BANK FOR INTERNATIONAL SETTLEMENTS

Monetary and Economic Department

INTERNATIONAL BANKING AND FINANCIAL MARKET DEVELOPMENTS

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INTRODUCTION

This commentary is divided into three parts. Part I provides a preliminary overview of developments in international financial and derivatives markets during the third quarter of 1995. It is based on partial quantitative and qualitative information. Part II deals with the volume and pattern of net financing flows through the international banking and financial markets during the second quarter of 1995, the latest period for which the full international banking statistics are available. Part III consists of the first half of an article on interest rate futures markets. It presents a description of the various types of instrument, the factors underlying their development and their relationship with other related risk management tools. The second half of this article will appear in the next issue of this publication and will consider more specifically the development of individual instruments in the major trading centres.

In the statistical annex, the tables on securities markets have been extensively redesigned. They provide, for the first time: a geographical and sectoral breakdown of total international debt securities (Tables 9-10D), consisting of the sum of international bonds and Euro-notes, which have been hitherto shown separately; new separate data on net issues of Euro-notes together with a detailed sectoral breakdown of Euro-notes (Table 11 A); and, finally, detailed data on domestic securities issues in the OECD countries (Table 15).

CONTENTS

I

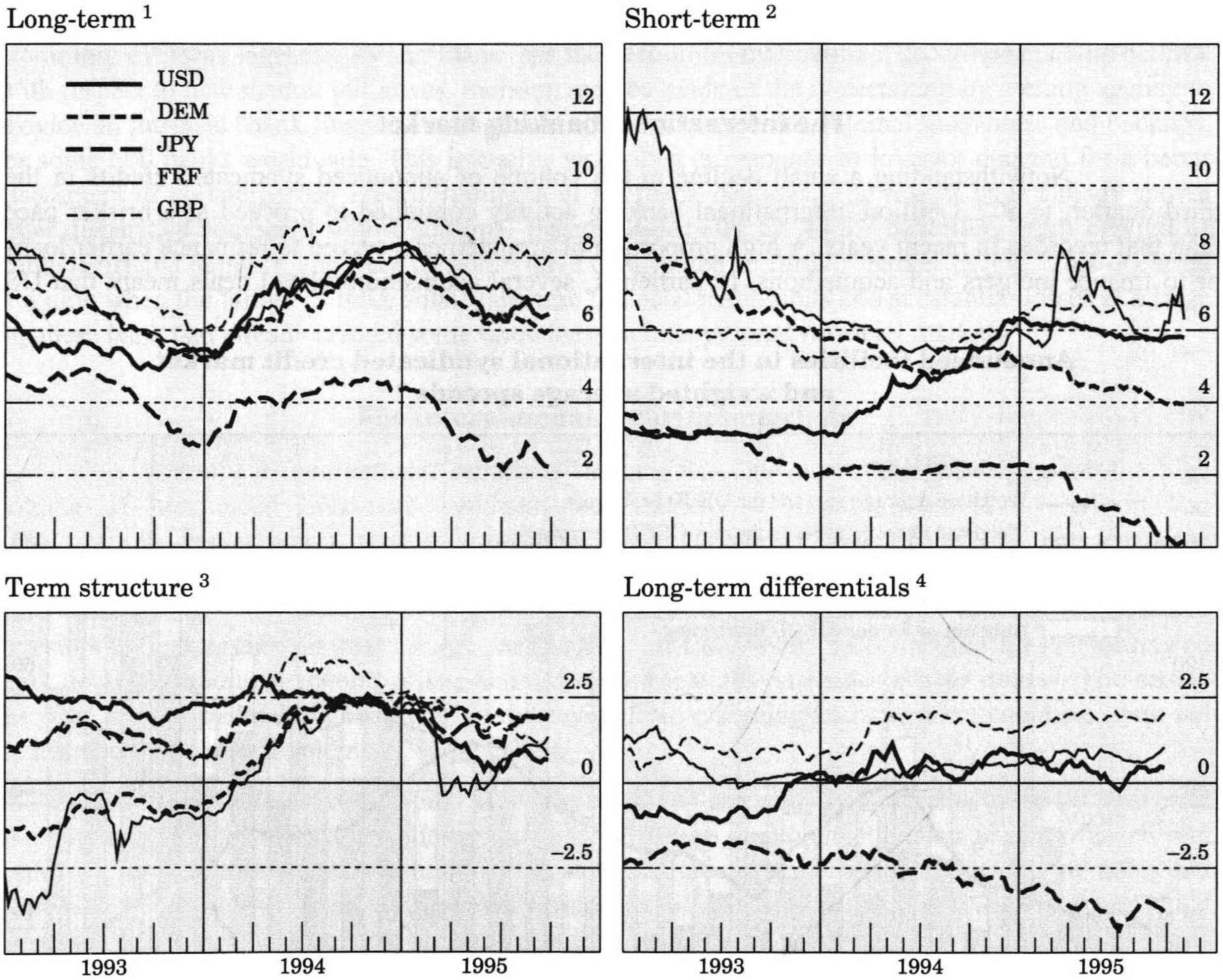
INTERNATIONAL FINANCIAL MARKET ACTIVITY DURING THE THIRD QUARTER OF 1995

Overview

A recovery of the US dollar in the exchange markets, some easing of currency tensions in Europe and lower interest rate volatility were the dominant features underlying international financial market activity in the third quarter of 1995. The low level of interest rates prevailing in some major countries encouraged investors to return to higher-risk markets, enabling a wide variety of borrowers to raise a record volume of funds through the international securities markets. However, with the Mexican crisis still fresh in international investors' minds, awareness of credit risk remained acute. This was illustrated as much by the high premia required of more risky borrowers as by the importance attached to other aspects of the financing equation such as the type of securities purchased, their maturity structure and the quality of their collateral backing.

International long and short-term interest rates

Weekly averages, in percentages and percentage points



[1] Yields in annual terms on five-year interest rate swaps. [2] Three-month Euro-market interest rates.

[3] Long-term rates minus short-term rates. [4] Vis-à-vis German long-term rates.

Source: BIS.

