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INTERNATIONAL LENDING AND THE EUROMARKETS

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

1978 Euromarkets Conference

sponsored by the

Financial Times

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The Euromarkets are one of the success stories of our day, which needs a few successes. In difficult times, they have helped to keep trade flowing, they have financed investment and development, they have enabled countries to deal with their balance-of-payments problems. The Euromarkets serve as a reminder of what a market system can achieve when it is allowed to operate freely.

But the Euromarkets also have been a cause for concern from time to time. Supervisors, commercial bankers, central bankers, and perhaps even the public have worried periodically about the soundness of the Eurobanks, the soundness of the Euroborrowers, and the possible inflationary implications of the market. Perhaps this worrying has helped to forestall the problems. In a well-functioning market, crises worried about in advance usually do not

occur. By not dealing with these matters here I do not mean to imply that grounds for worry have been altogether eliminated. First and foremost, however, the subject to worry about today in the syndicated loan market is spreads. Many of you probably are of the same opinion. What my remarks may lack in novelty I hope they can make up by being emphatic.

Euromarket Spreads

The dramatic decline in spreads between lending rates and the cost of money is not altogether unprecedented. In 1972-73, spreads also were severely squeezed. For a spectrum of 15 major borrowing countries, they reached an approximate low, on a weighted average basis, of 1.11 per cent in the fourth quarter of 1973. That was a time of dangerous euphoria when international indebtedness was much lower than it is today, the expansive forces of the international economy much stronger, and when one could not anticipate the financing problems that were to follow the rise in the price of oil.

In 1974, spreads expanded once again as the realization of risk in Euromarkets, following the Herstatt and Franklin failures, pushed risk premia to more realistic levels. By the fourth quarter of 1975, they reached a level of 1.63 per cent and remained approximately on that plateau through the middle of 1977. More recently, however, spreads once more have been cut to the bone by lessened balance of payments financing needs and the pressure of strong competition among banks resulting from slack loan demand in home markets, and by a large inflow of funds.

For particular groups of countries, the time pattern varied somewhat, with those for non-OPEC LDCs rising through 1976 and those for small OECD countries declining appreciably after 1975.

Naturally, there are always special circumstances that could explain low spreads on particular loans. At the short end, a one-shot deal at a very low spread, in the hope of being able to employ the funds more productively later, may be preferable to locking them in for a longer period at a not much better return.

At the longer end, there may be considerations of collateral business, ongoing relationships with the borrowing country, hopes of regulatory preferment in winning approval for branches and the like that may explain, although not justify, extraordinarily low margins. There are fees, especially for lead banks, there may sometimes be balances, and sometimes banks can fund a quarter or even a helf of a per cent below Libor (London Interbank Offering Rate), especially if they are prepared to do a little mismatching of maturities. On the other hand, I would not accept a bank's explanation of an unjustifiably low spread on the grounds that the bank had to maintain its share of the market. The implication that because some banks overlend, all others ought to do the same obviously points toward trouble.

The Composition of the Spread

I would, if I may, devote a few minutes to a conceptual exercise in studying the anatomy of a spread. The spread must cover at least three elements: (1) The risk premium to cover losses,

(2) the contribution to the bank's cost of capital related to the loan, and (3) the out-of-pocket and overhead operating costs.

The risk premium must be evaluated for each individual loan in the light of the circumstances of the borrower. An overall indication of loss prospects in international lending, which, of course, does not apply to any individual loan, can be derived from the loan losses that banks have already experienced. For a small group of American banks, the average loss during the years 1976-77 on foreign loans has been about one-third of one per cent, as against a domestic loan loss ratio of over three-quarters of one per cent. The range of individual bank experience, of course, is a good deal wider, especially on foreign loans.

The past, moveover, is not necessarily a guide to the future. Differences in individual bank experience as well as differences in the credit standing of particular borrowers, indicate that it would not be appropriate to impute to the spread some fixed risk component. But the order of magnitude, to date, of loss experience on international loans, when compared with syndicated loan spreads, nevertheless provides a useful benchmark.

