FOUNDATION PAPER NUMBER 4—MORGAN GUARANTY

INTERNATIONAL FINANCE AND THE CORPORATE TREASURER

by Dennis Weatherstone ACIS FIB

"The future is exciting—I do not sympathise with those who look back to more placid days with nostalgic yearning" . . . Such was the challenge underlying the Association's fourth Foundation Paper, given by Dennis Weatherstone, Chairman of the Executive Committee, Morgan Guaranty Trust Company of New York, at the Royal Society on 23 January. Listeners responded eagerly to his cogent and forceful message—and indeed to his brilliant fielding of subsequent questions. Understandably, many of his comments were off-the-record, and do not therefore appear in our discussion highlights (pp 12).

Dennis Weatherstone was born in London, and joined Morgan Guaranty's London office in 1946. He became Vice-President in 1965, and transferred to New York in 1971 as Head of the Foreign Exchange and International Treasury Department. In 1980, he became Chairman of the Executive Committee.

THE OPPORTUNITY FOR me to address you is particularly pleasing because my original training as a banker was in London, with supplementary experience in the last nine years in another major international financial centre—one that seems to characterise the famous Avis slogan, "No. 2, but we try harder". It seems especially appropriate to be talking to you about the international markets at this time—just 15 months after exchange controls have been lifted in the UK. The removal of these controls has given the corporate treasurer new freedom—freedom to generate more international growth, more problems, and the more complex international financing mechanisms which, of course, will be devised to solve the problems.

In looking at the last 15 years, one is struck by how deeply the corporate treasurer has become immersed in the international financial markets. Equally striking has been the growth and flexibility of the Euromarkets, which have been the mainstay of the world economic system. These markets have represented a basic point of contact—or the interface, as our computer colleagues would put it—between the evolving national economies of the world for both governments and corporations.

As corporate treasurers, you live with the perennial challenge of supplying the working capital and the term capital that your companies require to operate and grow. What funds you cannot generate internally, you must obtain from the financial markets. This becomes more interesting as your companies grow internationally, and capital requirements take the form of more and more foreign currencies. At the same time, your subsidiaries are generating funds in many different currencies. You, who are treasurers of multinational companies, know all too well the difficulties and complexities of balancing these foreign currency requirements and flows. The accounting problem is bad enough, even for the accountants, but tonight I will concentrate my remarks on the real or economic problems, although I realise many—perhaps, most—of you have the job of solving both.

The international markets have evolved as a marvellous tool for meeting corporate requirements, and the resourceful corporate treasurer can make effective use of their flexibility, but it is a high-stakes game you must play, as your companies' overseas operations expand in scale and as currency markets increase in volatility. That's when striking the right balance of sources and uses of various currencies can make a considerable difference.

Take, for instance, a UK company making a 12-month borrowing on 24 October 1979, the day that exchange controls were removed. It would have paid 14¾% if it had borrowed in sterling, but by borrowing Swiss francs it would have made a net gain of 10% in sterling terms. Making the best choice of currency—a choice that had not been available to all—had a 25% impact on the borrowers' cost of funds in just one year.

I don't mean by this illustration to incite speculation through unhedged foreign-currency borrowing, but to demonstrate what effect the volatility of the market now open to you can have. With the future levels of both interest and foreign-exchange rates so uncertain, the company that can forecast and measure its economic exposures accurately and take them into account when addressing its sources and uses of funds equation will reap a real reward. But it is not easy, and for many companies it is quite complex.

The critical first step in successfully meeting the challenge of financing a multinational business in this environment is, we believe, to develop a definition of exchange exposure appropriate to a company's situation, and then to put in place a practical reporting system to measure and forecast its exposures. Through experience with many multinational customers, who have sought their bankers' help in this area particularly since the February 1973 float, banks have now become useful consultants on reporting systems. Companies quickly perceive that such systems may have benefits in identifying ways to minimise their cash float with banks. Who better than a banker to advise on this!

Banks are now working with customers on computerising the flows among their international subsidiaries, not just to provide the parent with exposure information, but also to open up the possibility of using the intercompany trade flows as a flexible financing tool. In this way, a company may be able to reduce the proportion of total capital it needs to raise by external funding.