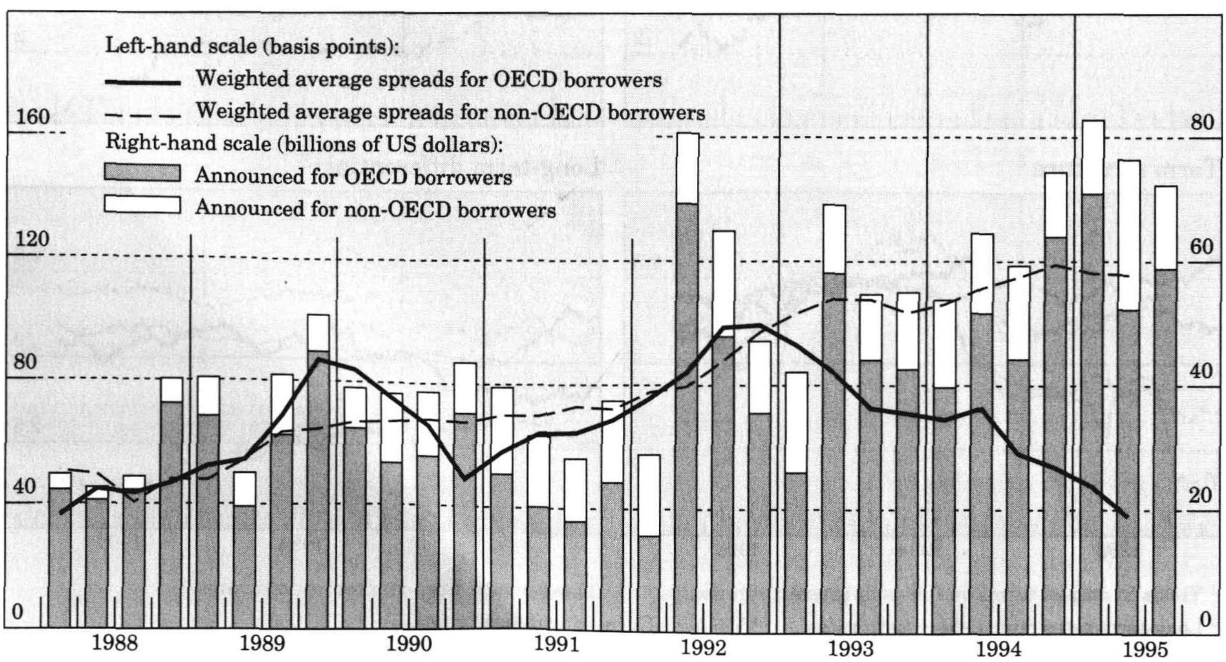
The Mexican crisis also alerted developing and transition countries to the potential for instability resulting from large and volatile capital flows. The record volume of funds raised by borrowers in such countries made this issue highly topical, leading some authorities to adopt a number of measures, including taxes on foreign borrowing and domestic investment by non-residents, additional reserve requirements and the lifting of restrictions on the foreign investment activities of residents. In certain instances, policy responses also included restrictions on the use of "newer" financial instruments which have grown in importance in recent years such as American Depository Receipts (ADRs) and derivatives.

Euro-notes continued to gain market share relative to traditional Euro and foreign bonds, accounting for 56% of the net financing conducted through the international securities markets. This reflected some of the fundamental advantages of Euro-note facilities, such as their flexibility and the cost savings associated with issuance under single documentation. It may also have been related to some temporary influences such as a preference for smaller and shorter-term issues. Financial institutions continued to be the most active category of borrowers in the two segments of the securities markets. Despite a sharp recovery in the use of the US dollar in the international bond market, the share of that currency remained fairly low compared with the early 1980s (see page 25). The volume of announced syndicated credits was also high by historical standards and terms eased further; but the large number of refinancings in this sector suggests that net activity was more modest. Nevertheless, the narrowing of spreads relative to those prevailing in the Euro-securities markets led some market participants to question whether international financial markets were correctly pricing risks.

The international banking market

Notwithstanding a small decline in the volume of announced syndicated credits in the third quarter, to $72.3 billion, international banking activity continued to proceed at a brisker pace than that recorded in recent years. A high proportion of arrangements served to refinance earlier loans or to finance mergers and acquisitions. In particular, several acquisition-related deals meant that US

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



* Four-quarter moving average of spreads over LIBOR on US dollar credits.

Sources: Bank of England and BIS.

borrowers were particularly active, accounting for almost 50% of the total. Competition between lenders remained fierce, leading to a further easing of conditions for prime borrowers. In addition to the compression of lending margins, this easing also took new forms such as the elimination of restrictive clauses pertaining to "adverse material change" and the ability of borrowers to reset the pricing of loans before maturity. There was also a pronounced easing in the financing terms offered to borrowers from eastern Europe and Asia. However, the traditionally higher margins charged on loans arranged for acquisition purposes put some upward pressure on average lending spreads.

The high degree of liquidity in the international syndicated credit market is the result of two main factors. Firstly, following the Basle Capital Accord in 1988, the capitalisation of banks has been boosted by over-provisioning for non-performing loans and by strong growth in earnings. Secondly, new lending opportunities have been limited in recent years by a tendency for corporate borrowers either to deleverage their balance sheets through equity financing or to restructure them through debt issues. Excess capital has in turn set the stage for a wave of mergers and acquisitions in the financial industry. While this process may lead to greater efficiency through economies of scale and scope, it will also act to increase the competitive pressures between major financial groups and further blur the distinction between banks and other financial institutions.

Structural and regulatory developments. In the area of regulation, a measure that could indirectly affect international bank lending was the complete liberalisation in August of the foreign currency lending activity of Japanese life assurance companies. This was part of a more comprehensive package of measures announced by the Japanese Ministry of Finance aimed at promoting overseas investments and loans (see the section on international securities markets below). With respect to new market initiatives, mention may be made of the undertaking by a rating agency to provide an intrinsic "bank financial strength rating", which excludes external guarantees and backups, for some 600 banks worldwide. This initiative was taken in response to investor demand for a better assessment of counterparties' creditworthiness in interbank dealings. The results have already shown great disparities compared with traditional ratings, especially for banks benefiting from explicit or implicit official support, and may therefore have contributed to further market tiering. This occurred at a time when the failure of three small Japanese financial institutions and substantial losses at a large Japanese bank had already created some uneasiness in international financial markets.[1]

The international securities markets

Activity in international securities markets was buoyant in the third quarter. The high volume of announced Euro-note facilities and international bond issues ($74.4 billion and $111.1 billion respectively) was accompanied by a record volume of overall net financing ($104.1 billion). At the same time, Euro-notes continued to gain market share relative to traditional Euro-bond issues. The low level of interest rates prevailing in some countries induced international investors to seek higher returns through the purchase of lower-rated securities (such as subordinated bank debt) or structures encompassing derivative-type features (such as callable issues). The search for yield proved particularly beneficial to borrowers from emerging and transition countries, with net issues reaching a record volume of $15.7 billion.

