits. [3] Including net local claims funded externally in local currency. [4] Following the reclassification of South Korea as a high-income country, debt data for this country are no longer included in the World Bank figures.

Sources: World Bank and BIS.

Creditor versus debtor reporting systems

Supplementing the BIS international banking statistics with data from other non-debtor country sources provides an alternative estimate to the debt statistics reported by the debtor countries themselves, to the World Bank in particular. This is illustrated in the graphs on the previous page, which compare the Debtor Reporting System (DRS) of the World Bank with the two sets of BIS banking statistics and a "BIS total", defined as the sum of the quarterly figures, international securities debt (gathered from market sources) and OECD data on guaranteed non-bank trade credits. In some instances, the BIS total exceeds the World Bank figures, despite the lack of creditor data on non-guaranteed trade credits and domestic securities held by foreigners in the BIS total and the inclusion in the World Bank figures of some creditor statistics (as explained further below). This is particularly the case for Asia, which may suggest under-reporting of debt figures by individual debtor countries.

Another important feature of the creditor data collected by the BIS is that they are more timely, with a publication lag of five to six months compared with one to two years for the debtor country data. Therefore, they permit an earlier detection of the sharp rise in debt that often precedes a financial crisis. In the case of Thailand, for instance, the semi-annual statistics indicated as early as 1994 both greater debt than officially reported and an acceleration in the build up of short-term banking debt. Efforts under way to reduce the lag in the reporting of creditor data will further contribute to enhancing the role of such data as an indicator of the accumulation of external debt.

As shown in the table below, the main focus of the DRS of the World Bank has traditionally been the long-term external debt of public agencies and of private entities guaranteed by a public agency in the debtor country.[51] While data on long-term non-guaranteed private debt are now reported by the majority of developing countries, the World Bank has in recent years supplemented its DRS on long-term debt with data on short-term debt, relying primarily on creditor sources for that purpose.[52] It should be stressed, however, that the lack of adequate reporting of short-term private sector debt by debtor countries is not limited to emerging market economies. In some G-10 countries, for instance (the most outstanding example being the United States), domestic monetary and credit aggregates are adjusted to include offshore depositing and borrowing by domestic non-bank entities by using the BIS international banking statistics.

Main features of creditor and debtor reporting systems

	Creditor reporting system[1]	**Debtor reporting system**
Main focus of reporting.........................	Type/residence/nationality of creditor	Type of resident debtor
Main type of information	Maturity/type of resident debtor[2]	Long-term public/publicly guaranteed debt
Other information.................................	Currency/type of asset	Long-term private non-guaranteed/short-term debt/type of creditor[3]
Publication lag......................................	5 to 6 months	1 to 2 years

[1] BIS international banking statistics and OECD data on officially guaranteed claims. [2] Nationality of ultimate guarantor to be introduced in due course. [3] Short-term debt primarily estimated from creditor reporting systems. Type of creditor mostly available for long-term public and publicly guaranteed debt.

In two areas, however, both creditor and debtor reporting systems fail to provide an adequate picture of the external debt situation of countries. One is related to off-balance-sheet items

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51 See "Global Development Finance", World Bank, 1998.

52 The most important source is precisely the BIS semi-annual consolidated banking statistics, with their residual maturity distribution being used by the World Bank to estimate short-term country debt by original maturity.

and the other to ultimate risk.[53] The Asian crisis revealed that, in both respects, existing statistics did not capture the full extent of the debt of countries caught in the currency turmoil. First, off-balance-sheet exposure has increased substantially in recent years, as a result of the development of financial instruments that offer new ways of taking or hedging exposures. Mention may be made in this regard of the use of foreign exchange forward and swap operations, which create market risk (i.e. currency and interest rate) as well as credit risk exposures without being reported on the balance sheet.[54] Secondly, the accelerating pace of globalisation has offered opportunities for new borrowing and investment strategies, which further complicate the assessment of ultimate risk. For example, the increasing use of foreign vehicles by Korean borrowers for raising funds on foreign and international markets has led to a significant underestimation of the external debt of Korea.[55] Current efforts to improve the BIS international statistics therefore include the introduction of data on an ultimate risk basis.

