International
Finance & Treasury

WORLD TRADE Executive
International Business Advisories™
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Weekly Report for International Finance Executives

March 12, 2001

A Seamless Solution

A champion of the consortia explains how regional banking clubs can equal—and surpass—the overlay system.

Dr. Gerard J. McArdle, IBOS Association Limited

It is extremely invigorating to live at the end of one era and the beginning of the next. For corporate treasurers, the sun is coming up on a more creative world, in which they can throw off the manacles of uniformity and devise a structure that exactly fits their requirements.

Would they still prefer to accept the packaged version thrust upon them by large industrialized banks? For those old enough to remember, the attractions of the new regime are like the first time one saw color television.

Using a regional banking consortium (RBC), the treasurer can construct his own personal network, taking advantage of the arrangements between member banks and, if he so desires, retaining some of his existing bank relationships. When he uses a RBC, he gets a single point of contact to the network, he can select from the widest palette of local services, and he also gets the pricing benefit that reflects his purchasing power in the region, not just in any one bank.

Use of major local banks can also make the "sale" of a change in banking arrangements much easier to local staff; indeed, as members of RBCs are usually leading banks in their domestic market, there may be no change required at all.

Inevitably, in advocating a new approach to the construction of a re-

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Insuring MNC Risk

Cross-border claims and policies are subject to complications from currency exposure and political risk.

Gregory S. Thaler, Deloitte & Touche

U.S. businesses are increasingly exposed to the risks and rewards of globalization. During the mid-1990s, U.S. exports rose 50 percent to over $900 billion and now account for 13 percent of the world's exports. Direct foreign investment by U.S. and foreign companies has also surged.

Multinational companies (MNCs) face greater financial risks than their domestic counterparts. Business risks that are peculiar to MNCs can include remoteness of operating locations, political turmoil, foreign exchange fluctuations, and the need to move goods and assets across borders. When a property loss occurs at a MNC's foreign operation, repairing the damage and restoring the business can be monumental tasks.

Despite these complexities, a MNC can effectively manage its property damage and business interruption exposures through sound crisis management and continuity planning, creative insurance policies

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Treasury Operations

Presenting an (admittedly) partisan, but well reasoned, argument for organizing cash and treasury management through a banking club. The best provide critical mass at the national level, but are fast on their feet across borders.

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Risk Management

Risk managers for multinational groups face special, complicated problems involving currency exposure and sovereign risk. A consultant provides tricks of the trade to deal with these, in terms of coverage and policy language.

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Indicative options market volatilities for major world currencies vs. the dollar and euro.

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More mixed emotions and telling statistics about the UK and the euro; a Russian corporation prepares to float an issue in the capital markets.

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Keys to the Kingdom

This installment considers interest rate options and swaps, and demonstrates a few “construction projects” involving hybrids.

Warren Edwardes, Delphi Risk Management

The first installment in this series (*F&T,* 3/5) identified the four structural elements from which virtually all financial instruments are constructed: *spot contract, forward contract, options contract* and *deposit contract.* It also used practical examples to illustrate the considerable variety within each category of these instruments.

This concluding installment will consider options related to managing interest rate exposures and the uses of swaps. Finally, we will examine the way in which combinations of these instruments, or of varieties of the same instrument, can be used by financial engineers to develop complex derivative instruments.

> **Warrants are essentially standardized options, listed on a stock exchange in the form of capital market products.**

Interest Rate Options

Interest rate guarantees (IRGs): An interest rate guarantee is an option on a forward rate agreement (FRA). After paying an option premium, purchasers have the right, but not the obligation, to fix an interest rate for a specified future period in a specified currency for a specified notional principal amount.

As with FRAs, the interest rate fixing is on the London Interbank Offered Rate for the currency of the underlying obligation or investment (LIBOR) or EURIBOR for euro instruments. There are call IRGs to protect against upward movements in LIBOR and put IRGs to protect against downward movements in LIBOR.

Under FRAs, a buyer wins if LIBOR rises and loses if LIBOR falls. However, with a call IRG, while the buyer is compensated by the seller or writer if LIBOR rises, the buyer is under no obligation if LIBOR falls. For such insurance protection the buyer has paid a premium.

Settlement, as with FRAs, is at the beginning of the interest period. Unlike currency options, there is no decision to exercise, as settlement is automatic.

Interest rate caps and floors: An interest rate cap can be thought of as a strip of call IRGs, and an interest rate floor is a strip of put IRGs. Therefore, a cap is a strip of call options on FRAs.

Automatic settlement takes place at every interest period on the same basis as with FRAs, in almost all cases. Settlement takes place at the end of each interest period with no discounting.

Warrants: Warrants are essentially standardized options listed on a stock exchange in the form of capital market products.

They can be options to buy or sell a particular bond or equity. They are also warrants on commodities such as gold, copper or oil or on particular currencies or equity indices. In the case of warrants on equities, the issuer of the warrants may not be issuer of the underlying equities.

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International
Finance & Treasury
The International Business Information Source™
(ISSN 1070-9215)
Vol. 27, No. 11
March 12, 2001

EDITORIAL OFFICE
WorldTrade Executive, Inc.
P.O. Box 761
Concord, MA 01742-0761/USA
(978) 287-0301 Phone
(978) 287-0302 Fax
www.wtexec.com

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PUBLISHED WEEKLY (EXCEPT THE FIRST WEEK OF SEPTEMBER AND LAST WEEK OF DECEMBER) FOR SUBSCRIBERS ONLY

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SUBSCRIPTION INFORMATION: Annual subscription: US$1295 (add $50 for non–US postage) Single copy: US$26

Argentina *Agonistes*

The perennially troubled economy seems to be shuffling toward a new set of problems, after the briefest of respites.

Scott E. Pardee

***Ricardo López Murphy* has now succeeded *José Luis Machinea* as Economy Minister of Argentina. This move has been especially welcomed in the international investment community, where López Murphy, a University of Chicago economist, has already established a close working relationship with people in many investment firms.**

Despite the value of his contacts, López Murphy's tenure in office will not be measured by how many hands he shakes in New York and London, but by how many jobs he creates in Buenos Aires and Córdoba.

The Argentine economy has slipped back into recession. Auto sales have slumped, industrial production is down, consumer confidence is sour, prices are falling, and at the last reading, unemployment is at 14.7 percent. Altogether, that is not a good start for the second year of the administration of President *Fernando de la Rúa*.

One of López Murphy's first tasks is to renegotiate with the IMF the budgetary targets for this year that were part of the support package worked out late last year. IMF officials have indicated a willingness to give some ground, now that the economy is weakening. The government is still forecasting GDP growth of 2.5 percent for this year, but private forecasters are saying it will be 2 percent at the most.

The validity of these forecasts is *ultra vires* for the people who are running Argentina; it will depend upon how the U.S. and European economies fare.

In order to deal with the budget deficit, López Murphy says he will cut spending by reducing public sector jobs and cut taxes to stimulate investment in jobs in the private sector. Not surprisingly, Argentina's trade unions— among the most militant and obstructionist on this planet—are sharply critical of

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Exchange Strategies

Virtually all signs, from economic basics to monetary policy, point to a stronger euro—and a nose dive for the yen.

Brendan Murphy

The U.S. February employment report and other recent data were not conclusive on the direction of the economy. However, they were adequate to sustain the general belief that the economic downturn could be relatively brief and may already have touched bottom.

That is far from a universal perspective. ***J. P. Morgan-Chase*** economists expect a "broadening of weakness beyond manufacturing in the coming months" into the service sector, as households follow business in cutting back. To be sure, fundamentals are finely balanced, and the inventory overhand in technology could take some months to unwind. But a return to something akin to trend growth is conceivable.

Nevertheless, the employment report reminded observers that it is rarely possible to discern the longer-term cyclical growth trend on a real-time basis—even to the extent of stating whether the economy is heading south or north, or simply running flat.

The jobs report did, however, take the edge off the collective anxiety. It seems at least that the wheels are not coming off. That had the effect of tempering expectations for an immediate Federal Reserve rate cut ahead of the ***Federal Open Market Committee*** (FOMC) meeting on March 20th and 21st, or for an outsized 75 basis point rate cut.