Nevertheless, international investors remained prudent. This was illustrated by a reversal in some indicators of market confidence (such as an overall decline in the average size of fixed rate issues and in their average term to maturity) as well as a greater preference for floating rate notes and short-term Euro-notes. Moreover, greater awareness of the credit risks implied by lower-rated securities led investors to charge generally higher risk premia than in 1993 and 1994. This was particularly true for Latin American borrowers, where, in spite of a near-record volume of issues,

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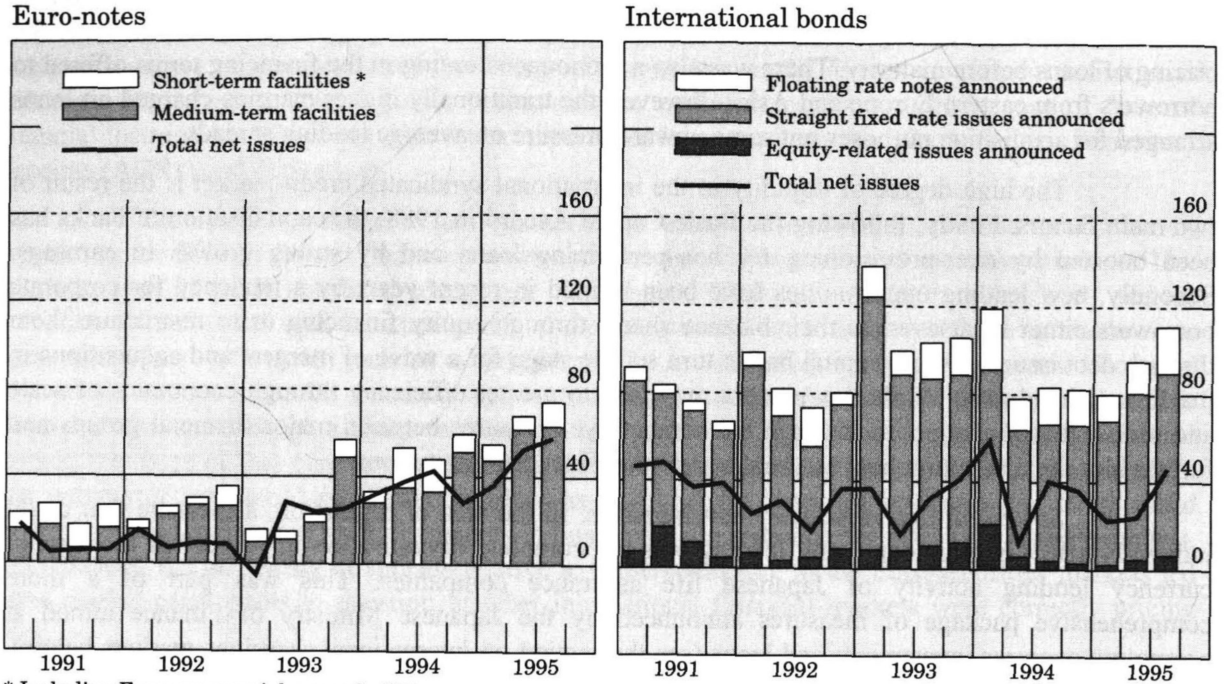
1 Japanese banks faced a risk premium in the interbank and OTC derivatives markets as well as some reduction in credit lines offered by non-Japanese institutions.

The international securities markets
In billions of US dollars



* Including Euro-commercial paper facilities.

Sources: Bank of England, Euroclear, International Securities Market Association (ISMA) and BIS.

yield spreads generally remained higher than before the Mexican crisis (see the graph on page 8). In addition, some developing country borrowers could only bring issues at acceptable cost with some form of collateral backing or with the provision of guarantees by international financial institutions. The more cautious attitude towards credit risk was also evident in the case of developed country names, with a greater volume and variety of issues encompassing some form of asset backing.

The Euro-note market

With $74.4 billion in announced new facilities and a record $57.8 billion of net new issuance of paper under existing facilities, the Euro-note market continued to demonstrate robust expansion in the third quarter of 1995. This sustained rapid growth has enabled it to catch up with the international bond market; Euro-notes now account for more than one-fifth of the total stock of international securities outstanding, compared with a mere 7% at the beginning of the 1990s. Euro-medium-term notes (EMTNs) were again the most buoyant, but there was a further recovery in short-term notes. Repeating the pattern seen in recent years, financing in currencies other than the US dollar continued to grow most rapidly, while banks and other financial institutions reinforced their dominant position. There also was a further recovery in issuance by developing country borrowers, with, in particular, a return to net borrowing by Mexican names. However, issuance by Mexican entities was mainly on a short-term basis, with costs remaining high in comparison with 1993 and 1994 (in excess of 1,200 basis points over LIBOR for some private sector entities).

The lower degree of regulation prevailing in the Euro-market together with the smaller documentation and dealing costs of Euro-note programmes were reported to have made the Euro-note market increasingly competitive relative to domestic financing instruments. However, the concentration of EMTN activity on plain vanilla business combined with the large number of institutions vying for business continued to put downward pressure on dealers' margins, with some dealers noting that this could lead to a shake-out of business similar to that which occurred some time ago in the Euro-commercial paper (ECP) market.