The maturity, sectoral and nationality distribution of international bank lending

The BIS press release of 25th May 1998 on the semi-annual consolidated statistics for end-1997 underlined the movements of funds which took place in the second half of 1997. It showed, in particular, a reduction in the claims on Asia,[56] reflecting in the main non-renewal of short-term credit. At the same time, the sectoral composition indicates that the decline vis-à-vis entities in Asia was more than accounted for by local banking counterparties, accentuating the growing tendency towards direct lending to the private non-bank sector.[57] The nationality breakdown also revealed important differences in the behaviour of major lending groups in this period of financial upheaval. On the one hand, Japanese and North American banks reduced their outstanding exposure to residents of emerging Asian economies. On the other hand, their European counterparts continued to increase their presence in the region, albeit more selectively (in terms of recipient countries).

From a longer-term perspective (see the table on the next page),[58] the *maturity composition* of lending to outside-area countries shows the predominance of short-term loans (defined here as lending with a residual maturity of “up to one year”) throughout the 1990s. Although there have been significant variations across regions, the proportion has increased fairly steadily over the decade (from 45% to 55% at end-1997). This reflects a number of factors, including the growth of trade financing, “arbitrage” opportunities created by interest rate differentials, financial liberalisation and the greater flexibility that banks have in monitoring funds that are frequently rolled over. In addition, the increasing use of secured lending (repos) and derivative instruments has broadened participation in the international wholesale market. Furthermore, while interbank business has been the core element in the international lending strategy of some banking groups, recipient countries have often been keen to encourage the development of regional or international financial centres within their national borders. Finally, the narrowness of equity and fixed income markets in the developing world has meant that local banking systems have generally been the principal avenue for the financing of growth. However, the rapid reassessment of short-term commitments has also brought new risks of

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53 Exposures measured on an ultimate risk basis identify counterparties according to the country in which the ultimate guarantors and/or head offices of branches are located.

54 Owing to the reporting burden it would impose on market participants, the derivatives statistics published by the BIS do not include a country breakdown of counterparties.

55 This may not always be the case. For instance, the extensive use of the Bangkok International Banking Facilities for channelling funds from the international banking market to other countries in the region through non-BIS reporting banks means that the true size of Thai external debt is overstated.