The FOMC seems very likely to cut federal funds another 50 basis points, to 5 percent, later this month, however, and might reasonably be expected to follow that in early May with an additional quarter point.

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Also in This Issue...

Scott Pardee has difficulty understanding why a smart, motivated and modern Argentina just can't get its economic house in order.
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Contributing editor and currency strategist ***Brendan Murphy*** is increasingly convinced it's time to get your bets down—long euro and short yen.
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F&T's weekly *"World Value of the Dollar"* exchange rate supplement.
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Rates, trends and forecasts for major currency pairs.
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***Argentina*, from Page 3**

the new Economy Minister and his policies.

However, the new policies are actually an extension of the approach laid down by the previous star Economy Minister, *Domingo Cavallo*, under former President *Carlos Menem*. In his Convertibility Plan, Cavallo fixed the peso to the dollar and forced the central bank to become a form of currency board.

With monetary policy and foreign exchange policy off the table, that leaves fiscal policy and wage policy as the active policy instruments. Fiscal policy is better, but has not been entirely fixed. Indeed, as long as economic growth lags projections, tax revenues will also fall short of projections. Tightening fiscal policy further may merely postpone economic recovery.

Fiscal policy is better, but has not been entirely fixed. Tightening it further may merely postpone economic recovery.

Thus, the full burden of the current efforts to restore growth is falling squarely on wage policy—workers have to accept lower pay in order for Argentina to compete in international markets.

The consumer price index has been falling in Argentina, but not enough to make Argentine products more competitive, especially against those of Brazil, where the real was floated in 1999. Argentine companies and jobs have been migrating to Brazil ever since.

López Murphy has assured everyone that he is true to the Convertibility Plan, so expect no radical departure from the current policy framework. This means that wages will have to fall further.

Tax cuts may help stimulate investment, but Nobel laureates *Modigliani* and *Miller* long ago showed that companies do best when they focus on real investments, i.e., the value created by capital and labor, rather than tax plays.

Companies that lose money don't pay taxes anyway, so giving them a tax break doesn't help much. Unemployed people don't pay taxes, so lower tax rates don't help them much either.

Those of us who have worked with *argentinos* and invested there over the years are frustrated that somehow they can't get it right. However, we are no more frustrated than their own people on the street who, when asked of their response to these changes in the government, responded, "So, what else is new?" ❑

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European Growth Moderation

Somewhere along the line the ***European Central Bank*** will also ease its 4.75 percent repo rate. Timing will be affected by a couple of considerations: core inflation remains stubbornly above target, and the monetary authority would probably like to see the euro forge its way a bit higher before it lowers the interest rate floor.

However, European growth remains well ahead of the U.S. pace, despite rather clear indications of softening. The Morgan-Chase team sees European growth running at a 1.8 percent pace in the first half of 2001, after 2.5 percent in the second half of 2000 and 3.4 percent in the first half of last year.

Household and corporate spending were also on a downward trend coming into 2001. Consumer spending increased 3.2 percent in the first half of 2000, but downshifted markedly, to 1.0 percent, in the second half. Corporate spending held up a bit better, by comparison, decelerating from a first half pace of 4.8 percent to 3.0 percent in the second half.

Though European household and corporate spending no doubt has weakened further this year, it probably remains at a level from which it could rebound handily on the back of a U.S. recovery, simply by virtue of the invigorating psychological effect on consumers and businesses. Though certain European sectors—notably German capital goods manufacturers—are highly sensitive to export demand, the fact remains that Europe is more self-contained on trade than any other part of the industrialized world.

Though certain European sectors are highly sensitive to export demand, the fact remains that Europe is more self-contained on trade than any other part of the industrialized world.

An additional positive factor is that European households have not experienced anything near the shock felt by U.S. counterparts as a consequence of the brutal 2000-2001 equities correction.

Time for Euro to Advance

A litany of familiar arguments, by now, as to why there is still good upside potential for the euro this year, even if the U.S. economy does not

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Bank of America's World Value of the Dollar as of March 9th

The table below gives the rates of exchange for the U.S. dollar against various currencies as of Friday, March 9th, 2001. The exchange rates are middle rates between the buying and selling rates as quoted between banks, unless otherwise indicated. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are not intended to be used as a basis for particular transactions. *Bank of America* does not undertake to trade in all listed foreign currencies, neither does *Bank of America* assume responsibility for errors.

EUR=$0.93181 SDR=$1.29211 3-month LIBOR 5.05 3-month SIBOR 5.05 6-month LIBOR 4.91 6-month SIBOR 4.94

Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani (c)	4750.00
Albania	Lek	142.00
Algeria	Dinar	73.08
American Samoa	US$	1.00
Andorra	Peseta	178.5622
Andorra	Franc	7.0396
Angola	Kwanza (5)	18.2458
Antigua	E. Car. $	2.70
Argentina	Peso	1.00
Armenia	Dram	552.18
Aruba	Florin	1.79
Australia	Dollar	1.9518
Austria	Schilling	14.7673
Azerbaijan	Manat	4558.00
Bahamas	Dollar	1.00
Bahrain	Dinar	0.377
Bangladesh	Taka	54.125
Barbados	Dollar	2.00
Belarus	Ruble	1210.00
Belgium	Franc	43.292
Belize	Dollar	2.00
Benin	CFA Franc	703.96
Bermuda	Dollar	1.00
Bhutan	Ngultrum	46.5345
Bolivia	Boliviano (f)	6.43
Bolivia	Boliviano (o)	6.07
Bosnia Herz.	Konv. Marka	2.099
Botswana	Pula	5.4245
Bouvet Island	Krone	8.7644
Brazil	Real	2.0515
Brunei	Dollar	1.7578
Bulgaria	Lev	2.0865
Burkina Faso	CFA Franc	703.96
Burundi	Franc	741.7345
Cameroun	CFA Franc	703.96
Canada	Dollar	1.5461
Cape Verde Is.	Escudo	116.758
Cayman Is.	Dollar	0.82
Cent. Af. Rep.	CFA Franc	703.96
Chad	CFA Franc	703.96
Chile	Peso (m)	589.85
Chile	Peso (o)	518.37
China	Renminbi	8.2774
Colombia	Peso (o) (1)	2261.00
CIS	Ruble (m)	28.681
Comoros Rep.	Franc	527.97
Congo Rep.	CFA Franc	703.96
Congo Dem. Rep.	Franc (4)	4.4999
Costa Rica	Colon	322.29
Cote d'Ivoire	CFA Franc	703.96
Croatia	Kuna	8.2295
Cuba	Peso	1.00
Cyprus	Pound *	1.6158
Czech Republic	Koruna	37.05
Denmark	Krone	8.0065
Djibouti	Franc	158.20
Dominica	E. Car. $	2.70
Domi. Rep.	Peso	15.70
Ecuador	Sucre (o) (2)	25000.00
Egypt	Pound	3.879
El Salvador	Colon (d)	8.752
Eq'tl. Guinea	CFA Franc	703.96
Estonia	Kroon	16.7281
Ethiopia	Birr (o)	8.255
European EMU	Euro*	0.9318
Faeroe Is.	Krone	8.0065
Falkland Is.	Pound *	1.4707
Fiji	Dollar	2.2727
Finland	Markka	6.3808
Fr. Pacific Is.	Franc	127.9926
France	Franc	7.0396
French Guinea	Franc	7.0396
Gabon	CFA Franc	703.96
Gambia	Dalasi	15.10
Georgia	Lari	1.97
Germany	Mark	2.099
Ghana	Cedi	7043.00
Gibraltar	Pound *	1.4707
Greece	Drachma (3)	
365.6844		
Greenland	Krone	8.0065
Grenada	E. Car. $	2.70
Guadeloupe	Franc	7.0396
Guam	US$	1.00
Guatemala	Quetzal	7.7t65
Guinea Rep.	Franc	1865.00
Guinea Bissau	Franc	703.96
Guyana	Dollar	180.50
Haiti	Gourde	24.00
Honduras	Lempira (d)	15.24
Hong Kong	Dollar	7.7997
Hungary	Forint	284.56
Iceland	Krona	85.60
India	Rupee (m)	46.5345
Indonesia	Rupiah	10155.00
Iran	Rial (o)	1752.50
Iraq	Dinar (o)	0.3124
Ireland	Punt *	1.1832
Israel	New Shekel	4.125
Italy	Lira	2077.9665
Jamaica	Dollar (o)	45.50
Japan	Yen	119.41
Jordan	Dinar	0.711
Kazakhstan	Tenga	145.335
Kenya	Shilling	77.50
Kiribati	Aus. Dollar	1.9518
Korea, North	Won	2.20
Korea, South	Won	1268.90
Kuwait	Dinar	0.3063
Kyrgyzstan	Som	48.304
Laos	Kip	7600.00
Latvia	Lat	0.6166
Lebanon	Pound	1514.27
Lesotho	Maloti	7.6663
Liberia	Dollar	1.00
Libya	Dinar	0.5357
Liechtenstein	Franc	1.6495
Lithuania	Litas	4.001
Luxembourg	Franc	43.292
Macao	Pataca	8.0571
Madagascar	Franc	6400.00
Malawi	Kwacha	80.10
Malaysia	Ringgit	3.80
Maldive Is.	Rufiyan	11.77
Mali Republic	CFA Franc	703.96
Malta	Lira *	2.2837
Martinique	Franc	7.0396
Mauretania	Ouguiya	253.19
Mauritius	Rupee	28.175
Mexico	New Peso	9.663
Moldova	Lei	12.3833
Monaco	Franc	7.0396
Mongolia	Tugrik (m)	1099.00
Montserrat	E. Car. $	2.70
Morocco	Dirham	10.623
Mozambique	Metical	18210.00
Myanmar	Kyat	6.585
Namibia	Dollar	7.71
Nauru Is.	Aus. Dollar	1.9518
Nepal	Rupee	74.3557
Neth. Antilles	Guilder	1.79
Neth. Antilles	Florin	1.79
Netherlands	Guilder	2.365
New Zealand	Dollar	2.3563
Nicaragua	Gold Cordoba	12.90
Niger Rep.	CFA Franc	703.96
Nigeria	Naira (m)	111.00
Norway	Krone	8.7644
Oman Sultanate	Rial	0.385
Pakistan	Rupee	60.20
Panama	Balboa	1.00
Papua N.G.	Kina	3.2626
Paraguay	Guarani (d)	3758.00
Peru	Nuevo Sol (d)	3.5168
Philippines	Peso	48.05
Pitcairn Island	NZ Dollar	2.3563
Poland	Zloty (o)	3.9775
Portugal	Escudo	215.1533
Puerto Rico	US$	1.00
Qatar	Riyal	3.6411
Rep. Macedonia	Dinar	64.045
Rep. Yemen	Rial (a)	161.458
Ile de la Reunion	Franc	7.0396
Romania	Leu	27176.50
Russia	Ruble	28.681
Rwanda	Franc	359.0281
San Marino	Lira	2077.9665
Sao Tome/Principe	Dobra	2390.98
Saudi Arabia	Riyal	3.7505
Senegal	CFA Franc	703.96
Seychelles	Rupee	6.411
Sierra Leone	Leone	1899.095
Singapore	Dollar	1.7578
Slovakia	Koruna	46.753
Slovenia	Tolar	230.665
Solomon Is.	Solomon $	5.1203
Somali Rep.	Shilling (d)	2620.00
South Africa	Rand (c)	7.6663
Spain	Peseta	178.5622
Sri Lanka	Rupee	84.82
St. Christopher	E. Car. $	2.70
St. Helena	Pound *	1.4707
St. Lucia	E. Car. $	2.70
St. Pierre/Miq'lon	Franc	7.0396
St. Vincent	E. Car. $	2.70
State Cambodia	Riel	3835.00
Sudan	Pound (c)	2560.00
Sudan	Dinar	256.00
Suriname	Guilder	981.00
Swaziland	Lilangeni	7.6663
Sweden	Krona	9.7039
Switzerland	Franc	1.6495
Syria	Pound	52.50
Taiwan	Dollar (o)	32.406
Tanzania	Shilling	827.00
Thailand	Baht	43.56
Togo Rep.	CFA Franc	703.96
Tonga Is.	Pa'anga	2.045
Trinidad/Tobago	Dollar	6.24
Tunisia	Dinar	1.3757
Turkey	Lira (8)	920000.00
Turks & Caicos	US$	1.00
Tuvalu	Aus. Dollar	1.9518
Uganda	Shilling	1727.50
Ukraine	Hryvnia	5.4218
United Kingdom	Pound *	1.4707
Uruguay	Peso (m)	11.3925
U.A.E.	Dirhan	3.6729
Uzbekistan	Sum	775.00
Vanuatu	Vatu	141.80
Vatican City	Lira	2077.9665
Venezuela	Bolivar (d)	705.255
Vietnam	Dong (o)	14580.00
Virgin Island BR	US$	1.00
Virgin Island US	US$	1.00
West. Samoa	Tala	3.4602
Yugoslavia	New Dinar (7)	63.3652
Zambia	Kwacha	3405.00
Zimbabwe	Dollar (6)	55.04

(n/a) Not Available. * U.S. Dollar per national currency unit. (a) Parallel. (c) Commercial. (d) Free market. (f) Financial. (m) Market. (o) Official. (1) Colombian peso allowed to float freely on 9/27/99. (2) Ecuador introduces dollarization, 25,000 sucres to the dollar. (3) Greek drachma incorporates 3.5 percent revaluation on 1/15/00. (4) Congo Democratic Republic, formerly Zaire Democratic Republic, Congolese franc is new currency. (5) Angolan kwanza revalued on 12/13/99. (6) Zimbabwe dollar delvalued by approximately 24 percent on 2/8/00. (7) Yugoslavian new dinar is now "managed float," linked to euro/mark. (8) Turkish lira allowed to float freely on 2/22/01.

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technically fall into a recession. We believe the U.S. economy will escape that fate (be it ever so narrowly). However, the impact of the 3,000-point decline in the ***Nasdaq*** over the past year, and lesser though still considerable losses in other indexes, will continue to be felt as households weigh their losses and corporations attempt to shore up their profitability.

This process could unwind fairly quickly, relative to past experience. But the net effect over the next quarter or two will be to handicap U.S. assets relative to European stocks (and bonds, too, given the historically narrow 35 basis point yield advantage of U.S. Treasuries).

The euro seems constitutionally unable to translate such fundamental advantages into significant or durable exchange rate gains.

Having said all this, the euro seems constitutionally unable to translate such fundamental advantages into significant or durable exchange rate gains. Last week, it was locked into an extremely tight $0.9275-$0.9375 range, closing at $0.9310, just above support in the region between $0.9277 and $0.9313, according to technical analyst *Joseph Klettner* at ***Commerzbank***.

Klettner told ***Market News International*** (MNI) that he expects support to hold. However, he did not neglect to advise that accounts long of the euro should consider setting stops under $0.9260. Upside resistance is not encountered until the $0.9446-$0.9469 area, Klettner adds; a break through that region would have bullish implications. None too soon, we would add.

Last-Resort Yen Depreciation

Japanese authorities are in a bind, and the only way out is for them to accept a significantly weaker yen.

It is clear by now that the economy is faltering badly, with the main engine of capital investment sputtering badly, the Bank of Japan with a mere 15 basis points left to ease before the zero-interest-rate policy is restored, and the fiscal instrument strained beyond capacity.

Deflation appears to be such that one of the top priorities of the Japanese central bank, ironically, must be to encourage, rather than fight, inflation.

Deflation appears to be battening on the economy with renewed strength, such that one of the top priorities of the Japanese central bank, ironically, must be to encourage, rather than fight, inflation. One need not be a monetary economist to figure out that substantial yen depreciation is in order.

The market has taken dollar-yen to the ¥120 level, but is seemingly unwilling to venture beyond ¥120.50, perhaps because the market is long of dollars against yen and wary of a retracement on some political development or a final flurry of repatriation before the March 31st fiscal year-end in Japan.

