1. INTERNATIONAL FINANCIAL MARKETS – HISTORICAL DEVELOPMENT AND EVOLUTION

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4. EURO NOTES AND PAPER

The fixed rate euro bond market would continue to develop with this being particularly attractive for sovereign and major corporate borrowers during low interest rate periods. Durations have nevertheless shortened from 10-20 years or more down to 3-7 years during the early 1970s. This would remain an important funding mechanism especially for international financial organisations or institutions such as the World Bank or the European Union agencies. The most significant early innovation was the creation of a parallel floating rate note (FRN) market with the fixed bond market beginning in 1969.

This was followed by the introduction of shorter duration instruments that could be rolled-over beginning with 3-6 months euro notes in 1978 and even shorter euro commercial paper based on the US domestic commercial paper market. Longer duration euro medium-term notes (euro-MTNs) were then introduced from 1985 with multi-option funding facilities (MOFFs) having been first used in 1984. Each of these new shorter duration instruments is considered in turn. With the introduction of floating rates and shorter durations, the markets were also characterised by 'pre-priced' deals and 'bought' deals and then with the development of revolving and then multiple option structures.

(a) Floating Rate Notes (FRNs)

Floating rate notes (FRNs) were developed in the early 1970s to allow companies to borrow on a floating rather than fixed basis. The first FRN was for 0.75% above LIBOR US$50m by the Italian national energy agency, *Ente Nazionale per L'Energia Elettrica* (ENEL), managed by S G Warburg and Bankers Trust International in May 1970.[1] Bankers Trust International raised a further US$75m for Pepsico in February 1970. The floating rate formula was developed by Evan Galbraith at Bankers Trust to create a more secure form of borrowing bridging the loan and bond markets. Debentures with floating interest rates had been offered previously such as with the Dreyfus Offshore Trust NV US$14.7m 5-year participating debentures although this was tied to a common share offering.[2] Opinion differs as to which was the first FRN issue. FRNs became common with rising interest rates during the early 1970s and the difficulty in placing fixed rate debt.

The first US$100m issue was by Morgan Stanley for Esso Overseas Finance NV in March 1971[3] and a further US$100m offer for New Zealand in 1971 by Kidder Peabody. Kidder Peabody also launched the first pre-price deal for New Zealand with a US$50m bond in 1975 without any open pricing[4]. Convertible issues became increasingly popular during the early 1970s[5] with other currencies also being used including specifically the Deutsch mark as the value of the dollar fell.[6] Growth was strong until October 1973 with the outbreak of the Middle East war and quadrupling of oil prices in 1974. US President Richard Nixon had announced the closure of the 'gold window' which precipitated the collapse of the fixed currency arrangements under Bretton Woods and the introduction of floating currencies. Nixon was forced to resign after Watergate with Edward Heath and West German Chancellor Willie Brandt also being removed from office. The FRN market closed during 1975 with low interest rates although bond maturities were cut from 10-20 years to 5-7 years.[7] The first euro yen issue and the first floating rate certificates of deposit (FRCDs) were

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1 The notes provided for 0.75% interest above 6 months LIBOR subject to redemption if the rate exceeded 13%. Warburg had identified ENEL following discussions between Peter Spira and Siegmund Warburg with Guido Carli, the Governor of the Bank of Italy, although the FRN mechanism was developed by Evan Galbraith and Dimitri de Gunzberg at Bankers Trust. Kerr (n) 35.

2 The Dreyfus offer was in May 1969 and lead managed by Kuhn Loeb Inc with Kuhn Loeb advising Howard Stein, President of Dreyfus in the US, to use a floating rather than fixed rate coupon. Kerr (n) 36.

3 The Esso issue was for US$100m euro bond with a 7 and a 15-year tranche.

4 The pre-priced deal allowed for smaller syndicates to be used with fewer managing and selling agents although the risk of mispricing the issue increased. Dosoo (n 26) 36.

5 The Eastman Kodak US$70m convertible in May 1968 was reported to have been US$530m oversubscribed. Jardine Matheson International NV offering 7.75% 15-year debentures with equity warrants attached in November 1971. Kerr (n) 41.