56 However, the reduction was smaller than in the quarterly statistics.

57 It should be emphasized that such movements do not include local claims in local currencies.

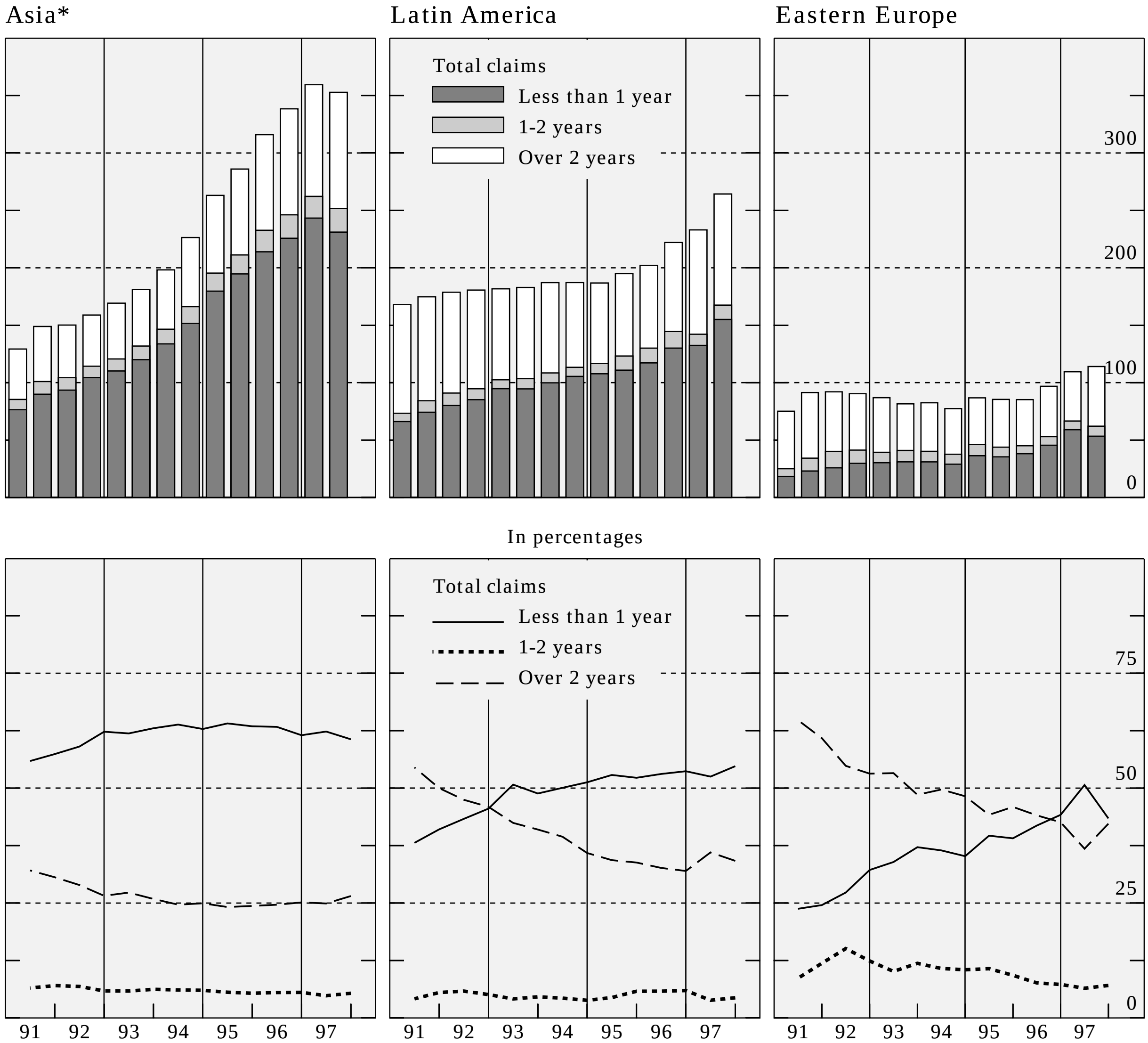
58 While the coverage encompasses all outside-area countries, the group of non-reporting developed countries is fairly heterogeneous in both geographical and economic terms and, therefore, does not lend itself easily to a common analysis. As a result, the present review is limited to emerging market economies and Eastern Europe.