Technically, there is support for the dollar

Actual and Forecast FX Ranges, *F&T* Outlook for Major Currency Pairs
(Exchange Rates from Thomson Financial/IFR, Boston)

Currency Pair	*Prior Range*	*Forecast Range*	*Last Week*	*Last Seen*	*Change (%)*	*Two-Week Outlook*
USD/Euro	0.9280–0.9375	0.9225–0.9475	0.9325	0.9310	–0.16%	Neutral
DEM/USD	2.0862–2.1076	2.0642–2.1201	2.0974	2.1008	+0.16%	Neutral
JPY/USD	118.20–120.40	117.75–121.25	119.10	119.65	–0.46%	Positive
JPY/Euro	109.45–112.30	108.75–113.25	111.00	111.40	–0.36%	Positive
JPY/DEM	55.96–57.42	55.60–57.90	56.75	56.96	–0.36%	Positive
USD/GBP	1.4570–1.4750	1.4550–1.4850	1.4680	1.4675	+0.03%	Neutral
GBP/Euro	0.6305–0.6385	0.6300–0.6400	0.6345	0.6340	+0.08%	Neutral
DEM/GBP	3.0632–3.1020	3.0560–3.1045	3.0825	3.0849	–0.08%	Neutral
CHF/USD	1.6425–1.6605	1.6400–1.6650	1.6505	1.6560	–0.33%	Neutral
CHF/Euro	1.5330–1.5445	1.5300–1.5450	1.5385	1.5420	–0.23%	Neutral
SEK/Euro	9.0070–9.1000	8.9750–9.1250	9.0405	9.0850	–0.49%	Neutral
CAD/USD	1.5365 –1.5520	1.5325–1.5525	1.5460	1.5470	–0.06%	Neutral
USD/AUD	0.5060–0.5295	0.5025–0.5275	0.5285	0.5085	+3.78%	Neutral
MXN/USD	9.5920–9.6850	9.5850–9.7050	9.6550	9.6650	–0.10%	Cautious
BRL/USD	2.0140–2.0660	2.0250–2.0850	2.0250	2.0520	–1.33%	Cautious

Foreign exchange pairs given per U.S. convention. Percent change refers to numerator in respective currency pair; positive change means that the denominator, or base currency, has gained. Outlook refers to base currencies, with the exception of the Canadian dollar, Mexican peso and Brazilian Real; in those cases it refers to the two-week outlook for the CAD, MXN or BRL against the USD.

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around ¥118.97-¥119.33, MNI reports; below that there is another support level in the region of ¥118.08-¥118.25.

On the upside, resistance is identified at ¥121.10. But we would not be surprised to see a run to ¥125 once the resistance at ¥120.50 (probably an options-related bank defense line) collapses, perhaps later this month.

Japanese political paralysis supports this scenario. Prime Minister *Yoshiro Mori* has one foot out the door, having prospectively tendered his resignation to Liberal Democratic Party leaders at the end of last week. In typical fashion, the transition will be stretched out into April, providing a grace period for the LDP to pull itself together before the run-up to July upper house elections.

A worse scenario for action on the economy could hardly be imagined, as this process is very likely to extend the indecision and paralysis, leaving the economic burden squarely upon the yen.

This was reflected last week in conflicting statements on the yen from seemingly every corner of Japanese officialdom. Finance Minister *Kiichi Miyazawa* suggested Japan would not mind seeing the yen "naturally" weaken, but ***Bank of Japan*** (BoJ) Governor *Masaru Hayami* countered later with the statement that a strong yen was in Japan's interest.

Vice Finance Minister *Haruhiko Kuroda* struck a middle ground during a U.S. visit, resorting to the standard fallback of monetary officials that exchange rates should reflect fundamentals—though the implication for the yen could not be mistaken.

Laissez-Faire Yen Policy

Kuroda did say that authorities should not deliberately weaken or strengthen the yen. In practice, benign neglect has been determined to be a relatively effective strategy when currency depreciation is sought in the interest of stimulating a feeble economy.

Look for signals from the Bush administration that it will not resist or object to such a yen adjustment; though its own dollar policy is far from clear. The *laissez-faire* attitude it has expressed and its *pro forma* endorsement of the legacy strong dollar policy suggest that it wouldn't mind seeing dollar-yen rally even as euro-dollar pushed ahead.

Much of the market seems to have adopted this scenario; for instance, ***Brown Brothers Harriman*** analysts raised their forecast of the *average* 2001 dollar-yen rate to ¥140 from ¥120 previously. That implies a substantially higher peak than ¥140, which, to us, seems a bit aggressive.

We do not have trouble with forecasts of a ¥140 top to the envisioned dollar surge, though we think the market will be uneasy at such levels barring a more complete collapse of Japanese economic activity. Such a development would probably be accompanied by deep financial sector distress; as in previous such episodes, repatriation for balance-sheet repair would support the yen.

However things unfold in dollar-yen, we believe it is only a matter of time—and probably not much time—before the market is trading on ¥125 or higher; therefore, risk is strongly skewed.

At this point, readers who have followed our recommendations are long of the dollar against the yen and should be well positioned to reap the benefits of such a move. Complacency is not recommended, however; maintain stops under ¥118 in the event of a temporary consolidation.

Benign neglect has been determined to be a relatively effective strategy when currency depreciation is sought in the interest of stimulating a feeble economy.

Battered Aussie a Buy

Just a word on the Australian dollar: we would consider it a screaming buy at current levels near $0.5085, let alone at the new all-time low of $0.5060 which it set last week.

Though gross domestic product slipped into negative territory in the last quarter of 2000 with a –2.2 percent rate of growth, seasonally adjusted and annualized compared with the previous quarter, activity was massively skewed by July's introduction of the 10 percent Goods and Services Tax (GST). The acceleration of purchases ahead of GST introduction sapped growth potential from the second half, global deceleration accounted for the rest.

Morgan-Chase still sees 2 percent growth this year and 3.5 percent in 2002, lending Aussie upside. In the near term it will struggle to regain $0.55, but could push through it in the second half. ❑

We believe it is only a matter of time—and probably not much time—before the market is trading on ¥125 or higher; therefore, risk is strongly skewed.

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*Foreign exchange analysis and recommendations by Brendan Murphy, **Curragh Publishing**, New York. **Market News International**, New York, and **Thomson Financial-IFR**, Boston, have provided information and data for this report.*

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***Seamless*, from Page 1**

gional banking solution, one must take due cognizance of the current dominant force in the market. In making a positive case for the age of the RBC, one must draw a comparison with and highlight the obsolescence of the intermediary role and the rigidity necessarily imposed by an industrial system. No apology is offered for this approach.

In all their pomp, the money market giants that are the global banks fail to see their captive clientele organizing, investing and planning to replace them. The received wisdom of the 20th century, that a global bank overlay structure was the answer to every "maiden's prayer," has given way to that of the 21st century, which demands direct access, flexibility and choice.

The main role (of global banks) is that of intermediary, collating, collecting and consolidating. However, local banks, many of which are members of RBCs, mostly carry out the underlying transactions on which they feed.

For all the investment and hype, the global banks just do not get it. Their main role is that of intermediary, collating, collecting and consolidating. However, local banks, many of which are members of RBCs, mostly carry out the underlying transactions on which the global banks feed.

The theme of the argument below is that there will be an increasingly successful and prosperous future for the consortia. This is based on the changing environment that renders the role of intermediary vacuous, requires flexibility of offering, and enables technology to be applied in a highly efficient, cost-effective way.

"Bigger" Does Not Mean "Better"

What does the future hold?

The only thing we can be sure of is that there will be change and that this change will come at an increasingly fast pace. However, it is not really about the banks, although one sees many new initiatives on this front. We have to look at what customers are doing and try to foresee what they want to do.

These (global) banks have invested hundreds of millions of dollars in creating automated banking services for very large companies, while operating mostly away from their home bases.