The spread further must contain a contribution toward the cost of the bank's capital. It is a function of the bank's capital to support the holding of risk assets. Of course, if the bank believes itself to be acquiring a risk-free asset -- a short-term inter-bank placement might come close to this -- the acquisition would not raise the bank's ratio of risk assets to capital. The

return on such an asset might not be required to make much of a contribution toward covering the cost of capital. But assuming a not unusual capital/total assets ratio of 5 per cent, the spread on a loan of average risk must cover the required income before tax on capital equal to 5 per cent of the loan. Given further a not untypical return on capital after tax of 10 per cent, and a marginal tax rate of about 50 per cent, the loan must earn 20 per cent of 5 per cent of capital, or 1.0 per cent. These assumptions concerning capital surely are quite modest. Strictly speaking, it might be more appropriate to base this calculation on the ratio of risk assets to capital, which would call for a higher return. For some banks, however, particularly non-U.S. banks, capital ratios may be even lower than the 5 per cent illustratively assumed. To the extent that banks and their supervisors regard such ratios as adequate, the cost-of-capital component of the spread is reduced.

Concerning the operating costs of putting on a loan, I have no information, although I have heard complaints about the high level of rents, the high price of lunches, and the costs inflicted by recent U.S. tax changes affecting American citizens abroad.

Putting the foregoing data together, it would appear that a spread of 1.0 per cent, that for a while was considered a minimum, hardly gives a well capitalized bank an adequate return on capital and a reasonable risk premium, with nothing left over for operating costs. A spread of .75 per cent does not cover the cost of capital of even a very modestly capitalized bank plus a reasonable risk premium.

Banks that are putting on loans at such a spread, or even less, must have substantial funding advantages, or income and other benefits from the loan, aside from the spread, or they are diluting their earnings.

I do not find at all convincing an effort to justify low premia by a misguided appeal to the principle of marginal cost pricing -- that is, that any income above out-of-pocket costs is so much money to the good. There are risks to be taken into account, and there is the bank's balance sheet, with its capital ratios and corresponding cost of capital, to be considered. A measure of cost that ignores these legitimate components of marginal cost undermines the application of a sound economic concept.

While spreads have been declining, maturities have been advancing. In terms of risk, this implies an added cost which is not covered by the movement of spreads. Longer maturities convey an indirect benefit in reducing the prospective bunching of roll-overs and in reducing somewhat the disparity between the length of loans and the pay-out period of the investments that, however indirectly and remotely, are financed by them. But the lender must bear in mind that loans of long maturity are almost certain to be tested by a variety of adverse circumstances.

A Comparison of Euromarket and U.S. Bond Market Spreads

It is interesting to compare changes in the dispersion of spreads among high- and low-risk borrowers in the Euromarket with similar changes among borrowers in the American bond market. In

the Eurocurrency market, the rise in spreads was accompanied by a narrowing of the dispersion. Spreads rose most for what had originally been the low spread borrowers. In the U.S. bond market, spreads widened as interest rates rose during 1973 and 1974. The lower quality risks had to pay substantially more relative to the higher grades.

In terms of credit risk, it would seem that the American market evaluated changing risks rationally, allowing for a greater increase in the danger of failure among the borrowers where risk was perceived as high to begin with. The Euromarket, to the contrary, appeared to wipe out differences among borrowers and to assign to all of them a similar higher risk rating. Conceivably, this may reflect the difference between credit risk and sovereign or country risk. The circumstances of 1974 may have been of a sort to exacerbate primarily the element of country risk.

A second and more casual observation may follow from an inspection of quality spreads in the Eurocurrency market and the U.S. bond market. In the Eurocurrency market, the spread even for relatively weak risks rarely has gone much above 2 per cent, representing a differential over prime risks of perhaps 1.5 per cent at most. In the U.S. bond market, the differential between A-rated utilities, by no means a weak risk, and U.S. Government bonds in 1975 went above 2 per cent. Given the absence of country risk in the U.S. bond market, it is hard to avoid the impression

that the latter evaluates risks more sensitively and conservatively than the market for syndicated Eurocurrency loans. Whether front end fees and the like provide reason to modify this assessment significantly, cannot be said with any assurance.

The Recent Decline in Spreads

Why are spreads declining so sharply in the Euromarkets? Are risks clearly diminishing? Or have banks come under such pressure to lend that the market has become clearly a borrower's market?