6 The Deutsch mark had been revalued by 9.3% in 1969 and 13.6% in December 1971 following the Smithsonian Agreement.

7 [The first dual currency bond was for A$30m for the Rural and Industries Bank of Western Australia with repayment either in Australian dollars or Deutsch marks in 1972 managed by the Orion Royal Bank.]

in 1977[8] and the introduction of the 'grey market' in 1978[9] and the first currency linked swap and opening of the 'grey market' in 1979.[10] The first 'drop-lock' issue was in April 1979 for TVO Power.[11] The first convertible issue with the option to exchange into fixed debt was by Goldman Sachs for US$50m 10.75% convertible debentures for NICOR Overseas Finance NV in April 1980.

Markets were disrupted again by the second oil price crisis in 1978 and 1979. Paul Volker was appointed Chairman of Federal Reserve Board on 5 August 1979 and had to attempt to deal with a collapse in the value of the dollar with rising interest rates. (Jimmy) 'Carter' bonds were issued with separate Deutsch mark and Swiss franc tranches to support the dollar. Bond markets rallied between March and July 1980 following Carter's monetary and credit restraint program although the market fell between July 1980 and 1982. Credit Suisse introduced 'bought deals' in 1980 for General Motors Acceptance Corporation (GMAC)[12] with the investment bank undertaking to manage the whole issue including arranging the syndication, participation and underwriting[13]. The first US$1bn issue was for the Kingdom of Sweden on 5 January 1982.[14] The FRN market grew between 1980 and 1981 with the US 30% withholding tax being removed in July 1984. Commercial banks issued US$19bn of perpetual FRNs in the mid-1980s before the collapse of the market at the end of 1986.[15] Despite further innovations, the FRN as a whole collapsed in 1987 through increased competition and the availability of better rates in the fixed bond market or new shorter duration euro commercial paper market.[16] The dollar was supported under the Louvre Accord in February 1987 by the G7 although tensions continued, particularly, between the US and West Germany.[17] The New York Stock Market crashed on 16 October 2007 and the London market on 19 October 2007 despite the earlier promise of the UK 'Big Bang' under the Financial Services Act 1986. This led to a collapse in the FRN and fixed rate bond markets with investors only looking for higher quality sovereign debt.

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8 The first FRCD was for US$10m for Dai-Ichi Kangyo Bank in April 1977 managed by Credit Suisse First Boston. Japanese city banks had been prevented from borrowing through the FRN market by the Ministry of Finance in 1977 with the FRCD mechanism being developed to allow them to obtain 3-5 years funds. This was followed by an issue on behalf of Sumitomo Bank with 'tap' FRCDs being introduced by Credit Suisse subsequently. Kerr (n) 48.

9 The grey market required managers to quote prices for issues before being officially priced. This replaced the earlier non-transparent system of discounting. Dosoo (n 26) 37-38. This led to bond brokers moving from the US to the UK. Brokers would typically charge a fee of 0.0625%. US style broking was transferred to London in August 1978 with Sandy Joyce of Purcell Graham. While initially resistant, bond brokers are now treated as an essential of the market. Kerr (n) 110-111. [On defaulted bond issues, Kerr (n) 113-114.]

Stanley Ross was considered to be the first to publish pre-issue prices for bonds at the end of 1978 with the first official grey market pricing for a US$200m Dow Chemical 9.625% loan in February 1979. This effectively brought the primary and secondary markets together. Kerr (n) 57.

10 The first currency swap related bond was for the Royal Bank of Canada subsidiary, Royalease, in September 1979 for DM60m 6.75% notes due 1984 managed by Orion Bank with the Royal Bank of Canada and Westdeutsche Landesbank. The funds could be immediately converted into Canadian or US dollars with low cost original borrowing in Deutsch marks. Dosoo (n 26) 37; and Kerr (n) 56.

11 Credit Suisse managed the US$30m issue with a 0.25% premium over LIBOR on the FRNs which would automatically be converted into 9% 12-year fixed rate bonds if the LIBOR fell below 9%. This was later used again for the Kingdom of Sweden with a US$150m FRN issue in 1979. The formula was nevertheless criticised with its mandatory rather than optional conversion and was not commonly used. Kerr (n) 57.