Main features of the Euro-note market

In billions of US dollars

Instruments, currencies and type of issuer	1993	1994	1994		1995			Stocks at end-Sept. 1995
	Year	Year	Q3	Q4	Q1	Q2	Q3	
Announced facilities	**109.8**	**194.0**	**47.9**	**59.7**	**54.9**	**68.1**	**74.4**	
Short-term notes[1]	21.2	46.7	14.8	8.3	7.5	6.2	11.1	
Medium-term notes	88.6	147.4	33.1	51.4	47.4	61.9	63.2	
Net issues[2]	**72.1**	**140.2**	**42.7**	**28.2**	**36.0**	**52.6**	**57.8**	**556.3**
US dollar	23.2	36.3	7.6	4.6	4.1	15.0	14.1	219.6
Japanese yen	17.9	61.5	24.1	11.5	12.3	19.8	21.3	140.6
Other currencies	31.0	42.3	11.0	12.1	19.7	17.8	22.5	196.0
Banks[3]	20.2	67.6	22.6	14.3	25.0	24.4	36.9	276.3
Public sector[4]	26.7	44.6	11.9	11.1	5.0	12.3	10.9	142.6
Other	25.3	28.1	8.1	2.8	6.1	16.0	10.0	137.4

[1] Including Euro-commercial paper. [2] Changes in amounts outstanding excluding exchange rate valuation effects. [3] Commercial banks and other financial institutions. [4] Governments, state agencies and international institutions.

Sources: Bank of England, Euroclear and BIS.

The international bond market

In spite of the interruption of the bond market rally in the major industrialised countries and the strong competition offered by syndicated loans and Euro-note facilities, there was a 17% increase in the volume of announced international bond issues in the third quarter. At $111.1 billion, gross activity reached the highest level since the first quarter of 1994, while net issuance nearly doubled to $46.2 billion. Expansion was most pronounced for floating rate instruments and was underpinned by the diversification of funding by financial institutions (especially by those that have traditionally been domestically-oriented, such as US government-sponsored lending agencies and German mortgage banks), refinancings, mergers and acquisitions as well as a more active use of the market by non-financial companies. Borrowers from the United States reinforced their lead with a total of $23.2 billion of gross issues. The improvement in the overall economic and financial performance of a number of industrialised countries with high public sector deficits and indebtedness meant that their international issues met with a favourable reception. This was particularly true of Sweden, with government and state agencies doubling their recourse to the market.

A return of Japanese investors to investment in foreign securities combined with a partly related recovery of the US dollar in foreign exchange markets provided a fertile background for issuance in US dollars, which expanded by over 50%. However, deeply rooted aversion to currency risk meant that Japanese investors also continued to purchase a high volume of yen-denominated securities, thus offering support to the yen segment of the market. Concerns connected with the new single currency that would emerge under European economic and monetary union (EMU) discouraged issuance in the long-term segment of the German mark yield curve and continued to depress issuing activity in ECUs. In contrast, the Swiss franc sector benefited from EMU-related uncertainty. Meanwhile, political and economic uncertainty continued to hold back financing in the French franc sector. Lastly, positive economic developments in Australia reinforced the attraction of the relatively high-yielding Australian dollar Euro-bond market, with issues more than doubling (to $3.3 billion). Several borrowers in that sector launched zero coupon securities that were specifically targeted at Japanese retail investors (who benefit from partial tax exemption on such securities).

Main features of the international bond market

In billions of US dollars

Instruments, currencies and type of issuer	1993	1994	1994		1995		
	Year	Year	Q3	Q4	Q1	Q2	Q3
Announced issues	**446.7**	**362.5**	**83.2**	**82.2**	**80.1**	**95.0**	**111.1**
Straight fixed rate issues	348.8	254.0	62.4	63.1	65.7	76.0	83.2
Floating rate notes	58.3	75.3	16.8	16.4	12.1	14.4	21.2
Equity-related issues[1]	39.6	33.2	4.0	2.8	2.3	4.6	6.7
US dollar	159.7	115.8	25.3	28.4	22.4	28.3	42.7
Japanese yen	55.0	69.6	21.8	21.3	12.5	24.0	23.5
German Mark	55.8	38.1	7.4	8.8	12.1	18.9	12.8
Swiss franc	27.5	20.5	6.2	4.0	5.7	6.8	9.3
Pound sterling	39.8	26.6	5.0	3.6	5.1	3.9	4.6
French franc	40.5	25.4	2.0	2.5	4.2	3.2	2.2
Other currencies	68.2	66.5	15.5	13.6	18.1	9.9	16.0
Banks[2]	142.3	156.9	36.3	35.9	41.0	39.4	49.8
Public sector[3]	168.1	121.0	29.5	30.9	25.0	32.5	33.9
Other	136.3	84.5	17.5	15.4	14.1	23.1	27.5
Net issues	**125.6**	**146.8**	**40.2**	**35.8**	**22.3**	**23.9**	**46.2**
Memorandum item: Bonds announced under EMTN programmes	**31.9**	**58.2**	**13.5**	**13.8**	**17.6**	**8.6**	**9.1**

[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, ISMA and BIS.

At the same time, the process of international financial diversification continued. The use of the global bond structure by a wider spectrum of borrowers increased the issuance of such securities by 17% (to $12.9 billion),[2] while new Euro-market investment currencies were introduced (the South African rand and the Taiwanese dollar). The high proportion of developing country issues denominated in German marks or yen (45%) also illustrated the diversification of funding sources undertaken by borrowers from those countries.

Straight fixed rate issues. The volume of announced fixed rate bond issues increased by 9% to reach $83.2 billion in the third quarter. Although global offerings remained high at $7.1 billion, there was an overall reduction in the average size (the major exception being the US dollar segment) and maturity of issues. Offsetting changes in the use of European currencies and a stable flow of yen issues meant that most of the expansion took place in US dollars. The more favourable disposition of international investors towards US dollar securities enabled a wider spectrum of Euro-market borrowers to launch more and also larger issues than in the previous quarter. The limited supply of corporate debt offerings in the US domestic market also increased the willingness of US investors to consider purchases of foreign bonds, leading to a further increase in the volume of Yankee bonds. As a result, with $24.6 billion in announced issues, the US dollar overtook both the German mark and the yen to become the most important currency of issuance.

