"OFFSHORE FUNDING"

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The three papers as presented by Mr. W. P. Bonds, Mr. D. M. R. Payne and Mr. J. C. Simkiss are included in this issue for the benefit of members of the Institute.

THE OVERSEAS BANKER'S ROLE

by

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I. *Introductory Remarks*

As the first speaker today, I should mention that my remarks are not intended to overlap with the presentations by Mr. Ray Payne and Mr. John Simkiss. Consequently, I will not be addressing matters related to forward cover, taxes and documentation, I will be concentrating my observations on the funding capabilities of offshore banks (and U.S. banks in particular). But before addressing these funding capabilities I would like to suggest a framework for understanding the factors which influence the overseas banks' role in an Australian context.

II. *Role Determinants for Offshore Banks*

As you can appreciate, there are a number of factors which interact in various ways to differentiate the roles played by foreign banks. It is important to appreciate these different capabilities and roles if one is to understand the approach being taken by a given foreign bank in this marketplace; and it is particularly important for a borrower who wishes not only to achieve the best possible terms and conditions for a particular loan, but to establish a relationship with the foreign bank which can, over the longer term, offer the most appropriate services to him. I have classified the role determinants under four headings: Currency Base, Industry Expertise, Lending Capacity and Orientation to the Australian market.

A) *Currency Base*

The denomination of the currency base for the predominant share of its deposits represents one of the most fundamental role determinants for an overseas bank. While it is true that many international banks enjoy access to the eurocurrency market and negotiate loans using the same LIBOR (interbank rate) pricing base, an offshore bank's ability to draw on its particular domestic currency base, which typically represents a lower cost source of funds relative to the respective eurocurrency, is critical to its competitive position. An offshore bank can not only tap its domestic deposit base, but can also directly deal in domestic money markets through such instruments as the U.S. bankers acceptance (bank bill). In addition, certain European and Japanese banks offer a strong underwriting capacity for fixed rate obligations both domestically and in the eurobond markets. U.S. banking regulations restrict U.S. banks in their underwriting functions within the United States; these restrictions do not apply abroad and hence a number of U.S. banks have developed an underwriting capability offshore.

B) *Industry Expertise*

A second role determinant, industry expertise, ranks equally in importance to the first, especially in those industries with high financial gearing requirements coupled with complex marketing environments created by changing technology and strong cyclical swings in demand. Borrowers in these circumstances understandably prefer to deal with banks which understand their business and financial problems and have established a track record in meeting these special requirements. In building their particular customer bases over the years, banks do develop specialization in dealing with various economic sectors such as mining, electronics, shipping and commodities to name just a few. The institutions frequently incorporate industry lending specialists in their organizational structure to achieve the highest degree of responsiveness to customer needs.

C) *Lending Capacity*

Bank lending capacity is of importance to the largest borrowers (both government and corporate). A bank's aggregate exposure limit established for a single customer will typically be determined by bank regulatory authorities or by bank policy. Individual U.S. banks are limited by banking regulations to a maximum exposure equivalent to 10% of the bank's capital base. For a major U.S. bank, this would range from say $50 million to over $200 million. The application of the aggregate lending limits to foreign government borrowers has recently been required by the U.S. banking authorities with certain provisions which extend the limits to each governmental agency which enjoys an independent revenue base capable of servicing its debt. The ceiling now being proposed by bank regulations for government borrowers is 20% of a bank's capital base.

D) *Orientation to the Australian Market*

The fourth factor, orientation to the Australian market, deals with the determinants for the foreign bank's credit and pricing policies. Because the importance of individual determinants can fluctuate, a given bank may take a more active or more conservative approach to market opportunities at different points in time. I would suggest that we can view a bank's orientation to the Australian market based upon three fundamental considerations:

1. *Country Limits*

   Country limits, the first consideration, is largely theoretical with regard to Australia and other developed nations and of greater importance with less developed countries. Banks (particularly U.S. banks) have found it useful to establish limits on the total exposure which they are prepared to undertake in any given country. As a bank's loan book increases or decreases in relationship to these country limits, the bank's credit and pricing policies are thereby likely to be influenced. In other words, a relatively moderate current level of lending activity in relationship to the country limit ceiling, with other factors remaining constant, would encourage a more active marketing approach than the reverse of that situation. The purpose of the country limit is to achieve an overall balance in the institution's international loan portfolio and is based on an assessment of the economic and political environment in the particular market. The country limits are typically reviewed periodically and do not represent a rigid ceiling, but rather are adjusted in line with a bank's overall lending capacity and its appraisal of the risk factors related to the particular market.