To both questions, the answer is "yes." The condition of many borrowers has improved. But unfortunately it is also true that the pressure on banks to lend has increased. To that extent, the decline in spreads must be viewed as a very uncomfortable development.

Among the pressures converging on the bank are the following:

(1) Liquidity is high. Rising assets and liabilities in the Euromarket do not absorb limited supplies of reserves, as they would in national money markets. Monetary authorities, in pursuing their monetary targets, in some cases have overshot, in part due to exchange market intervention. Monetary authorities must bear in mind that money creation in the Euromarket, although historically quite limited, nevertheless occurs, and must factor it into their overall assessment of liquidity needs.

(2) Domestic loan demands in many countries other than the United States has been weak. In the United States, the large money market banks have experienced weaker demand than the rest of the banking system. They, of course, are the principal U.S. lenders in the Eurocurrency markets.

(3) There is pressure to maintain earnings growth, on penalty of being downgraded by security analysts. If their stock fails to advance, their prospects of raising new capital diminish. Yet they need to raise new capital if they want to continue to lend.

(4) Banks have built up large establishments and have built in high costs which require continued activity. It would be costly to disassemble and perhaps later reassemble these.

(5) Borrowing countries today are exerting powerful pressures, reminding banks of the need to maintain a continuing relationship, and meanwhile taking advantage of their ability to repay and refund earlier loans at lower spreads.

(6) Finally, all banks look at their peer group. So long as all do the same, no single bank needs to feel that it is making an obvious mistake. That, in some circles, is known as the lemming theory of banking.

Obviously, however compelling these considerations may appear to the individual bank, they do not justify a lowering of

credit standards. Banks in the Euromarkets enjoy a degree of freedom from control that is unusual in domestic banking systems, although they, and particularly U.S. banks, are by no means unsupervised and unregulated. U.S. banks, in particular, are subject to the regular examinations and other supervisory activities of the U.S. banking agencies, no matter where their branches and subsidiaries are located. But it is true that the volume of lending in Euromarkets is less directly controlled by central bank action than is the volume of domestic lending. Hence, banks should be disciplined all the more by high credit standards as they expand in these markets.

The Euromarkets, as I said at the beginning, have given evidence of what a market system can achieve when it is allowed to operate freely subject only to prudential supervision. The continuance of this freedom will depend on the responsibility with which it is used.

Table 1

Interest Spreads and Maturities of Euro-currency Credits to Selected Countries Arranged by Category

	Q_4 1973		Q_4 1975		Q_4 1976		Q_3 1977		Q_4 1977		Q_1 1978	
	Average Spread (basis points)	Average Maturity (years)	Average Spread (basis points)	Average Maturity (years)	Average Spread (basis points)	Average Maturity (years)	Average Spread (basis points)	Average Maturity (years)	Average Spread (basis points)	Average Maturity (years)	Average Spread (basis points)	Average Maturity (years)
Non-oil LDCs[a]	121	10.9	165	5.4	187	5.1	179	4.6	177	7.3	158	8.3
OPEC[a]	129	7.3	167	5.7	133	7.0	132	5.6	159	5.5	104	8.5
Eastern Europe[a]	61	8.8	149	5.5	129	5.5	113[c]	7.0[c]	116[c]	6.0[c]	123	7.2
Small OECD Countries[a]	94	9.1	158	6.5	137	5.3	120	6.5	109	6.8	83	7.2
Range of spreads among country groups	(68)		(18)		(58)		(66)		(68)		(75)	
Average of individual countries:												
Weighted	111	9.5	163	5.7	161	5.6	153	5.3	155	7.0	132	8.2
(Unweighted)	(99)	(9.6)	(166)	(5.6)	(159)	(5.7)	(155)	(5.9)	(149)	(6.4)	(123)	(8.1)
Minimum spread for individual loans[b]	56		125		113		88		88		57	

a/ Average spreads for individual countries shown in Table 3 weighted by total volume of borrowing by each country.
b/ Rate shown is lowest rate for syndicated Eurocurrency credit to all borrowers. To avoid extreme observations, rate reported is lowest rate for minimum of three credits.
c/ Observation from a single loan.
Source: IBRD, Borrowing in International Capital Markets, various issues.