Floating rate notes. Announcements of floating rate issues (FRNs) increased by 47% to $21.2 billion in the third quarter. A sharp rise in global offerings (from $1.6 billion to $5.8 billion) made mainly by US government-sponsored lending agencies and several asset-backed issuing entities

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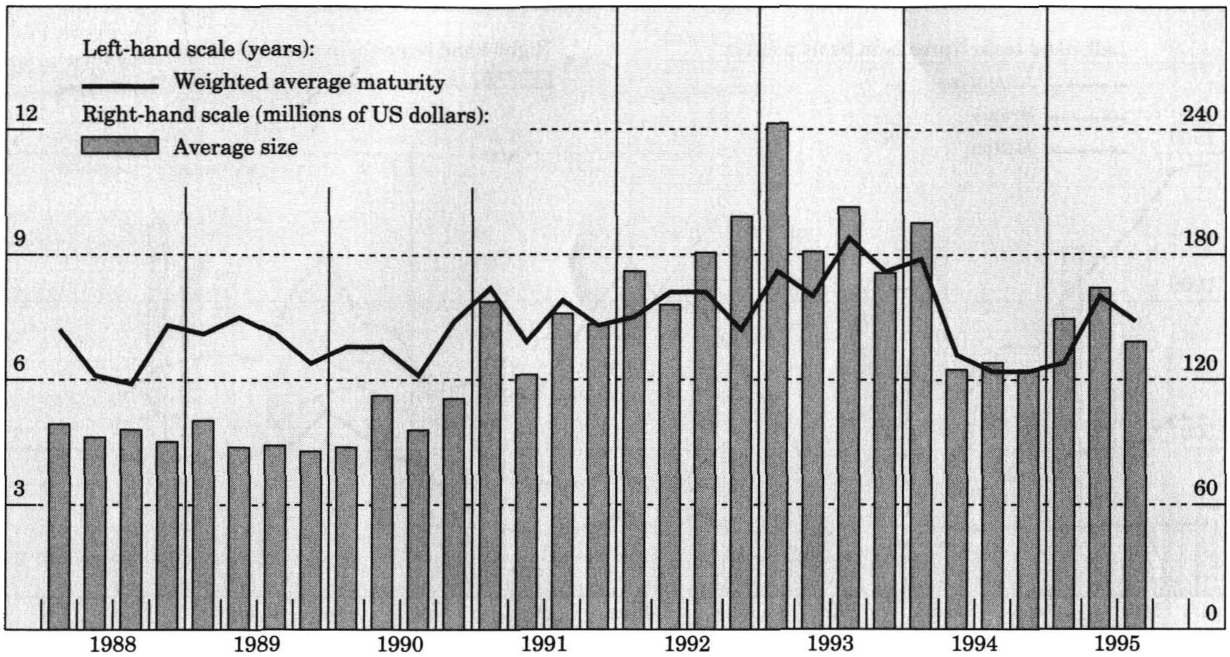
2 Some observers have argued, however, that few such bonds launched during the quarter were truly global because they were largely sold in the US market.

Average size and maturity of announced straight fixed rate international bond issues *



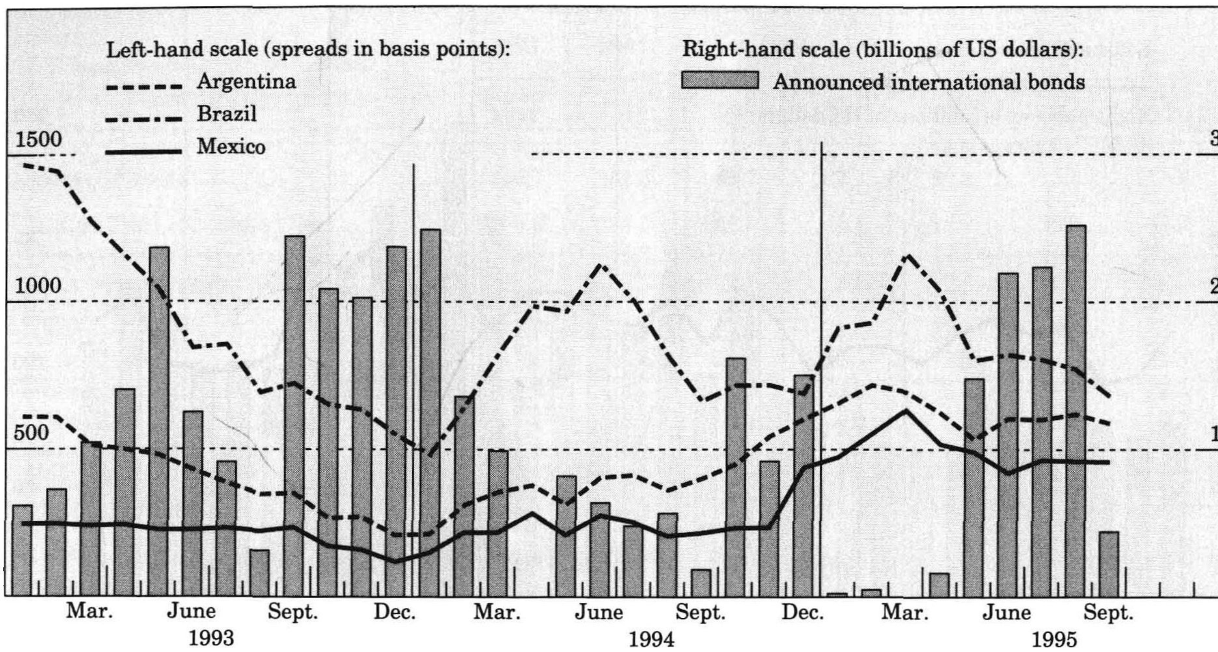
* Based on announcement dates.

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

accounted for much of the expansion in the US dollar segment of the market (to 67% of total issues). Strong demand for floating rate assets continued to exert downward pressure on the secondary market spreads of most types of FRNs, encouraging investors to diversify into higher-yielding instruments such as subordinated bank issues and a variety of asset-backed notes. Capitalising on the robust or improving health of the financial industry in Europe and North America, bank and non-bank financial institutions were the main driving force behind the market's sharp expansion, accounting for \$14.7 billion worth of issues. Although issuance by government entities and state agencies more than tripled to \$3.7 billion, much of that was the result of an ECU 1 billion (\$1.3 billion) issue for the Republic of Italy and a \$1 billion issue each for Mexico and for the US Federal National Mortgage Association (FNMA). In spite of favourable margins relative to LIBOR, sovereign issuers generally seemed to have found more attractive borrowing opportunities in domestic and other international market segments. There was a further widening in the spectrum of asset-backed issuers with several deals backed by credit card receivables originating in the United States and the United Kingdom. The fact that credit card debts are reimbursed rapidly in continental Europe has limited the opportunities existing for this type of securitisation.