12 This was a US$100m 13.35% 5-year note issue offered on 8 April 1980 managed by Credit Suisse. The deal had been initially offered to IBM. Kerr (n) 62.

13 This is distinct from a 'standby' commitment (for any unsold issue) and a 'best efforts' commitment (best efforts to sell the issue). With the deal also being 'pre-priced', the bank assumes the market risk although it can still profit from selling the issue to investors at a price higher than the bought price. The underwriting can still be managed through smaller 'clubs'. Bought deals allow for competitive bidding which would not be possible under more traditional syndication. Dosoo (n 26) 40.

14 US$1.2bn 10-year notes had been issued at 0.25% above LIBOR managed through Credit Suisse First Boston. This was followed by an EC US$1.8bn offering for France with a further US$1bn 20-year floating rate bond for Sweden in December 1983. Dosoo (n 26) 42; and Kerr (n) 75.

15 Regulators had been concerned that banks had become the main purchasers as well as issuers of perpetual FRNs which concentrated rather than diversified risk. Bank ratings were reduced as the secondary market dried up and prices collapsed. Many perpetuals were repackaged although it was not expected that they would be commonly used again. Dosoo (n 26) 45.

16 The FRN market had expanded substantially between 1984 and the beginning of 1986 with new currencies being introduced and market entrants such as UK building societies which were allowed to use the market under the Building Societies Act 1986. 'Reverse FRNs', 'high margin' FRNs and 'collateralised mortgage obligations' (CMOs) were also introduced. Margins had nevertheless narrowed with early redemptions increasing with a collapse in liquidity and market prices. Dosoo (n 26) 45.

17 James Baker called on West Germany to increase growth on 12 October 1987 rather than contract contrary to the Louvre Accord.

(b) Euro Notes and Note Issuance Facilities (NIFs)

Euro notes are short duration promissory notes issued by non-banking borrowers. These have durations for between 5 and 7 years and emerged as floating rate alternatives to shorter fixed bonds. The first euro notes were in the late 1970s and were issued by a non-US corporate borrower and then by a sovereign entity. The notes were generally underwritten which distinguished them from the even shorter duration commercial paper market which originally developed in the US in the late 19th century.[18] The first euro note was for the New Zealand Shipping Corporation in 1978 and managed by Citicorp with 3 or 6 months notes over a 6-year period.[19] The market for euro notes grew substantially during the early 1980s from US$1.03bn in 1981 to US$33.14bn in 1985.[20] Euro notes subsequently grew from US$50.3bn in 1985 to US$77.1bn in 1988.[21] Euro note issuance fell to US$40.5bn in 1987 as investors preferred shorter euro commercial paper programs with dealership rather than panel structures. Secondary trading was also always limited.[22]

As shorter duration instruments, euro notes were typically issued under a Note Issuance Facility (NIF) with the underwriting banks being committed to sell or purchase the notes issued. Notes were generally issued in amounts of US$500,000 or more. Revolving underwriting facilities (RUFs) were introduced in 1982 with the lead bank acting as a 'sole placing agent' to distribute the notes with a separate underwriting group taking up any unsold amounts or providing loans to the same value. 'Tender panels' were introduced in 1983 to allow the panel group to bid for the notes with only the residue being taken up by the underwriters under a 'backstop facility'. 'Continuous tender panels' were created in 1984 to allow underwriters to purchase the notes up to a pro rata share during the offer period. Underwriters can sell their commitments under a transferable revolving underwriting facility (TRUF). The borrower can also issue smaller amounts under a 'tap issue' as investor demand varies.