Main features of consolidated international banking statistics

Positions vis-à-vis	Consolidated cross-border claims in all currencies and local claims in non-local currencies								
	Total	Distribution by maturity		Distribution by sector			Distribution by nationality of reporting banks		
		Up to and including one year	Over one year	Banks	Public sector	Non-bank private sector	European banks	North American banks	Japanese banks
	in billions of US dollars	as a percentage of total consolidated claims							
All countries									
end-1985	583.6	43.7	52.5	29.1	37.8	27.8	41.1	27.8	18.7
end-1990	664.8	45.0	50.2	35.6	30.8	31.0	48.3	13.1	24.4
end-1995	873.6	55.3	36.8	40.7	18.7	39.7	53.4	13.7	19.0
end-1996	991.4	55.1	35.8	40.2	16.3	42.6	54.2	15.0	17.1
end-1997	1,120.1	54.9	35.9	37.7	14.2	47.2	59.6	13.8	14.6
of which:									
Developed countries									
end-1985	95.3	43.0	51.3	26.5	26.8	37.9	41.0	22.3	22.3
end-1990	146.6	49.0	43.0	35.6	19.2	40.6	43.9	7.4	32.9
end-1995	152.5	53.6	34.7	39.6	15.3	44.3	54.7	7.1	17.8
end-1996	171.0	53.2	32.0	40.5	14.6	43.9	56.4	9.7	13.2
end-1997	195.7	53.5	29.7	40.3	14.5	44.1	60.3	8.4	12.1
Eastern Europe									
end-1985	59.7	39.4	51.3	50.2	30.8	0.0	62.3	5.1	15.9
end-1990	92.5	26.4	70.8	67.5	20.0	10.1	69.5	1.3	14.6
end-1995	90.6	39.1	55.2	70.0	14.6	15.3	82.7	4.4	5.2
end-1996	103.0	44.2	49.9	64.2	15.1	20.4	79.5	9.3	3.9
end-1997	123.0	43.4	49.3	52.7	12.8	34.4	80.4	8.9	3.4
Developing countries									
end-1985	428.1	44.5	53.0	26.7	41.3	29.4	38.2	32.2	18.3
end-1990	422.0	47.6	48.6	28.6	37.4	32.3	45.1	17.8	23.7
end-1995	622.7	58.4	34.9	37.0	20.3	42.3	48.8	16.8	21.5
end-1996	708.2	57.7	35.1	36.7	17.1	46.0	50.2	17.6	19.8
end-1997	774.6	58.1	35.4	35.1	14.0	50.8	55.9	15.9	17.5
of which:									
Asia									
end-1985	94.3	45.1	51.1	30.5	39.4	27.6	29.4	28.2	33.4
end-1990	135.4	54.8	39.8	33.8	28.8	36.0	30.6	10.7	44.5
end-1995	306.9	63.5	29.8	43.4	11.5	45.0	38.6	9.8	36.8
end-1996	367.0	61.5	30.7	43.3	9.0	47.6	42.2	11.0	32.3
end-1997	381.3	60.6	31.9	40.7	7.4	51.8	47.1	9.7	30.1
Latin America									
end-1985	236.5	39.5	59.2	21.9	50.1	26.3	33.2	39.8	16.3
end-1990	184.8	36.9	60.1	21.0	52.0	25.9	43.9	28.4	16.8
end-1995	212.2	52.3	39.6	24.6	32.2	43.0	52.7	31.4	6.8
end-1996	242.4	53.7	37.9	24.2	27.9	47.7	54.2	31.2	6.4
end-1997	283.1	54.8	38.6	26.0	21.2	52.6	61.8	26.4	5.2
Middle East									
end-1985	41.3	71.7	25.9	46.0	12.3	34.1	47.8	19.8	11.2
end-1990	42.6	72.1	25.8	43.9	17.4	34.7	57.5	7.4	11.7
end-1995	51.2	59.1	38.9	46.0	23.8	29.4	66.3	8.1	7.0
end-1996	48.6	56.7	40.9	47.3	20.1	32.6	66.0	8.9	5.8
end-1997	52.2	60.0	37.6	45.8	19.2	35.0	62.4	10.9	6.5
Africa									
end-1985	56.0	44.5	49.3	25.9	28.2	41.6	66.7	15.7	6.6
end-1990	59.2	47.0	49.3	29.6	25.8	42.1	72.8	8.1	6.8
end-1995	52.4	53.1	42.5	41.2	20.3	37.3	75.4	7.4	5.7
end-1996	50.2	49.8	47.2	39.1	21.4	38.7	74.5	8.6	6.9
end-1997	58.0	56.3	40.1	33.1	17.4	49.4	78.4	9.7	4.8