Equity-related bonds. Primary market activity in the equity-related sector increased further to \$6.7 billion as a result of the recovery of key equity markets and of the US dollar, as well as of the reflow of funds from redemptions. While convertible issues continued to predominate, there was also some recovery in the issuance of bonds with equity warrants attached. Noteworthy was the fact that some Japanese issuers were able to create "synthetic" equity warrant issues through swap-related structures allowing them to capture the accounting and tax benefits of convertible issues. At the same time, the improvement seen in the Japanese stock market encouraged a return of Japanese borrowers, with issues made on gradually improving terms. While the cautious mood of investors meant that most issues launched by Japanese borrowers were of a relatively small size, one major bank floated a \$2 billion convertible issue which was the largest single-tranche convertible issue ever made in the international market. However, with repayments again exceeding the volume of new issues, there was a further contraction in the stock of outstanding paper, from \$179.9 billion to \$170 billion.

Announcements of international bonds issued by Latin American entities and spreads *



* End-of-month spreads over equivalent US Treasury bonds based on yields of Brady bonds for Argentina and Mexico and IDU (interest due and unpaid) bonds for Brazil.
Sources: Salomon Brothers, Bank of England, Euroclear, ISMA and BIS.

Structural and regulatory developments

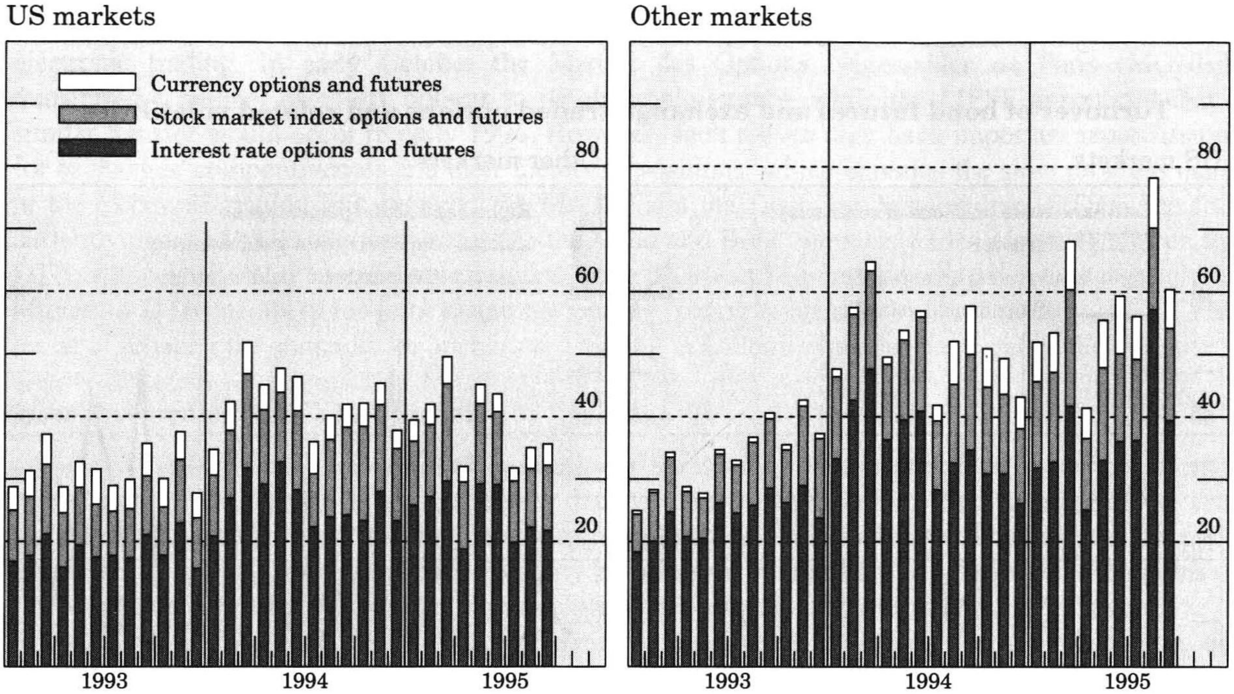
In August, the Japanese Ministry of Finance announced a package of measures to promote overseas investments and loans. This comprised: the lifting of most remaining restrictions on the sale of Euro-yen bonds in Japan (ahead of the originally scheduled date of January 1996); greater flexibility in the accounting treatment of foreign bond holdings of domestic institutional investors; an easing of the foreign exchange restrictions imposed on authorised foreign exchange banks; and the encouragement of investment in foreign bonds by official institutions. With the exception of the first initiative, these measures were aimed at correcting the excessive strength of the yen by encouraging a durable shift of Japanese investment in favour of foreign currency assets. However, given the importance of Japanese purchases of Euro-yen paper in recent quarters, these initiatives may have a limited impact on investment in non-yen currencies. Other measures taken during the third quarter of 1995 which may also have long-term implications for the international securities markets included initiatives to develop domestic bond markets (in Malaysia and Thailand) and to enhance liquidity in government debt markets (Portugal).

Derivatives markets

Exchange-traded instruments

The aggregate turnover of exchange-traded financial futures and options increased by 7% between the second and third quarters of 1995, to a total of 297 million contracts. However, this gives a somewhat misleading impression of underlying developments in that the growth in business was more than accounted for by a sharp increase in the trading of small interest rate contracts on Brazilian exchanges. Excluding Brazilian contracts, turnover declined by 11%, to a total of 217.5 million contracts. There was a widespread reduction of activity in both interest rate and stock index contracts and a modest expansion in currency contracts. Total turnover (again excluding Brazilian contracts) in the first three quarters of 1995 amounted to 732.7 million contracts, a 9% decline compared with the same period in 1994.

Turnover of derivative financial instruments traded on organised exchanges
In millions of contracts



Sources: Futures Industry Association and BIS.

