
FRBSF WEEKLY LETTER

October 9, 1987

NIF, SNIF, RUF, Gesundheit!

The Note Issuance Facility (NIF) has been one of the fastest growing innovations in international financial markets. Credit extended under NIFs has grown from \$1.5 billion in 1981 to about \$69.5 billion in 1986, of which American issuers borrowed over one quarter. Over the same period, syndicated Eurobank loans fell from \$96.5 billion to \$38 billion. To a large and growing extent, NIFs are evidently replacing Eurobank loans in the Eurocredit market (see chart).

So what's a NIF?

NIFs are medium-term credit facilities that allow borrowers to issue their own short-term notes, which are then placed or distributed by the financial institution(s) providing the NIF. The birth of the NIF may be traced back to 1978 when the New Zealand Shipping Company negotiated the first such facility. By 1980, several American financial institutions, including Citicorp and Merrill Lynch, had entered the market. Since then, most of the large banks active in the Euromarket have supplied NIF services.

The NIF is typically set up for 5 or 6 years, during which time notes may be issued by the borrower on a revolving basis. The notes most frequently have maturities of 3 or 6 months, although maturities as short as seven days and as long as one year are used. Most notes are denominated in U.S. dollars although an increasing proportion are issued in other currencies. Furthermore, notes are usually bearer instruments issued in large denominations, generally \$500,000. A small but growing secondary market has developed that provides some liquidity.

NIFs, sometimes also called Short-term Note Issuance Facilities (SNIFs), have some features of the American commercial paper market and some features of U.S. commercial lines of credit or loan commitments. Like commercial paper, notes under NIFs are unsecured short-term debt generally issued by large corporations with high credit ratings. Financial institutions providing NIFs supply broker and marketing services somewhat like dealers or brokers of commercial

paper. Like loan commitment contracts in the United States, NIFs generally include multiple pricing components for various contract features, including a market-based interest rate and one or more fees known as participation, facility, and underwriting fees. Participation fees are paid when the contract is formalized and are generally about 10 basis points times the facility size. Other fees are paid annually, and are sometimes based on the full size of the facility, sometimes on the unused portions thereof.

The interest on notes to be issued is generally a floating rate based on LIBOR, the London Interbank Offer Rate, although other bases are used. The contract often includes a series of clauses or covenants that allow the NIF provider to revoke the arrangements under certain circumstances. These circumstances include deterioration in the borrower's creditworthiness or external changes that affect the costs to the NIF providers. Some notes include caps on interest rates or conversion clauses that allow the interest formula to change.

A somewhat more complex version of the NIF is the multiple component facility (MCF). This facility increases borrowers' flexibility, allowing them to draw funds in several alternative forms, including short-term advances, swingline credits (for provision of same-day funds), or bankers' acceptances. Borrowers may also be able to choose among several currencies in which to issue their debt.

The marketing of NIF notes

The provider of a NIF agrees to accept notes issued by the borrower throughout the term of the contract and to distribute them on a "best efforts" basis to purchasers/investors under pre-arranged terms, which include the timing of issues and the term of notes. It has been most common for NIFs to include underwriting services as part of the arrangements. When they are included, the arrangement generally takes the form of a revolving underwriting facility (RUF).

Inclusion of underwriting services in the NIF means that the borrower is ensured a maximum

FRBSF

interest rate and rapid access to funds. The bank in effect provides the borrower with a price floor for the notes, and makes up any "shortfall." The borrower, of course, must pay for this "insurance" through the RUF fees.

Like underwriting arrangements in other markets, the RUF is generally provided by a lead manager who puts together a tender panel of banks, although sole placement agents are sometimes used. The panel then purchases the notes for distribution, although it occasionally holds the notes. The shares of each panel member are determined in the agreement. The panel members generally agree to take up any notes that cannot be placed or to extend short-term loans to the issuer. Often, the RUF agreement also provides the borrower with the option of taking short-term advances, sometimes in the form of a swingline — a standby arrangement that provides same-day funds.

Since 1984, a growing number of NIFs have been arranged without underwriting commitments or standby credit arrangements. Instead, banks act simply as brokers/distributors. While only 5 percent of NIFs were made without underwriting features in 1984, by 1986 the percentage had reached almost 60 percent. Generally, borrowers under such NIFs have been large corporations with very high credit ratings. They apparently feel sufficiently secure of their ability to sell their notes quickly that they dispense with underwriting services and save the associated costs. NIF providers then market the notes, but give no guarantee about the price or rate the borrower would end up paying.

Such NIFs closely resemble commercial paper in the United States, which is usually distributed through dealers without underwriting. Indeed, such NIFs have become known as Euro-commercial paper. U.S. commercial paper, however, usually has a shorter maturity than notes issued under NIFs. In a small but growing number of cases, Euro-paper has been rated by rating services.

Who uses NIFs?

London has been the center for most NIF activity. Initially, in the early 1980s, most borrowers under NIFs were governments. Since then, the percent of NIF borrowers who are industrial firms has risen from 38 percent in

1981 to over two-thirds in 1986, while the role of governments has fallen to 7 percent. The remainder are financial institutions and international agencies.