Maturity distribution of international bank lending

In billions of US dollars



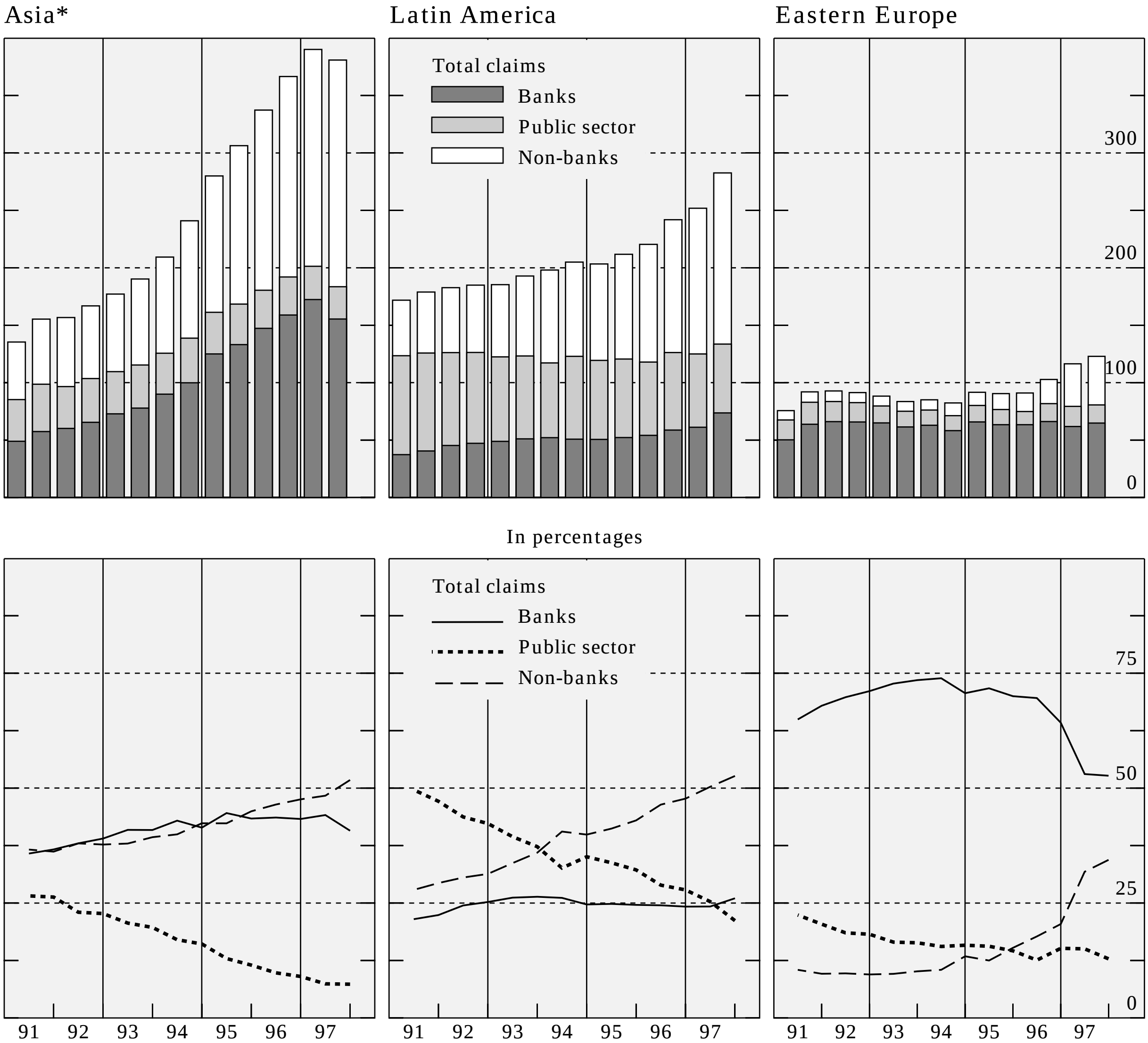
* Excluding Hong Kong, Japan and Singapore.
Source: BIS.

financial instability in the countries concerned, as shown by the Asian crisis.

The proportion of short-term loans has been highest in Asia over the decade. However, the increase in the share of the short-term component in the early part of the decade has been followed by a slight decline from the peak of 64% reached in 1995. This recent lengthening of the maturity profile may have been related to the greater importance of longer-term project financing and, more recently, the Asian crisis, as short-term credit lines have not been renewed. In Latin America, too, there has been a steady increase in the proportion of short-term lending, but from a much lower initial level than in Asia (from 37% at the end of 1990 to 55% at the end of 1997). This gain has reflected the growing importance of short-term lending to the private non-bank sector, as severe financial crises in a number of countries (in particular in Venezuela in 1994, and in Argentina and Mexico in 1995) have moderated banks' enthusiasm for short-term government debt instruments and induced greater caution with respect to interbank lending. It has also occurred despite the lengthening of the maturity profile resulting from debt rescheduling agreements. In a context of less buoyant lending conditions, Eastern Europe has seen an even more pronounced increase in the weight of the short-term category over the period (from 26% to 43%). Aside from the general factors mentioned above, the greater weight of

Sectoral distribution of international bank lending

In billions of US dollars



* Excluding Hong Kong, Japan and Singapore.

Source: BIS.

short-term lending has reflected the transition to market economics and, thus, the growing use of private financial channels. Year-to-year variations in the maturity structure in this region have been largely associated with a build-up of arrears, followed by the conclusion of debt rescheduling agreements. Despite heavy bank purchases of short-term Russian government debt instruments, the rescheduling agreement concluded by Russia in late 1997 resulted in a sharp fall in the short-term debt component.