The market in products has become extremely wide. The most advanced companies are embracing the e-treasury world, participating in e-marketplaces, developing electronic invoice presentment, establishing shared service centers, automating account reconciliation, and a host of other things.

At the same time, there are companies that are still evaluating the possibilities, waiting to see how things will evolve, and companies for which balance reporting is like manna from Heaven.

Although it is a generalization, the envelope is being pushed more in North America than in Europe. But, regardless of venue, who is adding the value? Is it the banks or the software providers?

Another factor that has to be considered is changes in technology and their impact on a wide range of companies.

Technology is becoming cheaper and easier to implement and use. Many companies are recognizing inefficiencies in their administrative organizations, duplicate accounts payable areas, elaborate processes for buying from suppliers, manual effort involved in the accounting for receivables, and so on. These are not necessarily large companies, which might warrant the establishment of a specialized financial vehicle or a shared service center.

The need for "pipeline," or one point of entry products, is the result of this widespread recognition. Hence, payments will become more centralized, duplications will be pruned aggressively and many more activities will be automated.

Banks' Reaction

In recent years, global banks have introduced some very attractive products and services. These products set the standards to which we all aspire. However, the investment required has been immense, in terms of people, systems, customer service, marketing and so on.

To what end?

Stripped down to the essentials, these banks have invested hundreds of millions of dollars in creating automated banking services for very large companies, while operating mostly away from their home bases. This has several consequences:

- there is a problem in differentiating services;
- large companies generally pay minimum fees and are very demanding;
- any processes that require human intervention are devastatingly expensive for banks operating outside their home bases;
- the "overlay" is now stale, seen as an expensive intermediary step and prone to the introduction of float;
- the investment is so large that reaction to a changing environment may require write-offs and further investment that proves politically impossible;
- the return on investment may be inadequate compared with the other uses to which large banks can put such capital; and
- ultimately, the services are delivered by local banks.

How Does This Affect Regional Consortia?

Fundamentally, RBCs are made up of banks that operate in their home markets. In these markets they are mainly retail-oriented, but the vol-

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ume of business and commitment inherent in this establishes a firm base for the wholesale corporate business built on top.

RBC member banks have hundreds of branches spread nationwide. They are members of all the relevant clearing systems. They are banks set up and designed to operate in the particular environments. Moreover, they have the economies of scale needed to deliver the various payment systems and services in the market at competitive prices.

There is no way that a bank established in a single office or branch in a country can offer a service comparable to a local bank. None of this is controversial. If a company has facilities in only one country, the natural, best response is to have an account in a domestic bank. The main question to be answered is how such a strategy can be successful across several countries or a region.

The challenge facing the RBCs is to combine in such a way that the linkage between different banks and environments is sufficiently seamless to overcome the inevitable uniformity of a single bank solution. As separate institutions, members of a RBC are better, one by one, from Norway to Portugal and from Finland to Ireland.

In the ***IBOS Association***, the multinational solution is delivered through the imposition of a rigorous set of *Guaranteed Service Levels* (GSLs), which cover the interchanges between banks. For example, some of the areas covered will be account opening procedures and timetables, co-ordination of RFPs, turnaround times on payments, provision of credit.

Aside from these fundamental areas, a system of working groups has evolved, which lays down standards for *SWIFT* messages such as MT 100, MT 101, MT 920, MT 940, MT941, MT 942. These are structured to ensure that they are identified as IBOS traffic in the receiving bank and treated accordingly.

This results in a firm foundation, providing a basis for progress on to a higher level of service provision.

Reference was made above to the trend for centralization. This is happening not only in large companies covered by global banks, but also in the multitude of large international companies that operate in the single market of the European Union. These companies are aware of possibilities that exist for cash and treasury management today, but are confused about the identity(ies) and location(s) of supplier(s).

While global banks have natural constituencies with large U.S., Dutch or German companies, smaller companies within these constituencies, together with French, Irish, Spanish, Italian, Belgian and Portuguese companies will look initially to their main domestic banks (and their partnerships) for the provision of solutions. Indeed, other large companies will (or have already) realize(d) that they have the capability and resources (people and technology) to go straight to the markets in which they require services and, therefore, have no need for an intermediary that adds cost and complexity.

However, without the necessary product offerings, a consortium will still not be the answer. And therein lies the future.

The products required are well known, because the global banks have developed them, market-tested them, and built them at great expense. The RBCs can do the same.

The leading ones have underway development programs of products designed for centralized delivery by any of their member banks. Remember, they already have links to all the clearings, access to all local ACH systems, access to large commercial payment systems, (RIBA, LCR, etc.), membership of direct debit systems, all collection systems and anything else necessary. These are all delivered in the home markets electronically.

Hence, we begin to see the creation of liquidity products, centralizing positions on an end of day, same day basis across the member banks of consortia.

Integration technology is now so relatively cheap that some RBCs are in the process of developing centrally delivered local payment systems (non-resident access to resident ACH systems), centrally delivered local collection systems (covering direct debits and other commercial payments methods), the capability of providing a single regional matching and account reconciliation service, and the tools to manage this.

The banking partnerships know what is required and have added their own refinements to these products, to offset some of the weaknesses noticed. The prices of these services are known. Some have adopted a methodology of central development and capture/translation/delivery through an ASP structure. Development costs are relatively low, are shared by the members and deliverable through all banks in the same time frame.

RBCs need to combine in such a way that the linkage between different banks and environments is sufficiently seamless to overcome the inevitable uniformity of a single bank solution.

The banking partnerships know what is required and have added their own refinements to these (centralized cash and treasury management) products, to offset some of the weaknesses noticed.

Some Have Seen the Light

The question could well be asked if the RBC is a reality or a chimera. To the companies described below, it is a living, breathing central part of their daily activities.

A North American clothing company expanded

See *Seamless*, Page 15

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Keys, from Page 2

Swaps

"I've seen things in the market where I scratch my head and can't imagine why people did it. For example, when P&G lost all that money, I couldn't fathom what anyone at that company was thinking when they looked at that formula of the swap and said, 'Yes, that's exactly what I want to put on.'"—Anonymous author, "Confessions of a Structured Note Salesman," Derivatives Strategy, November 11th, 1995

Over time the term "swap" has come to mean very different things. There are foreign exchange swaps. As mentioned in the first installment, these swaps are also called forwards in the interbank market. The term swap is now more commonly used for interest rate and currency swaps.

Interest rate swap: An interest rate swap is, in essence, a series of FRAs priced at a flat rate across all the legs of the constituent FRAs.

The (interest rate) swap typically takes the form of one party paying a LIBOR-linked amount and receiving a fixed rate applied to a notional principal amount.

These swaps allow a borrower to covert its medium- to long-term floating rate liabilities to fixed rate liabilities and vice-versa.

Such swaps allow savings banks to provide fixed rate mortgages while raising funds in the floating rate note market, or through refinancing short-term money-market borrowings.

Interest rate swaps are more precisely known as *single currency interest rate swaps.* They can be floating to floating, in the form of three-month to six-month LIBOR, or floating to fixed rate.

The swap typically takes the form of one party paying a LIBOR-linked amount and receiving a fixed rate amount applied to a notional principal amount for each interest period of the swap which would have several interest periods of three or six months amounting to several years. There will be net settlement of the interest-linked amounts.

As with caps and floors, settlement takes place at the end of each interest period with no discounting.

Legally these are contracts for differences, and the amounts paid are not characterized as interest. In general, interest rate swaps do not have to have net settlement. An "annual vs. 3s" swap would have one party paying a fixed rate annually in arrears and the other party paying three-month LIBOR. A "semi vs. 6s" swap would have net settlement as the swap net settles amounts based on a fixed rate paid semiannually and six-month LIBOR.

Currency swap: Currency swaps were originally simply a series of forward exchange outright contracts priced at a flat rate, and were distinct from forward exchange swaps, which "time-shifted" currency exposure.

Currency swaps were tailored to meet customer demands and in the days of exchange controls were done between two multinational corporations on behalf of their subsidiaries in each others' countries. ***BP plc***, for example, could obtain dollars for its U.S. operations from ***Ford***, and Ford's British operation could obtain sterling from BP's head office in the UK.

