Puttable-callables surge in popularity

High volatility and declining US interest rates are enticing an ever-growing number of corporate treasurers to explore launching puttable-callable debt issues, or straight debt that contains a put-call tranche. A flurry of deals came to market towards the end of last year in the US, and industry officials expect the trend to continue, with a further spike in demand in the first quarter of this year. Some US industry officials believe that this quarter may see about US$10bn worth of puttable-callables go through. Despite a surge in activity in November and December, only US$30bn of this type of deal was launched during the whole of last year. However, no straight debt containing a put-call tranche has come to market yet.

"Because of the volatility in the options market, there is good value for selling the option and [in our deal] it decreases the first two years of funding cost," said an official at Baltimore Gas & Electric. Last month the company closed a US$173m 12-year put-call bond that can be re-marketed after two years.

In a puttable-callable, the put feature offers investors the option, and added protection, of redeeming the security – usually at par – at the put maturity date, in advance of the final maturity date. The call component gives issuers the option of retiring the issue – usually at a premium to par – before the final maturity date. Typically, the structure's option tenor ranges from one to five years, and the tail-to-debt expiration reaches out five to 10 years.

Issuers are attracted to the idea because the put-call structure synthetically reduces the interest rate at least until the put expiration date, and possibly over the life of the bond. Interest in straight debt that has a put-call tranche is being fuelled by the Federal Reserve's 50bp rate cut, which has made it cheaper for corporates to issue debt, explained industry officials. Investors are generally drawn to puttable-callables because they offer a structural premium of about 20 basis points.

Accounting benefits

Another force driving the put-call bonds' recent popularity is their FAS 133 friendliness, said Stuart Sparks, derivatives strategist at JP Morgan Chase in New York. The Financial Accounting Standards Board (FASB) has said that FAS 133 rules do not apply to puttable-callables.

In order to qualify for hedge accounting under FAS 133, the derivative that is used to hedge a risk and the value of the contract must be within an 80% to 120% hedge effectiveness band. Any other hedge must be marked to market and factored into the derivative user's earning statement. IFR

Behind the curve

Treasuries staged another powerful rally last week, fuelled by the mid-week inter-meeting 50bp cut in the Fed Funds rate. The yield curve steepened dramatically in response to the easing, with the entire on-the-run two to 30-year curve becoming positively sloped for the first time in 12 months. Treasuries are still seen as the place to be.

The sudden and unexpected easing is testimony to the perilous nature of the US economic situation and struck some market participants as suggestive of panic.

"A lot of companies that got financing should not have," said one New York-based money manager. "This is all coming home to roost. The Fed can lower rates all they want and it is not going to solve any of these problems."

The Fed said in a statement that: "These actions were taken in light of further weakening of sales and production, and in the context of lower consumer confidence, tight conditions in some segments of financial markets, and high energy prices sapping household and business purchasing power."

Sparking the cut in the near term was an ominous report from the National Association of Purchasing Managers. The overall NAPM report at 43.7, far below consensus estimates of 47, came close to the magical 42.4 level that has historically signalled a recession. IFR

Issue 1365, 6 January 2001

B of A pressures loan clients on fees

Bank of America broadsided corporate loan clients last week with a decree: give us more investment banking fees or lose our loan commitments. Faced with huge losses in its C&I loan book and struggling to dent the securities underwriting and M&A league tables, BofA said it would take a harder look at the way its biggest clients reward the bank for using its massive balance sheet. James Hance, BofA's chief financial officer, delivered the message – a common refrain among the biggest commercial bank these days – to investors attending a Goldman Sachs-sponsored conference last week. "We are not interested in renting our balance sheet to clients who are not delivering us additional fee-based business," he told the group.

On a practical level, the move could have broad implications on corporate liquidity and liquidity backstopping. BofA will not renew roughly 9.5% of its US$210bn loan portfolio over the next year.

BofA's aggressive C&I lending this year has landed it atop the league tables but in hot water on its P&L account. For the first time, it surpassed long-time rival Chase as the number one arranger of leveraged loans. It also topped Chase as the number one arranger of acquisition-related loans through the first three quarters of this year.