The *sectoral distribution* of claims on outside area countries shows a gradual decline in the weight of the public sector (from 31% at end-1990 to 14% at end-1997) and a parallel increase in the proportion of loans made to private non-bank borrowers (from 31% to 47%). These offsetting trends have been evident across most regions, and direct credit to the non-bank private sector is now predominant in Asia and Latin America. The factors underlying the decrease in claims to the public sector include fiscal consolidation, privatisation and debt reduction agreements. Refinancing of bank loans made to government entities in the international securities market is also likely to have played a role, since a proportion of the new issues was purchased by non-bank investors. Claims on the public sector now amount to 21%, 13% and 7% of total lending to Latin America, Eastern Europe and Asia respectively. At the same time, lending to the non-bank private sector has been boosted by the growth of international trade and, in some countries, by the greater cost of funds offered by local banking systems. Industrial companies in emerging market countries have diversified their funding sources by increasing their direct recourse to foreign banks, prompted by the liberalisation of capital account transactions, a higher degree of sophistication of debt management, restrictions on access to external funds imposed on local banking systems and, until the Asian crisis, the stability of currencies. The expansion of business by companies from the industrialised world and buoyant transactions related to project financing have also contributed to this process.

The share of claims on banking systems increased substantially in the early part of the decade, owing to the rapid development of local and offshore banking systems (particularly in Asia) and extensive interbank interest rate arbitrage. It reached a plateau between 1993 and 1996 but declined in 1997 under the influence of the Asian financial crisis. However, by encouraging a further opening of local financial systems, the Asian crisis could well add to the growing involvement of international banks in local markets. It has been argued that, by spreading risks to a wider array of borrowing entities, direct lending to the non-bank sector could reduce the potential for an abrupt reversal of short-term banking flows. But, as the recent Asian crisis has shown, the large proportion of lending to non-banks has complicated the process of debt restructuring. It has also heightened the need for better financial reporting.

With respect to the *nationality distribution* of international bank lending to outside-area countries, one of the most striking developments since 1990 has been the buoyant activity of *European banks*, with their share in outstanding claims increasing from 48% to 60%. Within the European group, German banks have been the most active, accounting for 17% of total claims outstanding at end-1997, followed by French and UK banks (11% and 8% respectively). This compares with 15% for Japanese banks and 11% for US banks. The weakness of domestic demand in Europe and the low returns in traditional business have induced European-based banks to search for profitable new opportunities. While Asian and Latin American markets have seemed easier to penetrate or more promising in terms of growth and overall financial returns than those of Europe or North America, lending to these regions has also paralleled the operations of large European companies. Buoyant short-term trade financing (including officially sponsored lending) and the perceived need to diversify away from regions where they had traditionally enjoyed a dominant position (Africa, Eastern Europe and the Middle East) were other supporting factors. Lending to Asia has been particularly strong, with European banks overtaking Japanese lenders in that region in 1995 after having overtaken North American institutions in Latin America as early as 1987. Although their outstanding exposures tend to be more geographically diversified than those of banking groups from North America and Japan, the pattern of lending among the European continent's individual country groups since the beginning of the decade has been fairly differentiated. Thus, Dutch and Spanish banks have concentrated on Asia and Latin America respectively, and banks from Scandinavia have actually cut back their international exposures. Among the main groups, UK, German and French-based banks have focused on Asian emerging markets as well as, in the case of German banks, Eastern Europe.[59]

Meanwhile, *North American banks* have expanded their exposure at a slower pace than their European counterparts, with their market share hovering between 13% and 15% over the period under review. The somewhat cautious attitude of North American banks results in part from the scars left by the multiplication of problem loans in the early 1980s. Although banks from North America enjoyed a dramatic improvement in their credit standing thereafter, they appear to have given preference in recent years to domestic borrowers, in view of the rapid pace of economic expansion.