Currency swaps now take the form of *cross currency interest rate swaps.* These are generalized single currency interest rate swaps, with the liabilities denominated in different currencies. They can be floating in one currency ex-

Foreign Exchange Market Options Data

Provided by *Bank of America*

	3/ 9/01	Year Ago	% Chg. $ Value	Implied Volatility for At–the–Money Options: 1 Week	1 Month	2 Month	3 Month	6 Month	1 Year
EUR/USD	0.9347	0.9616	2.80%	11.5/12.5	12.1/12.4	12.1/12.4	12.4/12.7	12.5/12.8	12.6/12.9
USD/JPY	119.16	106.43	11.96%	12.0/13.0	12.3/12.6	12.3/12.6	12.4/12.7	12.5/12.9	12.6/12.9
GBP/USD	1.4667	1.5786	7.09%	8.5/ 9.5	9.1/ 9.5	9.2/ 9.5	9.4/ 9.7	9.5/ 9.8	9.6/ 9.9
USD/CAD	1.5466	1.4554	6.27%	6.3/ 7.3	6.3/ 6.7	6.1/ 6.4	6.0/ 6.3	5.9/ 6.2	5.8/ 6.1
AUD/USD	0.5123	0.6145	16.63%	13.6/14.6	13.8/14.2	13.5/13.8	13.4/13.7	13.0/13.3	12.7/13.1
USD/CHF	1.6501	1.6702	8.72%	10.1/11.1	11.1/11.4	11.3/11.6	11.6/11.9	11.9/12.2	12.1/12.4
USD/MXN	9.6850	9.2850	4.31%		7.4/ 8.6	8.6/ 9.4	9.6/10.4	10.6/11.4	12.6/13.4
USD/BRL	2.0570	1.7420	18.08%		8.4/ 9.7	8.7/ 9.8	9.0/10.0	9.5/10.5	11.0/12.0
USD/HKD	7.7990	7.7838	0.20%		0.0/ 0.5	0.1/ 0.6	0.2/ 0.6	0.5/ 0.8	0.9/ 1.5
EUR/JPY	111.37	102.29	–8.87%	17.4/18.4	17.0/17.4	16.5/16.9	16.2/16.5	15.9/16.2	15.6/16.2
EUR/CHF	1.5425	1.6066	3.99%	3.5/ 4.5	3.7/ 4.0	3.8/ 4.1	3.9/ 4.2	4.0/ 4.2	3.9/ 4.3
EUR/GBP	0.6370	0.6086	–4.67%	8.5/ 9.5	9.1/ 9.4	9.2/ 9.5	9.4/ 9.7	9.5/ 9.8	9.6/ 9.9

Implied Volatilities

As USD/JPY consolidated under 120.00, we see JPY vols softening into the weekend. OTM JPY calls seem very cheap, given the market still feels as if it has short JPY exposures.

USD/BRL vols have popped higher with spot BRL. However, implied vols continued to look cheap compared with moves in spot we have been seeing.

EUR/USD vols remain stagnant, though there does seem to be latent demand to buy OTM EUR puts and sell OTM EUR calls.

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changed for fixed in another currency or floating to fixed or even fixed to fixed.

A zero coupon fixed to zero coupon fixed cross currency swap is essentially another form of an outright forward contract. The forward swap rates used by banks to generate outright forwards are based on interest rate differential between the two currencies.

However, in a forward contract, there is no explicit payment of interest. In this particular form of cross currency interest rate swap the interest related amounts are rolled up and settled simultaneously on maturity.

Swaptions: A swaption is an option on a swap, and is critically different from a cap or a floor. A cap is a series of options on short term (typically three-month) interest rates, but a swaption is but one option on a medium term interest rate (say, five years).

Some of the component options in a cap may prove to be in-the-money and valuable, while others turn out to be out-of-the-money and valueless. A swaption is exercised once, if at all, during the option period.

There are two forms of swaption, originally distinguished by the similar terms *swaption* and *swoption*, though the latter name is uncommon now. A swaption can be an option within a certain option period to enter into a swap of a certain period, or it can give the right, within the option period, to enter into a swap maturing on an agreed date. The notional principal amount is specified under the contract.

Hybrids: Using Building Blocks

"Due to my inexperience, I placed a great deal of reliance on the advice of market professionals—I wish I had more training in complex government securities."—Robert Citron, former treasurer, Orange County, California

Forward Exchange Contracts: The most basic hybrid financial instrument is none other than the forward exchange outright contract. Forward exchange contracts to buy one currency vs. another at some specified date in the future are not traded in the inter-bank market, but are a hybrid product built from the inter-bank financial instrument building blocks.

A forward outright is the combination of a spot contract and forward exchange swap.

Break Forwards: The "break forward" is another hybrid financial instrument. It represents a combination of a forward contract to buy currency "A" and sell currency "B" at a fixed forward rate and an attached option to do the opposite, sell currency "A" and buy currency "B" at a different rate, the "break rate."

In addition, under the break forward, there is no premium paid up front. The insurance cost is built into the prices of the two explicit contracts and these are settled at maturity. The construction of the break forward therefore requires another contract, a loan contract to defer the payment of the implicit option premium.

The three products together, through the put-call parity principle of options, actually result in being equivalent to another option to buy currency "A" and sell currency "B."

Asset Swaps: An asset swap is a combination of an asset, plus an interest rate or currency swap used to change the nature of the asset. These are sold as packages to banks seeking high-yielding floating rate assets.

Bonds tend to be more volatile than loans, which are infrequently revalued. When a bond, typically fixed rate, falls in price because of adverse news of a company, asset swappers buy them at a discount. They attach a fixed to floating rate interest rate swap to them, so that the package becomes a look-alike loan but with a higher than normal margin over LIBOR.

Conclusion

I have only listed a few hybrid contracts but there are an infinite number of them. The message here is the need to understand that the most complex instruments are composed of the four building blocks. They can be combined with themselves or with each other in various ways.

With that concept firmly grasped, you not only understand all of the financial products that have been invented but also, more important, most—dare I say, all—of the financial products likely to be invented. ❑

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*Warren Edwardes is chief executive of **Delphi Risk Management Limited**, a London-based financial products innovation and risk management consulting firm. This article is based on a chapter in the book* Key Financial Instruments: Understanding and Innovating in the World of Derivatives, *published by "Financial Times"/Prentice Hall, ©2000 Pearson Education and Delphi Risk Management and reprinted with permission. Mr. Edwardes can be contacted by readers seeking further information about derivatives and risk management, either via the company's Website at* www.dc3.co.uk *or by e-mail at* we@dc3.co.uk *directly.*

A cap is a series of options on short term (typically three-month) interest rates, but a swaption is but one option on a medium term interest rate (say, five years).

An asset swap is a combination of an asset, plus an interest rate or currency swap used to change the nature of the asset. These are sold as packages to banks seeking high-yielding floating rate assets.

(Somewhat) Open for Business

Foreign banks are actively soliciting credit relationships in Mexico; that is not the case with their domestic counterparts.

Erika Morphy

As foreign banks gain increasing market share in Mexico, they are indeed lending more and extending credit more. Mexican banks, however, have yet to follow suit.

A regional initiative modeled on Mexico's earliest attempts to modernize its banking system could well propel Mexico even further along the path of banking reform.

Late last year when *Nacional Financiera* (NAFIN), Mexico's state-owned development bank, granted Hartford-based *First International Bank* a "pass-through" lending authority to offer working capital loans to Mexican companies, foreign and local executives believed the country reached a significant milestone. Business credit, which had always been scarce in the country, virtually vanished overnight with the peso crisis in 1994. Last year's unprecedented outreach to a foreign bank was a signal that it was beginning to return.

"The culture of non-lending in Mexico definitely began to ebb," says *Charles Baker*, senior vice president of the International Buyer Finance Unit at First International.

"There have been a number of reforms in the banking sector over the last 12 months," Baker says. "A lot of the weaker banks have either gone under or have been taken over by large international banks." As a result, corporate lending is on the rise, he says.