(c) Euro Commercial Paper (ECP)

Euro commercial paper is a specific form of commercial paper which is a short negotiable unsecured promissory note. Commercial paper began in the US with companies attempting to raise funds in other states through the sale of bankers' acceptances of commercial paper to avoid the restrictions of the McFadden Act.[23] UK companies were only allowed to issue sterling commercial paper (SCP) from April 1986 under exemption from the need to obtain authorisation under the Banking Act and now the Financial Services and Markets Act 2000[24]. Relevant conditions were amended in 1989 and [ ] with standard procedures being issued by the British Bankers' Association.[25] Banks and building societies previously issued short-term paper in the form of certificates of deposit (CDs) or London CDs.[26]

The first euro commercial paper (ECP) was reported to be in 1985[27] although commercial paper was used in the euro markets by US firms in the early 1970s[28]. Minimum denominations are US$100,000 with maturities of between 2 and 365 days. The domestic and euro markets can be accessed through 'global commercial paper' (GCP) using 'global notes'.[29] The market was damaged by corporate defaults in the late 1980s[30] although the market has recovered since.

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18 Subsection

19 Dosoo (n 26) 73.

20 Sarwal (n 45) 122.

21 Bank of England quoted in Sarwal (n 45) 125.

22 Sarwal (n 45) 125.

23 Consumer finance companies also began to issue commercial paper during the 1920s with bank holding companies, foreign companies, banks and sovereign borrowers also issuing US commercial paper subsequently. Issues are for between US$25,000 and US$5m. US paper may be backed by a separate letter of credit guarantee. The US commercial paper was worth US$375m in 1987. Sarwal (n 45) 78-79.

24 See generally Michael Blair QC, George Walker and Robert Purves, *Financial Services Law* (Oxford University Press Oxford 2nd ed 2008).

25 http://www.bba.co.uk .

26 Sarwal (n 45) 80-81.

27 Sarwal (n 45) 81.

28 Dosoo (n 26) 73.

29 Some global notes were issued in the form of 'grid notes' with a grid agent managing transfers by book entry. 'Universal notes' have also been used with non-specific bearer notes being issued and security printed notes only being used if delivery is necessary outside the clearing system. Sarwal (n 45) 82-83.

30 These included Integrated Resources (US$63m) June 1989; Wang Laboratories (US$96m) August 1989; Lomas Financial Corporation (US$70m) September 1989; DFC New Zealand (US$270m) October 1989; and Drexel Burnham Lambert (US$30.5m) February 1990. Dosoo (n 26) 74.

(d) Euro Medium-Term Notes (MTNs)

Euro medium-term notes (euro-MTNs) were introduced in 1985 from the US medium-term note market.[31] Euro-MTNs had greater flexibility in term of speed, timing and size of issuance. Notes can be issued on short notice as market opportunities open at attractive rates. Later euro-MTNs were issued with currency and interest rate swaps or other ad hoc features.

US medium-term notes (US-MTNs) were again developed in the early 1980s to bridge the corporate bond and commercial paper markets. Typical maturities were between 9 months and 15 years. Issues grew from US$12bn in 1984 to US$36bn by 1986. As revolving facilities, MTNs were issued under SEC Rule 415 (shelf registration) or exempt under Regulation D. Foreign banks were also allowed to issue deposit note MTNs from September 1986 in place of certificates of deposit.[32]

(e) Multi-Option Facilities (MOFs)

Borrowers can also set up multiple component facilities or multiple option funding facilities (MOFFs) or multi-option facilities (MOFs). The first MOFF was by a sovereign in 1984 with additional flexibility being provided in achieving the best maturity, currency and interest rate availability. This can be considered to be an extension of the NIF with further borrowing options provided. These include short-term multi-currency advances, swing-line facilities, domestic and euro commercial paper, bankers' acceptances and medium-term notes (MTNs). This allows a mixture of committed and uncommitted facilities to be made available at any time. A multiple loan facility (MLF) is a combination of committed credit options such as a revolving credit and short-term advances and acceptances option.[33] A 'BONUS' (Borrowers' Options for Notes and Underwriting Standby) is a specific type of MOFF.

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[31] Issues grew from 2 in 1985 with a value of US$800,000 to 165 with a value of US$89.9bn in 1990. Dosoo (n 26) 78.

[32] Sarwal (n 45) 202 and 202-205.

[33] MOFFs grew from US$1,500m in 1984 to US$7,118m in 1985 with a drop to US$5,724m in 1986 and then increased to US$7,898m in 1987. Multiple loan facilities grew from US$250m in 1985 to US$5,487m in 1986 to US$32,170m in 1987. IFR quoted in Sarwal (n 45) 131-132.