The multinational treasurer who has a meaningful measure of his present and forecast exposures can then look for various ways of balancing them. In assessing the cost of covering his short-term exposures, he will want to estimate the risk involved in any particular currency. This exchange rate information is supplied by the banks in two parts: short-term, trading-type information from the bank dealers, and medium to longer-term trends from their international economic departments.

I might add an observation here, that in the United States and on the Continent we have seen corporations quite actively and aggressively managing their foreign exchange positions, not just limiting themselves to protecting or hedging their positions. I think those who do that—and I would not necessarily want to be critical of them—should certainly see that they have a very good system of internal controls and that their board of directors are well aware of what they are doing.

When a treasurer has determined his exchange position and the outlook for the currencies involved, he is ready to consider the most appropriate international markets he might enter as a borrower or investor.

Most appropriate international markets

For short-term needs he can look at three markets. The first is the local currency market where he borrows from banks domiciled in the country where the cash is needed. International banks have been expanding their branch networks to meet the growing need for local borrowing.

Second is the Eurocurrency market which has grown and innovated in response to borrowers' and depositors' requirements, and now offers a considerable range of financing and investment options, thanks to its freedom from regulation. This market is now over $1 trillion in total size. Much of the demand has been from government institutions for balance of payments purposes, but companies have also been significant users of the market to facilitate international trade and investment.

The corporate treasurer can use the Euromarkets to meet short-term funding requirements in all the major currencies. Banks will structure floating-rate facilities with multicurrency options which allow the treasurer to move from one currency to another as financing requirements change—although local exchange control regulations may, of course, interfere at times with complete freedom to effect such movements.

The third market that the corporate treasurer can look to is the foreign exchange market, which has expanded to meet customers' needs, and will now quote forward exchange rates in most currencies for periods up to two years. It is possible to do deals out 10 years and beyond, but these are by individual negotiation and do not constitute a true market, yet. While forward rates are largely based on the interest rates in the Eurocurrency market, the capacity to buy and sell currency forward does expand the treasurer's flexibility to convert funds from one currency to another without incurring exchange exposure and without borrowing.

The availability of these markets—local currency, Euro, and foreign exchange—offers you considerable flexibility. Choosing the most advantageous alternative for a specific need requires up-to-date market information, overseas exchange control information, and a knowledge of the tax effect that would result from employing various alternatives in the UK and overseas. Here again, banks are organised to provide assistance, including suggestions as to which corporate entity would be the most favourable borrower in order to minimise the overall after-tax financing cost.

The same three markets that serve a multinational in meeting its working capital requirements are available for its long-term foreign currency requirements, but for these purposes they have less depth. Therefore, they must be approached with even greater skill and imagination to come up with optimal financing solutions.

In many countries, it is hard for the multinational to gain access to the domestic long-term market, even if such a market exists. The long-term Eurocurrency market, therefore, is of great importance.

The "early birds" wait for the proceedings to begin.

The Eurobond market has grown rapidly, and provides funds in most of the major currencies, normally for periods of up to 15 years. It is to respond to the growing importance of this market that both the commercial and investment banks have set up Eurobond underwriting groups, mostly based here in London.

The Eurobond market, however, has a number of limitations. First, central banks can effectively control activity in their own currencies. For example, access to the Euro-yen bond market is still effectively closed to most borrowers, and the Euro-French franc bondmarket is tightly controlled by a queue system. Secondly, the Eurobond market depends on investors' views on both interest rates and exchange rates. This means there are periods when the Eurobond market in a particular currency practically dries up.

So, if the local currency markets are normally not available for term needs, and the Eurobond market is a useful source of only some of the currencies for some of the time, can one use the forward markets to increase a company's long-term financing options? The standard forward exchange market based on the Eurocurrency deposit market extends only one or two years—so it is not an alternative. However, companies' long-term foreign-currency needs are growing, and where there is a need there is often a way. Let me draw examples from our own experience of how companies have been able to combine the strengths of these different markets to meet their requirements.

Empirical examples

A company in Canada needed to raise medium-term, fixed-rate Canadian dollars. We reviewed with them the three alternative markets. In this case, a bond issue in the domestic market was viable, and its price could be used as a benchmark for comparing the other alternatives. The Eurobond market at the time was not looking for Canadian investments, which made it seem that only a limited amount could be raised, at a cost of probably ¼% over the domestic market rate. The Eurobond market was, however, aggressively seeking US dollar investments.