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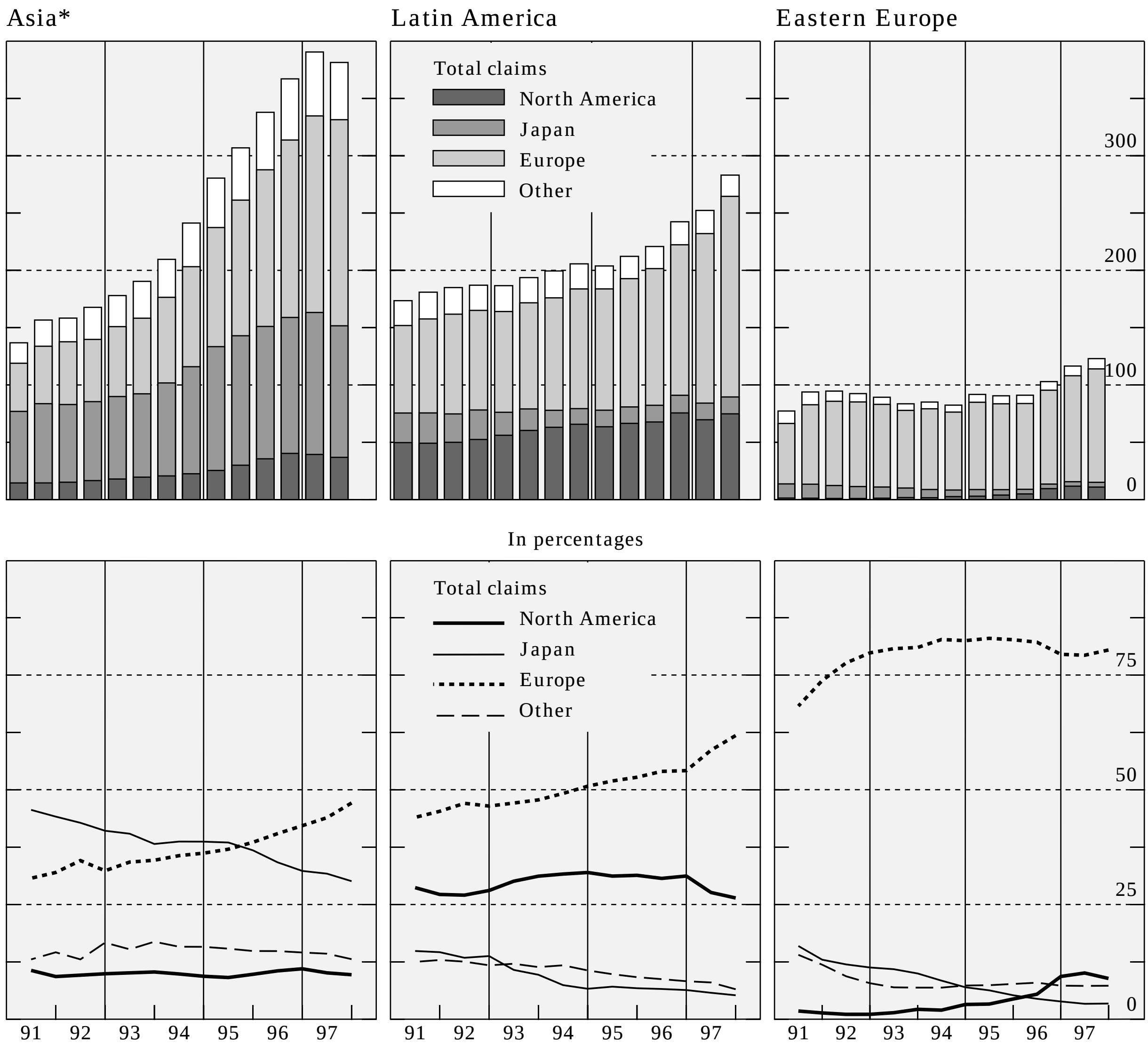
59 Although UK banks have made strong efforts to develop their Asian business, they have remained somewhat less exposed to troubled Asian countries than their German and French counterparts. Their expansion in Latin America has also proceeded at a slower pace. This has been attributed by some observers to the greater attention paid by UK lenders to their more buoyant domestic market, the lessons learned from earlier losses on international loans and, possibly, to more active management of credit risk. However, it should be mentioned that systemic risk may arise as much from the absolute level of exposure of banks as from the concentration of lending within a group of banks.