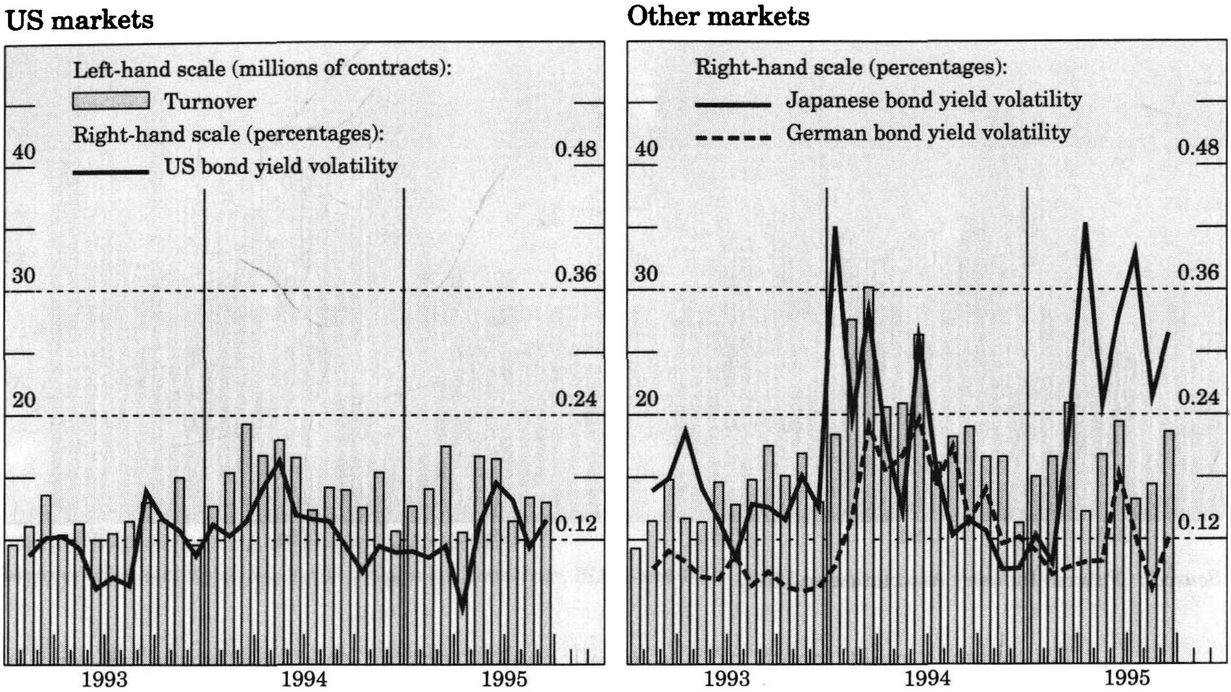
Following a quiet month of July in all product groups, there was some rebound of activity in interest rate and currency contracts. This recovery was related to a number of factors, including significant movements in US and Japanese interest rates in the middle of the quarter as well as the reversal in September of positions based on expectations of interest rate convergence in continental Europe. Over the full quarter, activity in interest rate products declined by 17% on US exchanges and by 9% on non-US exchanges (excluding Brazil). The Euro-dollar futures contract traded on the Chicago Mercantile Exchange (CME) maintained its recent lead over the US Treasury bond contract traded on the Chicago Board of Trade (CBOT) as the most actively traded contract in the United States. In Europe, activity in Bund futures contracts traded on the London International Financial Futures and Options Exchange (LIFFE) overtook that of the "notionnel" contracts on the Marché à Terme International de France (MATIF), helping LIFFE to consolidate its leading position in Europe. At the same time, the historically low level of volatility prevailing in US equity markets was associated with a significant decline in the turnover of US equity contracts (16%). Save for a substantial increase of activity in Germany, total contract turnover on equity indices on the major exchanges outside the United States was generally flat. The slight expansion in currency contracts reflected the sharp increase in the trading of instruments involving the yen and the German mark. In spite of the recent listing in the United States of currency contracts sharing some of the characteristics of OTC instruments and the reintroduction of currency contracts in Europe, activity in exchange-traded currency instruments continues to be held back by the preference of large market participants for the bigger and more liquid OTC currency market.

In the case of Brazil, the high volume of activity on a newly reporting exchange meant that reported business more than doubled relative to the second quarter, to 79.4 million contracts.[3] In

[3] The data on Brazilian business must be treated with caution, however, because the notional value of contracts is substantially smaller than that of contracts traded in developed countries. This illustrates the limitations of any analysis based simply on the number of contracts traded. With arrangements being finalised in several developing countries for the launch of new exchanges which may also have contracts of a small size, greater importance will need to be attached to other measures of activity, such as notional amounts and related margin flows.

mid-August, the Banco do Brasil introduced a ban on foreign participation in local derivatives markets aimed at curbing investment strategies enabling non-residents to benefit from the high level of Brazilian interest rates, while at the same time avoiding the taxes payable on fixed income investments. This was followed by a sharp contraction in the use of interest rate instruments.

Turnover of bond futures and exchange-traded options and related volatilities *



* Rolling standard deviation of 20 previous daily percentage changes in benchmark yields.
Sources: Datastream, Futures Industry Association and BIS.

Although established exchanges announced proposals for a variety of new contracts, new launches made over the quarter were limited to equity contracts on market indices and on single shares. Noteworthy was the introduction by the Chicago Board Options Exchange (CBOE) of a cash-settled European-style option on the Latin 15 index, which provides exposure to the stocks of Argentinian, Brazilian, Chilean and Mexican companies. However, in early October, the CME introduced futures and options contracts based on the (monthly average of the) daily US federal funds rate. The aim is to enable traders to conduct low-cost arbitrage transactions with the exchange's other existing short-term contracts (one-month LIBOR, thirteen-week Treasury bill and three-month Euro-dollar).[4] The contracts will also enter into direct competition with the CBOT's federal funds rate contracts introduced in October 1988 (although they are slightly different in terms of notional amounts, price-setting, expiry dates and tick size).

In spite of the introduction of a few new interest rate contracts since the beginning of the year, the scope for expansion in this area is limited by the fact that the markets for interest rate futures are now well established and mature. This is leading exchanges to adopt new strategies. In the United States, the locus of innovation has moved to relatively "new" areas such as credit risk, insurance, real estate and pollution. In addition to the establishment of international trading links, US exchanges have also stepped up their diversification efforts through the design of instruments based on the financial assets of developing countries and through the provision of assistance in the setting-up of local exchanges. In Europe, along with attempts to move into new areas, exchanges appear to be devoting more resources to the development of currency and commodity derivatives.