Some say BofA has been too aggressive in climbing the league table ladder, especially in a year when credit fears dampened the whole second half. IFR

Risk back in favour

Treasuries sold off last week as investors' attention turned toward the primary corporate market. A record week of corporate supply, much of it coming at extremely wide spreads, prompted investors to dump government issues in favour of adding more credit risk. While the back-up in government bonds broke through a number of trend lines, a continued sell-off is viewed as an opportunity to add to positions.

"At some point, you have to start buying Treasuries again," said one portfolio manager. "I don't think it's going to be a V-shaped recovery in the economy. On any major pullbacks, you reload."

The 10-year Treasury yield swelled to 5.21% from 4.94% on the week while the 30-year yield rose to 5.60% from 5.41%. The two-year note's yield climbed to 4.85% from 4.56%. The two to 30-year curve flattened by 10bp to 75bp.

Traders said the long bond, which was down by a full point midday in New York on Friday, needed to bounce back to finish with a yield of 5.52% or better or it would break a key closing trendline.

Some of the selling was chalked up to fears that price pressures remain in the economy and that those pressures are a key risk to the Federal Reserve's strategy of easing monetary policy. IFR

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Pub group hedges weather risk

Massive Limited, a London pub and restaurant owner, has entered into a weather derivatives deal to hedge against potential temperature-related losses for one of its pubs, the White Swan in Twickenham. Speedwell Weather Derivatives arranged the deal, and Societe Generale provided the protection. Massive owns 26 pubs and restaurants in London.

The contract will pay out if a specified number of Fridays and Saturdays between April and July are above or below a reference temperature. For example, the White Swan is protected if the number of Fridays and Saturdays in April that are above 14C, and in May that are above 18C, are too few. It is also protected if there are too many Fridays and Saturdays in June that are below 18C, and in July that are below 20C.

"We discovered that this site needed a large number of hot days at the beginning of the summer season, but the benefit of such days diminished during the latter months. At the end of the summer, it is too many cold days that cause problems. It is a subtle but important difference," said Rob Preston, a director of Speedwell. IFR

US report gives rate swaps nod of approval

The US President's Council of Economic Advisors is its annual report, released last week, gave its support to the use of swaps as a benchmarking alternative to US Treasury securities. The interest-rate swap market's depth and range of maturities, as well as the decline in US Treasury issuance, were cited as the key reasons behind the CEA's stance. Early last year, the US Treasury yield curve began to reflect the impact that the US Government's debt pay-down plan was having on the Treasury yield curve. Yields on longer-term Treasuries plummeted on worries over the declining supply of these securities. The fall warped the shape of the Treasury yield curve and raised questions about whether Treasuries could remain a viable benchmark for evaluating interest rates. IFR

Demergers' ISDA challenge

Last year's split-up of National Power proved to be a challenge to the treatment of demerger situations under the ISDA credit derivative definitions that has only recently been resolved. While the industry cleared this latest hurdle with relative ease, more trouble is brewing; the break-up of US telephone giant AT&T is bound to raise a flurry of documentation issues. When a company breaks up, or spins off parts of its businesses, the ISDA's 1999 Credit Derivatives Definitions provide that a credit swap written on the back of this entity does not terminate. Instead, the counterparties have to assess which one of the spun-off entities will serve as a successor to the original reference entity.

As a test, ISDA stipulates that the direct or indirect successor to the reference entity will be whichever assumes all or substantially all of the obligations thereof, by way of merger consolidation, amalgamation, transfer or otherwise. The definition is based on corporate governance similar to that used in loan agreements.

With the new entities, International Power and Innogy, trading at vastly different levels in the credit default swap markets, counterparties had to ascertain which of the two new entities should replace the reference entity originally specified in the swap contract.

Financial institutions took until Christmas to work out how to deal with the break-up, but the emerging consensus illustrates the credit derivative market's ability to work with the ISDA credit definitions to produce a sensible result, one banker said.

The stumbling blocks in this latest case could prove minor, compared with the difficulties that will be in store for the credit derivative market in connection with the AT&T break-up – thanks to the company's size, the vast range of its obligations and the extent of its reorganisation. IFR

These extracts are from IFR (International Financing Review). For further details, please contact Lara Bull on 020 7369 7984 (tel) or 020 7369 7397 (fax). Email: lara.bull@tfeurope.com