The solution for this company was to issue a five-year, US dollar Eurobond at attractive terms, and convert the proceeds into Canadian dollars. At the same time, they covered the interest and principal repayments on the bonds by purchasing US dollars forward. These forward exchange contracts could be executed by the bank at an attractive rate, as another customer wished to sell US dollars forward for Canadian dollars to cover its trading exposures. Thus, by combining the opportunity in the Eurobond market and different companies' complementary exchange exposure requirements, it was possible to solve two problems. The company with the trade exposure could hedge its position. The company raising Canadian dollar finance did so at an effective all-in rate of ¼% to ½% below the domestic alternative.

Another very similar transaction was completed recently for a US company which wished to borrow dollars. In this case, the Eurobond market was not favourable to dollar issues, and the solution was a sterling Eurobond hedged by the purchase of long-date forward sterling. This provided effective dollar finance for a cost approximately 40 basis points lower than a domestic dollar-bond issue.

An interesting example of a multinational with a very specific problem occurred last year. Its UK subsidiary had an attractive £30m eight-year lease, which the company did not wish to prepay. However, the group was cash rich, and did not need the finance involved in the lease; in addition, the future sterling lease payments presented an unwanted exchange exposure for them. One possibility for the group was to enter into forward exchange contracts to cover the lease payments. But there was an even more attractive course.

There were several companies that wished to borrow term-sterling, but were prevented from doing so in the absence of a domestic medium-term market in London and a lack of receptivity to sterling issues by the Eurobond market at that time. The solution was for the company with the sterling lease to use the group's excess cash to make a term-sterling private placement, the repayments of which would exactly cover the lease obligations. As the lease payments were a level flow, the matching sterling placement was made in the form of an annuity. This was an exceptional opportunity for the potential sterling borrowers, who submitted closed bids for this annuity loan. This solution covered the exchange exposure involved in the lease at very attractive rates, while producing a scarce resource—term-sterling—for the highest bidder.

I would also like to illustrate that this can be done on a large scale. When Caracas was planning its new underground system—Metro Al Caracas—it received quotations for the construction from France, Germany, Japan, the UK, and the US, with support in each case from the national export agency. The French won the deal with a contract denominated in French francs. Clearly, no one company was going to wish to sell this amount of French francs for payment spread over 13 years. Venezuela preferred a dollar exposure to a French franc exposure, and the problem was to arrange the long-date purchases of French francs. What made it challenging to the bank was that the total amount involved was enormous: 1.2bn French francs forward, but it was possible to put together a sizeable group of companies to cover the entire amount. We were able to show companies that this was a virtually unique opportunity to sell French francs forward for periods up to 13 years. Two kinds of companies took advantage of the opportunity: overseas investors in France who wished to cover their net exposure, and French companies interested in term-French franc financing which were able to borrow in the dollar Eurobond market and hedge the dollar exposure.

These examples illustrate some of the flexibility already provided by the international markets. Because these markets do not stand still, I would like to turn now to some thoughts on future trends.

President Alan Clements sets the scene.

Future trends

How these markets evolve will be very much influenced by oil price changes and by that phenomenon that has been labelled "the recycling problem". The oil price surges of recent years have changed the relationships of the world's economies. The result has been severe strain on the international markets over the last decade. The markets have coped with these demands surprisingly well, which I believe is due in large part to the additional flexibility that was introduced in 1973 by the generalised floating of currencies.

This gave markets the resilience to adapt to changing circumstances. Some of the market reactions may have appeared erratic, but overall I do not believe the markets could have succeeded as well as they did if there had been a fixed or regulated exchange rate system. Since then, we have seen the markets move towards a managed float to dampen erratic swings, and the EMS, instituted in March 1979, represents a yet more disciplined approach to international monetary management.

The outlook for 1981 and beyond appears to be that demands on the markets will increase. As participants in these markets, we must all adapt to the volatility in exchange rates and interest rates that this may imply. Although we must accept a world characterised by greater market fluctuations, the markets themselves will be expanding to help us deal with the resulting exposures.