2. *Market Penetration*

   Following from the country limit consideration, banks typically predetermine the sectors in which they are prepared to undertake credit risk. The sectors can be classified in a number of ways from both marketing and credit standpoints. The following categories represent one approach towards segmenting the Australian marketplace from a foreign bank's point of view. The degree of penetration in any of these sectors would depend on the particular marketing strategy and credit policies of the bank concerned. Some foreign banks would seek involvement in all four sectors, others might actively market their services with only the government and major multinational firms. The suggested sectors would be:

   (1) Government borrowers (whether the federal treasury, marketing authorities, state treasury or semi governmental authorities or government owned corporations such as Qantas and Telecom.

   (2) Major Australian firms or affiliates of major multinational firms or ventures in which two or more such firms combine their technology and

other resources.

(3) Firms with overseas affiliates where the affiliate represents a bank customer or prospect. Here, I refer to those Australian subsidiaries of American and European companies already dealing with the bank or to Australian multinational firms whose subsidiaries are located in an offshore market served by the bank.

(4) Other major firms with financing needs which can be met by the offshore bank.

3. *Liquidity Conditions*

A third consideration affecting orientation to the Australian marketplace can be attributed to the liquidity conditions which influence a bank's lending volume and the terms and conditions it is prepared to accept. While banks seek to maintain a consistent presence in a market, cyclical swings in liquidity do influence changes in the terms and conditions which they are prepared to offer. Liquidity influences can be viewed from two perspectives.

(1) Both the global loan demand (denominated in various currencies) and domestic loan demand (for its base currency) influence a bank's policy toward the volume of new loans it seeks in Australia and the acceptable terms and pricing associated with the new business. A strong global demand and or a strong demand in its home marketplace for loan funds, of course, could result in generally more conservative terms and pricing offered in all its markets, including Australia.

(2) From the perspective of demand for offshore funding for all but the large syndicated loans and apart from governmental restrictions on borrowing offshore, Australian dollar interest rate levels to a great extent determine the attractiveness of the offshore borrowing alternative. Given expansionary loan policies, U.S. banks, for example, can become more active in the Australian marketplace should US$ borrowings appear more attractively priced than the Australian dollar options (including consideration of the cost and availability of forward cover).

III. *U.S. Bank Funding Capabilities*

I would now like to address the funding techniques employed by American banks with regard to the offshore financing of government, industry and commerce in Australia.

I trust that you will agree that it would take several sessions and numerous other speakers to deal comprehensively with the offshore funding capabilities of all major offshore banks offering their services in Australia.

A) *Floating Rate Loans*

U.S. banks typically extend commercial loans, whether on a short or long term basis, utilizing a floating rate structure (although fixed rate lending has become more common in response to competitive pressures). The floating rate approach arises from the U.S. banks' predominantly short term deposit base. The pricing structure offered by an American bank would be based on its prime rate (the traditional domestic U.S. pricing base) or the London Interbank Offered Rate (LIBOR) for eurocurrencies, or the borrower might be provided with the option to switch from one basis to the other. The loans extended by American banks are primarily denominated in U.S. dollars, often with a multicurrency option. Both the U.S. prime rate and the six month LIBOR rate are currently 9¼%. The prime rate is a lending rate at which loans are made (at prime or at a margin over prime) whereas LIBOR represents a cost of funds to the banks against which a margin of profit is added. American banks continue to prefer utilizing the LIBOR rate for the greater portion of their offshore lending since it represents a cost base against which a fixed profit margin can be negotiated. The prime rate convention has historically been tied to the practice of maintaining compensating demand deposits with the lending institution which is not always practical in an international context.

Whatever pricing alternative may be offered by an American bank, the floating rate US$ loan represents its major lending tool and offers flexibility to the borrower in terms of multiple drawings and repayments. These and other advantages to the borrower, of course, are off-set by lack of a predictable interest cost over the life of the loan. The eurodeposit market has continued to develop and today banks can obtain five year and longer term fixed rate deposits against which fixed rate loans are being negotiated to offer medium scale borrowers an alternative to a floating rate structure.

B) *Bank Bill Financing*

The U.S. banker's acceptance represents a traditional method of financing international trade denominated in U.S. dollars, particularly with regard to drafts drawn on American banks under U.S. dollar letters of credit. U.S. Banker's Acceptance financing is limited (with certain exceptions) to financing transactions which are trade related and to borrowings with terms of up to 180 days. A trade transaction can in fact be financed outside the flow of documentation related to letters of credit, and in this regard, a great deal of flexibility is available to select borrowers who can deal directly with a U.S. bank by presenting drafts to that bank for acceptance. The U.S. bankers acceptance discount rate typically represents a lower cost source of funds than eurodollars and as such is a highly desirable funding source.