But Baker has it only partly right. As foreign banks gain increasing market share in Mexico, they are indeed lending more and extending credit more. Mexican banks, however, have yet to follow suit.

Logically, this should not be the case. Simply put, Mexico's economy is hot, registering record levels of growth and unemployment. More to the point, last spring the country implemented some significant reforms to its banking regime, making it easier for companies to post assets to secure loans, and for banks to recover collateral quickly when a borrower defaults.

Although they represent an improvement, the new rules did not go far enough.

"There are still a lot of aspects of the system that can be very frustrating," says *Barry Machlin*, a partner and project finance attorney with ***Mayer, Brown & Platt*** in Chicago.

For example, registering title for a project that spans several states (such as an oil pipeline) is time consuming and costly, he says. "There might be five or ten different state and local registries involved and every one will assess some very substantial fees, which are usually a fraction of the loan amount."

The result is that Mexico, a country that is among the fastest growing in the world, is credit starved. The ***World Bank*** estimates that the tight credit market costs Mexico some 15 percent in output of goods and services every year. The ***World Economic Forum*** downgraded Mexican competitiveness between 1999 and 2000, from 34th position to 42nd, primarily because middle market companies are unable to find competitive financing.

However, there is increasing evidence that the situation could well be changing.

First, of course, was the election of business-friendly President *Vicente Fox*. Emboldened by his arrival, officials in Congress and the executive branch are preparing to make further regulatory changes that are expected to increase the availability of asset-based financing, and business credit in general.

At the same time, a regional initiative modeled on Mexico's earliest attempts to modernize its banking system could well propel Mexico even further along the path of banking reform.

Foreign Presence

This is not to say that business credit is non existent in Mexico. *Abraham Hernandez*, chief financial officer of the Mexican auto parts manufacturer ***Arbomex***, has steady banking relationships with two of Mexico's leading banks as well as a financing arrangement with First International.

"The situation in Mexico is much improved since 1994," he says. Having noted that improvement, it is clear a large portion of business credit is still being provided by foreign banks active in Mexico.

Through the mid-1990s only one foreign bank, ***Citibank***, was allowed to operate in Mexico. Following the 1994 crash of the peso, however, Mexico wisely removed all restrictions on foreign investment. Today, foreign investors control over 22 percent of the deposits in Mexico's banking system and 40 percent of bank assets. ***Banco Santander Central Hispano***, ***Bilbao Vizcaya***, ***Hong Kong & Shanghai Banking Corporation***, ***J. P. Morgan-Chase & Co.***, ***Citibank***, ***Bank of Nova Scotia*** and ***Bank of Montreal*** now dominate a large share of the local banking system by virtue of both acquisition and local expansion.

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These foreign entrants have had a real impact on business lending in Mexico, according to a report by *B. Gerard Dages*, *Linda Goldberg* and *Daniel Kinney*, officials at the ***Federal Reserve Bank of New York***. A review of bank lending patterns from 1994 through mid-1999 shows that foreign banks in Mexico exhibited stronger and less volatile loan growth than domestic banks. During the early 1990s, foreign lending accounted for less than 1 percent of total loans. By 1998, foreign bank participation in the local loan market had grown 18 percent.

There is a broad range of reasons why domestic banks are not more generous with their funds. Some of the key causes—hazy title procedures and courts that offer lenders little protection against loan defaults—were addressed only partly in legislation last year, with little practical affect. Now Mexican legislators are gearing up to finish the job.

New Legislation

Basically the country's banking system has been based on rules that dated back to the 1920s and early 1930s.

"They only provided a limited number of mechanisms for which a secured transaction could be accomplished," says *Michell Nader*, partner in charge of banking and finance at ***Jauregui, Navarrete, Nader y Rojas, S.C.*** in Mexico City.

For example, a company that wanted to use equipment as collateral for a loan would actually have to physically give it to a banker or third party to hold. For their part, lenders tended to steer clear of financing against collateral, anyway. The existing statutes made establishing clear title against most types of capital equipment, or even property in some cases, a dubious prospect at best.

New rules were drafted early last year by Mexico's ***Ministry of Commerce and Industry*** and ***Ministry of the Treasury***. They were aided in this process by the ***National Law Center for Inter-American Trade***, a think tank affiliated with the ***University of Arizona***. The new provisions were intended to eliminate many of these problems.

"This legislation was long overdue for Mexico," *Boris Kozolchyk*, director of the Center, says. "But it didn't go far enough." Last minute amendments, he says, negated much of the intent of the original draft.

This is what the legislation did accomplish: it allowed companies to use many more assets as collateral, including intellectual property, accounts receivable, stock shares, investment securities and other general intangibles. It also clearly defined procedures on how this collateral is foreclosed, giving lenders a much clearer idea of their risks in these sorts of transactions.

Unfortunately, what it didn't address is nearly as important: it supplemented, but didn't replace the old law. Instead, borrowers were allowed to choose between the two versions.

"By leaving the existing law untouched, banks were still exposed to a plethora of secret liens that might exist against the collateral," Kozolchyk says. The old law also didn't give lenders the right to pursue borrowers for repayment of amounts in excess of the value of the collateral pledged.

HIstorically, a company that wanted to use equipment as collateral for a loan would actually have to physically give it to a banker or third party to hold.

Getting the legislation passed was basically a hollow victory, Kozolchyk says. "Officials finally realized the importance of establishing a straightforward system of secured lending, but it was executed in a defective manner."

The good news is that there is a great likelihood that new legislation will be passed this year, correcting some of the defects of last year's law. The political climate is different enough, observers say, for this to happen. Kozolchyk, in fact, reports that officials in the ministries, as well as certain members of Congress are working on a new draft to address the existing limitations of the old law.

"There is a general understanding that changes need to be made," he says.

Even more promising, he says, is a regional movement promoted by the ***Organization of American States***, to adopt Mexico's original package of regulations as a model for Latin America. "A debate will take place this fall in Guatemala" about that proposal, says Kozolchyk.

Eventually the goal is to create a regional secured transactions law, or a hemisphere-wide credit bureau of sorts, he says. "Lending and filing of security interests will be harmonized through a single financial statement that can be accessed throughout the region. So if a banker in the United States wishes to lend to someone in Brazil or Chile, he can look up the recordings that exist against that borrower. And he can file a financial statement that will be recorded in the country where the debtor and the assets are located." The result will be lower interest rates in the region and better access to credit.

"Officials finally realized the importance of establishing a straightforward system of secured lending, but it was executed in a defective manner."

Getting all the countries on board will not be easy, he says. Mexico's half-hearted efforts at reform bear witness to that. But, in a way, the Mexican experience can serve as a warning to other countries, as Mexican companies continue to receive credit in insufficient amounts. ❑

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***Risk*, from Page 1**

tailored to international exposure, and international claims management strategies.

The valuation of property damage, lost earnings, and inventory losses can often become a complex feature of any insurance claim. When operations span international borders, valuation is compounded by foreign exchange fluctuations. An awareness of currency exposures can help the policyholder anticipate claims issues likely to arise, as well as the record-keeping and accounting techniques that will maximize recovery.

Property Damage: Assume that a U.S. manufacturer suffers a fire at its plant in Mexico, and the necessary replacement equipment must be imported from the States. If its policy has values for each piece of equipment expressed in Mexican pesos and the peso has declined since the policy values were calculated, the insured may recover far less than it actually cost to replace the damaged property.

Businesses should provide for inclusion of policy language that specifically provides for coverage against exchange rate movements after a loss.

U.S. businesses with substantial assets in countries with devalued currencies can insulate themselves by reporting values in U.S. dollars and by having a loss valuation clause that provides for replacement cost paid in U.S. dollars.

Business Interruption: Foreign exchange factors can worsen business interruption losses, by magnifying the detrimental impact of delays in production and sales. Even if the insured is ultimately able to make up lost production, it could still suffer lost revenue arising from market price changes.

A policyholder can attempt to recover this exposure through the business interruption claim. If the timing of sales was impacted by the loss event, the claim can be calculated based on the theoretical timing of sales and the actual exchange rates at that time. Claims of this nature can be controversial because they are based on projections.