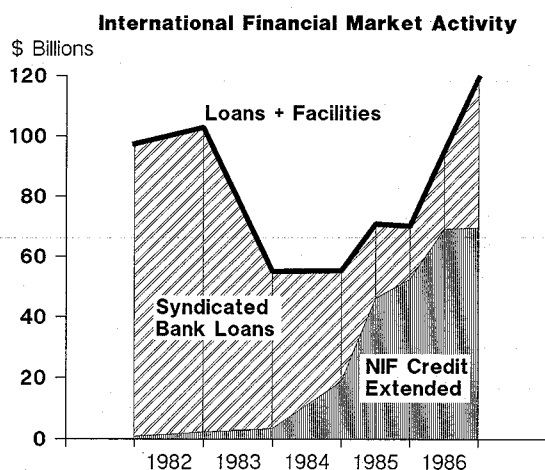
On the lending side, little is known about the ultimate investors in notes issued under NIFs. Much of the paper is placed with smaller banks and other financial institutions. We do know that the role of nonbank investors, primarily money market funds, corporations, insurance companies, and wealthy individuals, has increased. The investors regard the Euro-notes issued through NIFs as alternatives to CDs or bank deposits, and frequently purchase notes from the most creditworthy issuers. Consequently, the most creditworthy issuers have often been able to sell notes at or below LIBID, the "bid" rate analogous to the London interbank "ask" rate called LIBOR. (LIBOR is the rate at which banks offer to lend; LIBID is the rate at which banks offer to borrow.)

Off-balance sheet securitization

The growth of NIFs and the contraction of syndicated Eurobank loans is reminiscent of the expansion in recent years of off-balance sheet banking activities and loan securitization in the United States. It has often been suggested that off-balance sheet banking activity and securitized disintermediation are caused by regulations that impose costs in the form of reserve requirements and capital requirements on traditional financial intermediation. Banks may seek to avoid those costs by taking loans off their balance sheets. The same factors at work in the U.S. may be operating overseas to produce the expansion of NIF financing.

In essence, a NIF facility may be considered a standard loan commitment contract or credit line that involves immediate securitization of much or all of the credit utilized. Ordinarily under a credit line, funds are made available to the borrower by the bank at the borrower's chosen time. The bank must then raise any necessary funds by issuing its own liabilities. Both the borrower's credit takedown and the funds raised by the bank would appear on the bank's balance sheet, although unused credit line funds would not.

In contrast, the NIF involves the bank as a broker of short-term securitized notes issued by the



borrower. Except for very short-term financing provided to the customer under NIFs that include underwriting and standby provisions, the bank typically would neither borrow funds on its own account nor carry the credit used by the customer as an asset on its balance sheet. Banks would assume credit risk only if they held the notes on their own accounts. They would assume some interest risk (under RUFs) due to the danger that the issue may not sell at the guaranteed price.

The regulatory treatment of NIFs

The regulation of NIF facilities in many countries may explain much of the rapid growth in the role of NIFs. Since the NIF is largely or entirely

off a bank's balance sheet, changes in the regulation of such off-balance sheet activity now being considered will have a great impact on future developments in the NIF market.

Belgium, West Germany, Italy, Luxembourg, and Sweden, for example, have exempted NIF arrangements from capital adequacy requirements, but several of these countries are now considering eliminating the exemption. In Canada, France, Japan, the Netherlands, and the United Kingdom, NIFs have been subject to capital requirements of one form or another, and tighter regulation is now under consideration in some cases. In the United States, new regulation of all off-balance sheet bank activities is currently under consideration.

Banks have not provided NIFs within the United States because such facilities would violate the Glass-Steagall Act provisions that prohibit most underwriting activities by commercial banks. However, recent regulatory changes and court decisions have declared as legal some bank underwriting of commercial paper and other securities. These rulings may contain the seeds of growth for domestic NIF financing by American commercial banks.

Steven E. Plaut

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

Research Department Federal Reserve Bank of San Francisco

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 9/16/87 | Change from 9/9/87 | Change from 9/17/86 Dollar | Percent ⁷ |
|---|----------------------------------|--------------------------|-------------------------------|----------------------|
| Loans, Leases and Investments ^{1 2} | 206,744 | 1,893 | 2,351 | 1.1 |
| Loans and Leases ^{1 6} | 182,906 | 1,881 | 1,346 | 0.7 |
| Commercial and Industrial | 50,795 | 244 | 107 | 0.2 |
| Real estate | 69,906 | 168 | 2,501 | 3.7 |
| Loans to Individuals | 37,109 | 47 | 3,978 | 9.6 |
| Leases | 5,385 | 4 | 254 | 4.5 |
| U.S. Treasury and Agency Securities ² | 16,901 | 2 | 4,974 | 41.7 |
| Other Securities ² | 6,938 | 14 | 1,277 | 15.5 |
| Total Deposits | 207,063 | 943 | 598 | 0.2 |
| Demand Deposits | 52,908 | 316 | 310 | 0.5 |
| Demand Deposits Adjusted ³ | 35,750 | 26 | 12,752 | 26.2 |
| Other Transaction Balances ⁴ | 20,210 | 343 | 2,727 | 15.5 |
| Total Non-Transaction Balances ⁶ | 133,945 | 284 | 3,634 | 2.6 |
| Money Market Deposit Accounts—Total | 44,693 | 161 | 2,416 | 5.1 |
| Time Deposits in Amounts of \$100,000 or more | 30,950 | 83 | 3,822 | 10.9 |
| Other Liabilities for Borrowed Money ⁵ | 27,364 | 2,809 | 762 | 2.7 |
| Two Week Averages of Daily Figures | Period ended 9/7/87 | Period ended 8/24/87 | | |
| Reserve Position, All Reporting Banks | | | | |
| Excess Reserves (+)/Deficiency (—) | 45 | 186 | | |
| Borrowings | 6 | 24 | | |
| Net free reserves (+)/Net borrowed(—) | 39 | 162 | | |

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change