The initial reaction of the markets to cope with the greatly increased volatility of exchange rates was to make a corresponding increase in the depth and flexibility of the forward exchange markets so that corporations could cover their exposures. Another way of facing up to volatility in exchange rates may be to develop an inherently more stable currency. The SDR was originally established in 1969 by the IMF as a reserve asset defined in terms of gold. In 1974, the SDR was redefined in terms of a basket of 16 currencies. As of the first of January this year, it has again been redefined—this time in relation to only five currencies: the dollar, Deutschemark, sterling, French franc and Japanese yen.

In its original role as an institutional reserve asset, the SDR was not an important factor in the commercial markets. In its new form, however, it has the prospect and promise of being used commercially as a supranational currency with greater stability than can be provided by any single currency. To the extent that national and supra-national entities need to tap the private markets as part of the OPEC recycling process, the SDR could become the favoured denominator for the loans.

First commercial bank loan denominated in SDRs

The International banks are already developing the beginnings of a deposit market for SDRs, and a few exploratory moves have been made with certificates of deposit denominated in SDRs. To date, there have been fewer than a dozen SDR bond issues totalling approximately 250m SDRs, and a commercial bank loan in SDRs has yet to develop.

This paper was written a couple of weeks ago.

The markets do not stand still. We now happen to be—and it really is a coincidence—in process of syndicating the first commercial bank loan denominated in SDRs to a sovereign borrower. I was pleased about the timing, an accident, but a rather pleasant accident.

As yet there is no clearing system for the SDR to facilitate its market growth and to enable it to become a means of payment in trade transactions. However, just as I was proved somewhat out of date in saying that no SDR commercial bank loan has developed, it surely is not impossible for some ingenious banker somewhere to devise a workable clearance system. OPEC countries are interested in the SDR development. The IMF is interested in the SDR development. Airline companies, too, with their multitude of different currencies. I do not suggest that just because of recent improvement in the outlook, that this is the "greatest thing since sliced bread", but I do think it has added some flexibility to financing possibilities.

Interest rate futures

Chronic interest rate volatility will also challenge us to adapt traditional financing approaches. The growth of the futures market in financial instruments is one of the more recent and most dramatic developments in the US money markets. Banks have a very real interest in this market, which is hardly surprising since our "product" is money, and its price is the interest rate. In volatile financial markets, it has been possible for banks to use interest rate futures to aid their liability management, as well as protecting their trading and investment portfolios.

The Chicago interest rate futures markets, which began in 1976, were joined by the New York Futures Exchange last year. Traded contracts are currently based on the yield of certain US Treasury obligations, but I understand preparations are proceeding both in London and the US for the introduction of contracts based on domestic US bank certificates of deposit and Eurodollar CDs.

I believe you may have a study group working on this subject. I know the Bank of England is keenly interested. I do not think they have made up their mind yet.

These additions will enhance the effectiveness with which corporations can hedge their dollar funding costs. These costs are often more closely correlated to CD rates than to US Treasury rates. Some US companies have already begun to use the existing futures markets to hedge their exposure during the period between their decision to issue bonds and the date when the interest rate is actually determined.

As the newspapers make sure we remember, however, opportunities for abuses in the futures markets do exist. I would insert a warning that off-balance-sheet financing techniques like the use of futures, which have obvious attractions, also require particular care in accounting and tax matters, and rigorous internal controls.

Howard Macdonald (Council Member) presents a silver salver to Dennis Weatherstone.

The growing financial futures market and the beginnings of an SDR market are exciting prospects for the future; but then you may have sensed that I find what has been happening in the markets in the past to be exciting. I am not one who sympathises with those who look back to more placid days of fixed exchange rates and immobile interest rates with nostalgic yearning. In fact, I do not think a return to those conditions would serve the modern multinational corporation and its treasurer very well at all. This bears saying, I think, because one can see efforts to bring back the supposed benefits of the past through so-called proper regulation of the international markets.

Two cautionary thoughts

To you, who are charged with the official custody of corporate caution, I offer two cautionary thoughts on the subject of regulation intended to discipline these "unruly" market places:

- First, always remember that the markets have served corporations well by developing in response to your needs, and finding alternatives to clogged channels of financing.
- Second, reflect on the lesson we have been taught so often that the plausible and even laudable short-term benefits held out as the reasons for regulatory schemes seldom materialise; more certain are the long-term costs to be exacted by loss of market efficiency.

I firmly believe that the saga of "International Finance and the Corporate Treasurer" will continue to be an exciting and rewarding adventure. •