Insured businesses should provide for inclusion of policy language that specifically provides for coverage against exchange rate movements after a loss.

Political Risk Exposures: No analysis of international business insurance exposures is complete without a discussion of the substantial political risks in many parts of the world.

Operations in developing areas are more vulnerable to severe and protracted losses than might occur in Western countries. Despite the risks, global business continues to expand into emerging economies. Political risks in unstable areas include potential property damage caused by war or civil strife, expropriation of property—including burdensome tax policies—inconvertibility of currency, and rapidly changing regulations. There is also the real risk of kidnapping.

Insurance claims arising from these factors can be complicated. International companies may require specialized, political-risk coverage offered by organizations such as the ***Overseas Private Investment Corporation***, local governments seeking to promote foreign direct investment, and private firms.

Coverage Considerations

A key responsibility of a MNC risk manager is a comprehensive view of coverage for all entities, domestic and international. Companies need to choose the optimal mix of coverage from admitted versus non-admitted carriers, based on tax considerations and coverage adequacy.

Foreign subsidiaries are often insured by small, local insurers with different, frequently inferior, coverage compared to U.S. policies. Many local policies cover property only at actual cash value, which can limit recovery to the depreciated value of the plant or equipment, rather than at replacement cost. These local policies also lack critical coverage, such as for typhoons or earthquakes in areas where they occur.

When Guam was battered by *Typhoon Paka* in 1997, many businesses discovered that their policies excluded damage resulting from wind-driven water. One hotel suffered glass damage of nearly $1 million, but its coverage was limited to $100,000.

Responding to International Losses

A range of challenges faces a policyholder in the wake of a major overseas loss, beginning with the enduring problem of different languages. Translating insurance-specific or industry-specific terminology can be especially problematic.

Local management has a key role in coordinating a successful claim resolution. It will lend crucial first-hand knowledge about the insured's operations, loss recovery activities, and loss-event details.

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***Seamless*, from Page 9**

into Europe. It wanted to obtain a strong local presence in each of several markets in order to handle in-country receivables, and disbursements and to concentrate cash regionally. The corporate treasurer commented that the RBC solution—provided, in this case, by IBOS—allowed establishment of the business in Europe much faster than would have been possible with the more traditional approach of setting up banking arrangements in each country and dealing with each bank individually

A large Scandinavian company has consumer-focused service operations all over Europe. Through IBOS, the company has set up concentration systems, local cash pools and local services at various partner banks. Liquidity is managed in Scandinavia, through a process of daily sweeping and funding. The group treasurer remarked: "We found that the IBOS way is efficient in combination with other core banks and these factors have been crucial for our choice of a pan-European cash management bank."

A major U.S. supplier to the automotive business turned to IBOS for a complete range of services, from pan-European centralization all the way to domestic services. The assistant treasurer said, "We could not find that with any global provider of cash management and treasury services."

Conclusion

The RBC alternative is a strategy to cope with the intermediary services provided by global banks. Its essence is its emphasis on the local strengths of domestic banks, linking them efficiently and ensuring that the products and services match the requirements of our customers at the right price.

For the corporate treasurer, this paradigm shift presents a new range of opportunities. While not yet complete, RBCs should be considered as one of the solutions to be investigated as he surveys his options. ❑

The (RBC) essence is its emphasis on the local strengths of domestic banks, linking them efficiently and ensuring that the products and services match the requirements of our customers at the right price.

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***Risk*, from Page 14**

In 1997, half of all catastrophic events worldwide occurred in Asia, but only 13 percent of all insurance losses were reported in that region. This reflects the low level of insurance coverage in the region, despite the high level of exposure to loss. However, when an insured does have a claim in Asia, the culture often dictates that less documentation is needed to resolve the claim.

In Japan, the insurer and the insured are less likely to battle over a claim, as litigation is rare. But when a U.S. company insured by a U.S. insurer suffers a loss in Asia, the documentation required is usually no different than for a domestic claim.

Another nuance in calculating a loss for a foreign subsidiary is the consideration that local policies often require that the claim be presented in accordance with the language specified by the policy. For example, one British adjuster refused to accept a claim that calculated lost gross earnings because the UK policy was a profits-based form. It is most important to understand local policy conventions and semantics.

Tailor the Policy

An insured may be able to mitigate international losses by implementing a damage control plan at the first sign of a problem. Policyholders should also consider what risks will be covered in advance of loss and tailor the policy to address those risks.

A company that operates by means of many third-party distributors overseas may want to include policy language that will cover third-party expenses. Damage-control initiatives such as these can result in substantial savings to the insured and the insurer in mitigating lost sales and profits.

A company that operates by means of many third-party distributors overseas may want to include policy language that will cover third-party expenses.

Most MNCs are likely to suffer a significant loss event away from the home base at some time. Companies that have not properly assessed their exposures are likely to have insurance coverage that falls short. These firms may face a serious financial setback.

For the well-prepared policyholder, the loss event can be a mere transitory inconvenience incurred in the course of a successful, long term, global risk management strategy. ❑

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Snapshots

UK Study: Euro will not Improve Exchange Rate Stability

The "Financial Times" reports that more of Britain's exports to Germany are billed in dollars than in either marks or euros, according to official data released in late February. The data cast doubt on claims that joining economic and monetary union (EMU) will provide British exporters with greater exchange rate stability.

Opponents of British euro entry have been arguing that, if Britain's exports to the euro zone are primarily priced in dollars, EMU entry would increase, rather than dampen, exchange rate volatility to which exporters would be exposed.

Britain's ***Office of National Statistics*** said that 37 percent of exports to Germany in 1999 were billed in dollars, compared with 24 percent in marks and 8 percent in euros. For the European Union overall, 25 percent of exports from Britain were billed in dollars.

Ian Campbell, director-general of the ***Institute of Exporters***, said that a large proportion of Britain's exports is related to industries in which the dollar has been the dominant currency of trade. As well as being the dominant invoicing currency for commodities, the dollar is the *numeraire* for trade in aerospace, defense, chemicals and semiconductors.

Ian Milne, director of ***Global Britain***, an anti-euro campaign group, said the research undermined a central argument for British EMU membership. However, ***Britain in Europe***, a pro-European group, said the euro's role as an invoicing currency would increase.

The ***Confederation of British Industry*** said that the euro had yet to be fully accepted by many Continental companies as an instrument of trade, and that this was unlikely to change in the short term.

Russia's Gazprom Considers Future Flows Issue

Russia's ***Gazprom***, the world's largest gas producer, plans to sell its first international bond some time this spring, lead managers for the bond said in a recent statement. The deal will be the first international bond sale by a Russian corporation since the country's default on domestic debt and currency devaluation in August, 1998. Investment banks ***Credit Suisse First Boston*** and ***Schroder Salomon Smith Barney*** have been appointed to lead manage the bond, terms for which—including size, maturity and currency—will be decided after an investor road show.

Fund managers said the sketchy details given meant it was too early to be sure how the deal would be received, but that Gazprom could mimic other emerging market energy companies and securitize hard-currency receivables. Venezuelan state oil company ***Petróleos de Venezuela*** (PdVSA) has already structured large bond issues in this way and Gazprom had plans to sell bonds backed by income from gas exports prior to the 1998 economic collapse.

"We would expect that they (Gazprom) would securitize receivables. The question would then be the rate of the securitization, and how that would reflect on the credit quality of the bonds," said *Jana Benesova*, fund manager at Credit Suisse Asset Management in London.

Asset-backed debt is viewed as a safer investment than its unsecured counterpart, especially when country risk is high. The structure, involving the receipt of funds by a bankruptcy remote offshore SPV, could allow the debt to achieve a higher rating than the sovereign rating of the host country. Some investors were skeptical about a securitization, however, saying they would only buy corporate paper at a premium to Russia's $16 billion of Eurobonds.

The statement said that Gazprom would use proceeds from its forthcoming bond for investment projects and general corporate purposes. Gazprom controls 25 percent of the world's natural gas resources. ❑

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WorldTrade Executive, Inc.

The International Business Information Source™

March 12, 2001
Vol. 27, No. 11

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