4 Allowed by the netting of margins on spread trades.

The lower level of trading seen so far in 1995 has reduced the income of both brokers and exchanges, leading to renewed efforts to reduce operating costs. This has resulted in some retrenchment and in greater interest in linkages between exchanges. The lower operating costs of electronic systems are also likely to re-launch the debate on the relative merits of open outcry versus electronic trading. In early October the Marché des Options Négociables de Paris (MONEP) transferred a number of equity options to its electronic system, while the LIFFE announced that a similar transfer would occur in early 1996. However, such moves may have important repercussions for exchanges' competitiveness and their members' positions, which explains the slow progress made in the electronic trading link between the MATIF and the Deutsche Terminbörse (DTB). The link currently gives MATIF members access to the Bund and Bobl contracts traded electronically on the DTB. Although MATIF members were supposed to decide in February which two contracts would be offered to DTB members for joint electronic trading, strong resistance by floor traders and LIFFE's threat of relisting the contracts for open outcry trading in London appear to have stalled the initiative.

Over-the-counter (OTC) instruments

Swaps and swap-related business. In the swaps market, anecdotal evidence offers a mixed picture. On the one hand, the general decline in interest rates since the beginning of the year has tightened swap spreads over benchmark rates and therefore reduced the volume of new swapped issues; the parallel lowering of market volatility has lessened the need for end-users to fix the terms of future liabilities. It also appears that corporate users and institutional investors have been less active in using swaps, pending extensive reviews of their risk management systems. On the other hand, the uneven movements of interest rates more recently, both across the yield curve (of the yen and German mark in particular) and across currencies, have created some arbitrage opportunities. In addition, swaps are once again being used in conjunction with other instruments to create new higher-yielding synthetic products (for instance, callable bonds created by combining fixed rate issues with swaptions).

In *other segments of the OTC market*, warrants on currencies, equities, interest rates and commodities continued to be introduced at a steady pace during the quarter, with a total of 1,300 new contracts amounting to $20 billion. Equity index call and put warrants (especially on the German DAX index), remained preponderant, but new products were introduced, including warrants on a variety of cross-currency rates and on the equity of individual European companies. Other market segments were also active. In particular, the high level of interest rates prevailing in several developing countries in Asia was reported to have led to a sharp increase in demand for OTC currency and interest rate products denominated in Asian currencies. There was also a reported pick-up in demand for more complex OTC derivatives.

Structural and regulatory developments

In July, at the initiative of the Basle Committee on Banking Supervision, a Tripartite Group of bank, securities and insurance regulators released a report[5] which for the first time addresses the problem of supervision of financial conglomerates from a joint perspective. The report notes that deregulation and internationalisation have led to the emergence of groups which provide a wide range of financial services incorporating insurance and securities activities as well as traditional banking facilities. In contrast, supervision remains confined to a sectoral division of responsibilities. The report sets out three main areas for consideration. Firstly, with regard to capital adequacy, it states that a desired conglomerate-wide perspective could be achieved either through consolidated supervision (as traditionally done by bank supervisors) or through a "solo-plus" approach, which would complement the supervision of individual entities with a general qualitative assessment of the conglomerate as a whole. The second area concerns the need for intensive cooperation between supervisors over the exchange of prudential information. There is general support within the Tripartite

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5 "The Supervision of Financial Conglomerates", a Report by the Tripartite Group of Banks, Securities and Insurance Regulators, Basle, July 1995.

Group for the idea of a "lead supervisor" responsible for gathering information required by individual supervisors in order to have an overall perspective on the risks assumed by the conglomerate. The third area focuses on conglomerate structures. The report notes that experience has shown that supervision can be impeded by complex structures and expresses the view that supervisors need powers to obtain adequate information regarding managerial and legal structures and, if necessary, to prohibit structures which impair adequate supervision.

In August, a committee comprised of representatives of the Federal Reserve Bank of New York and financial industry associations published a final set of recommended practices for intermediaries involved in OTC markets.[6] The document states in particular that market participants should assume that they are dealing with each other on an "arm's length" basis. It also affirms that, unless specifically asked, participants are not obliged to provide market valuations of transactions to their counterparties. However, participants providing such valuations should clearly state their underlying parameters (such as mid-market, indicative or firm prices). The guidelines are intended to avoid ambiguities in participants' relationships and therefore to avert potential disputes arising from losses incurred through transactions in OTC cash and derivatives markets. A number of intermediaries are already issuing standard risk disclosure statements to existing and potential counterparties for OTC transactions, setting out the legal basis of the relationship they have with them.

Also in August, the British Bankers' Association and the Irish Bankers' Federation published a draft report proposing new recommendations on the accounting treatment and disclosure of derivatives market activity in banks' public financial statements.[7] The new *Statement of Recommended Accounting Practice (SORP)* takes into account earlier recommendations put forward by a number of bodies, including the Group of Ten central banks' Euro-currency Standing Committee (ECSC), the Institute of International Finance and the US General Accounting Office. The report's discussion of additional quantitative disclosure is carried out under three broad headings: trading/non-trading activity, credit risk and market risk. With respect to the first heading, the report suggests that a distinction be made between derivatives held for trading purposes (with gross positive and negative values provided) and others, as well as separate information on the notional value of the main instrument types used. With respect to credit risk, the report proposes new rules requiring banks to provide, for all transactions, an analysis of counterparty credit risk based on net replacement cost, distinguishing between financial and non-financial institutions. The report also recommends the provision of a maturity analysis of exposures arising from derivatives activity, with notional principal amounts and net replacement costs broken down by remaining maturity bands. With respect to market risk, the report states that more works needs to be done before a common basis for disclosure can be established. Although it does not prescribe in any detail the basis on which disclosure could be made, the report draws attention to the types of approach highlighted by other groups such as the ECSC.[8] The document also states that quantitative disclosure should be supplemented by qualitative information on the nature of the instruments held, the reasons for holding them and their use in the context of banks' overall activities.

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6 "Principles and Practices for Wholesale Financial Market Transactions", a joint report by the Federal Reserve Bank of New York, the Foreign Exchange Committee, the Emerging Markets Traders Association, the International Swaps and Derivatives Association, the New York Clearing House Association, the Public Securities Association and the Securities Industry Association, August 1995.

7 "Statement of Recommended Accounting Practice: Derivatives. Discussion Paper and Exposure Draft", British Bankers' Association and Irish Bankers' Federation, August 1995.

8 See "A discussion paper on Public Disclosure of Market and Credit Risks by Financial Intermediaries", Working Group of the Euro-currency Standing Committee of the Central Banks of the Group of Ten Countries, Basle, September 1994.