C) *U.S. Capital Goods Export Financing*

U.S. banks co-operate actively with the United States Export Import Bank in providing medium to long term financing for the export of U.S. produced capital goods, The Eximbank provides financing on a direct basis whereby it lends to an importer of U.S. capital goods, often in partnership with commercial banks which typically take the shorter maturities in a term arrangement. In addition, Exim provides discount facilities to U.S. banks for terms of up five years, or longer for certain purchases such as aircraft, whereby the U.S. bank can obtain a concessionary discount rate which can allow it to fix its interest rate to the borrower over the term of the loan. The current discount rate for up to five year terms would be as low as 8½%. As the commercial bank is allowed to charge an interest rate of 1% over the discount rate as its margin, the all-inclusive rate to the borrower could be as low as 9½%. In practice, the banks charge a fixed interest rate which may exceed the 9½% level and Exim would then apply a discount rate which would allow the bank a 1% margin. In any event, one can appreciate that with the prime rate in the United States currently at 9¼%, structuring a loan at an interest rate as low as 9½% for a term of up to five years offers an interesting pricing alternative to LIBOR or the U.S. prime rate.

D) *Standby Letter of Credit*

Standby letters of credit represent one means by which offshore banks are able to support the Australian dollar borrowings of companies which have not yet established their unsecured credit rating with bank and merchant bank lenders in Australia (Australian affiliates of foreign companies represent the most common example). A second application involves borrowers who wish to tap sources of debt funds in Australia which are limited to investments in bank or bank related obligations.

The standby letter of credit is an instrument issued by a bank on behalf of its customer (the borrower) in which it authorizes a beneficiary to draw drafts on the bank, provided the conditions of the letter of credit are met. U.S. banks are prohibited from issuing guarantees, hence the application of letters of credit, traditionally a trade financing instrument, to commercial financing situations. As a side note, the standby letter of credit is a versatile instrument which can also be utilized as a performance bond.

Certain conventions must be observed to ensure that the issuing bank conforms to relevant regulations. The standby letter of credit must contain language which limits the credit to a specific dollar amount. The beneficiary is authorized to draw drafts up to this amount (standbys with Australian beneficiaries are typically denominated in Australian dollars). It must also have a definite expiry date prior to which any drawings must take place. The bank must receive a fee or other consideration for issuing the standby letter of credit and of course payment of any drafts drawn against it can be made only upon presentation of specific documents so that the bank is not called upon to determine any disputed questions of fact or law. The borrower must have an agreement with the bank which represents an unqualified obligation to reimburse the bank on the same conditions as the bank has paid. The standby letter of credit typically requires the beneficiary's statement to the effect that the principal and/or interest on an obligation has fallen due and payment has not been made as agreed by the borrower. Of course, additional statements and documentation can be required as a condition of payment.

The beneficiaries utilizing standby letters of credit fall into three categories:

(1) Australian Banks (or in some cases

merchant banks) which when named as beneficiary in the letter of credit would be prepared to extend financing on a bank bill or other basis to a borrower.

(2) *Individual Investors*
These might be financial institutions which would accept only bank or bank supported obligations in their investment portfolio and would therefore accept a standby letter of credit in support of corporate borrowings. Frequently, institutional and other investors will require confirmation of letters of credit by an Australian bank which would eliminate any need to proceed on collecting payment under the credit outside Australian banking channels.

(3) *Trustees*
We have recently witnessed a new approach to the standby letter of credit technique whereby an offshore bank has opened a standby letter of credit in favour of a trustee which in turn administers the issuance of debenture stock to individual investors in Australia. The borrower, in this case the subsidiary of an American finance company, has thereby tapped medium scale investors and has allowed creation of a medium term debenture stock instrument which is readily marketable. One of the fundamental limitations for standby letter of credit supported instruments, namely limited marketability, has now been overcome.

IV. *The Corporate Banking Relationship*

I would like to close my remarks this afternoon with comments on establishing satisfactory relationships between offshore banks and Australian corporate borrowing clients.

Firstly, I believe the most satisfactory basis on which a relationship can be developed arises when there are ongoing requirements which can be matched by specific funding capabilities best suited to the borrower's needs. Needless to say, firms engaged in international trade with a material portion of cash flow denominated in foreign currency are best situated to undertake borrowings in these currencies and develop mutually satisfactory offshore banking relationships. In addition, Australian corporate borrowers, who are either branches or affiliates of offshore entities already dealing with the offshore bank concerned, can expect a high degree of responsiveness from that bank resulting from the parent company's interaction with it. Other situations encourage a mutually satisfactory relationship. For example, Australian companies which act as distributors for existing offshore customers are frequently well known to the bank and benefit from a fundamental understanding of their product line and business practices. Another favourable situation arises when an Australian corporation establishes operations offshore where the bank offers established lending capabilities. This would apply not only to the bank's home market, but also in other international financial centres where the bank has established a presence.

I should also mention that while U.S. banks, for example, enjoy lower cost sources of funds for several U.S. dollar funding alternatives, there are important longer term considerations to be evaluated when the corporate borrower sets out to obtain offshore funding, not the least of which should be the prospects for continued responsiveness to the firms ongoing requirements whether they be in Australia or abroad.

This concludes my prepared remarks and I will be pleased to address any questions you may have at the conclusion of today's program.