Nationality distribution of international bank lending

In billions of US dollars



* Excluding Hong Kong, Japan and Singapore.

Source: BIS.

US banks, in particular, resumed their lending to Latin American entities between 1992 and 1994, but the Mexican financial crisis that developed at the end of 1994 led to a massive disposal of Mexican dollar-linked Treasury bills. Following this episode, US banks moderated their lending to certain Latin American countries (Argentina and Mexico in particular) but continued to accumulate claims on Brazil. Nevertheless, the growth in North American claims on Latin America has failed to match that of European banks. While North American banks have also joined to some degree the European bandwagon into Asia, they have been much less exposed than any individual banking groups from the major European countries. A more significant development perhaps has been the effort made by US banks to expand in areas where their presence has been more modest (Africa, the Middle East and, more recently, Eastern Europe).

The international lending activity of *Japanese banks* has contrasted sharply with that of European banks. With outstanding loans stable in dollar terms over the period, their share in outstanding claims on outside-area countries has declined steadily (from 24% to 15%), following a massive expansion in the second half of the 1980s. Pressures to bolster capital (in the face of low latent reserves resulting from the weakness of equity markets) and mounting losses on domestic loans reduced their enthusiasm for international lending. There was a tentative return to the international market between 1994 and 1995, particularly to Asian emerging market countries and offshore centres (China, Hong Kong, Korea, Thailand and Singapore). However, mounting concerns about the strength of the Japanese financial sector and, related to it, the appearance of a significant premium on the financial liabilities of Japanese banks in the second half of 1995 and early 1996 brought a renewed shift away from international business. The Asian crisis led to a further cutback in the claims of Japanese banks in the second half of 1997. Nevertheless, with 70% of their outstanding international loans being to Asian residents, Japanese banks have the largest exposure to that region among the BIS reporting banks. Their total exposure amounted to 30% of total lending to Asia at the end of 1997, compared with 13% for German banks and 11% for French banks (the second and third most important lenders). The risks faced by Japanese banks are mitigated to some extent by the fact that a proportion of their Asian loans is to the affiliates of various Japanese companies (although these affiliates are not immune to the problems faced by troubled economies).

This snapshot shows that banks from different countries have followed a variety of strategies in the area of international lending. European banks have expanded the most rapidly but have also sought to diversify their exposures. North American banks have seen a slower growth of exposures, but also some diversification into areas where they have been hitherto less active. Japanese banks remain heavily exposed to Asia, but have tended to reduce their participation in relative terms. The Mexican crisis has failed to dent the enthusiasm of lenders for Latin America (except for Mexico itself), but the protracted Asian crisis might have a more substantial impact on new lending in the period ahead. It should be noted that these overall figures conceal differences in the degree of concentration within individual nationality groups, in the weight of guaranteed claims and in the volume of off-balance sheet exposure, which suggests a need for prudence in interpreting them.

Nevertheless, the recent events in Asia have revived interest in the BIS international banking statistics as a key source of information on creditor exposures and countries’ external debt. The importance of the information content of such creditor data explains current efforts to improve their comprehensiveness, quality and timeliness. This should enhance their usefulness for policy-makers and market participants in analysing cross-border exposures involving specific countries, as well as the size and structure of countries’ debt. However, improved transparency will also add to the role of users in making appropriate use of the information, recognising that this is a necessary, but not sufficient, prerequisite for the prevention of crises.

ABBREVIATIONS USED FOR EXCHANGES

AEX	Amsterdam Exchanges
CBOE	Chicago Board Options Exchange
CBOT	Chicago Board of Trade
CME	Chicago Mercantile Exchange
DB	Deutsche Börse
DTB	Deutsche Terminbörse
FINEX	New York Cotton Exchange - Finex Division
LIFFE	London International Financial Futures and Options Exchange
LSE	London Stock Exchange
MATIF	Marché à Terme International de France
MICEX	Moscow Interbank Currency Exchange
NASD	National Association of Securities Dealers
NYCE	New York Cotton Exchange
PHLX	Philadelphia Stock Exchange
SBF	Société des Bourses Françaises
SIMEX	Singapore International Monetary Exchange
SWX	Swiss Exchange
TSE	Tokyo Stock Exchange