

PAPER 2

OFF SHORE BORROWING

by

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The purpose of this paper is to give some information about the various aspects of offshore borrowings. It is written for people with a legal or an accountancy background, but it is not intended to be a document which exhaustively outlines all the aspects and its pitfalls of that type of financing.

OFFSHORE BORROWINGS

Spurred by the growth of international trade and the development of the Euro-currency markets, the local and international capital markets have opened to a greater number of sovereign and corporate borrowers. We will talk this afternoon about how the corporation can finance its own business or finance its international buyers and the choice it has of fixed or floating rate term lending from a variety of sources, including export finance schemes, in a variety of currencies.

Before explaining the various types of financing, I will give you a brief run-down of what a Euro-currency is and how it is developed.

EURO-CURRENCY LOANSWhat is a Euro-currency?

A Euro-currency is a convertible currency on deposit in a bank outside of the country of issue. The fact that it is called a Euro-currency does not indicate that it is limited to European currency. Also non-European currencies are called Euro-currencies when they relate to transactions outside their home country. For example, a dollar on deposit in London or Paris would be a Euro-dollar because it is on deposit in a bank outside of the United States. Although a Euro-dollar is a United States dollar on deposit with a bank outside the United States, the dollars actually are on deposit in the United States. Namely, that outside bank will have a dollar account with an American bank where it has placed the dollar on deposit, but it merely represents a change in the deposit's ownership. The reason that a currency is ultimately always on deposit in the country of origin is because nowhere else can one actually use that currency (you cannot pay for your local groceries in New Zealand with US dollars).

An example makes it all the more understandable. (Because the Euro-dollar is still the major currency in the Euro-market, the example will be based on a US dollar transaction).

Let us assume that a US company purchased New Zealand meat and will pay in US dollars. That US company will instruct his US bank to charge his account for, say, US\$100,000 and will pay it to the meat works in Auckland. His bank will charge his account and credit the account of a NZ bank in its books for the meat works' account. The New Zealand bank, in turn, will show a US\$100,000 deposit for the meat works on its books. By this means of transferring US\$100,000 from one account to another account with the same bank, the US\$100,000 become Euro-dollars, because they are now represented by a deposit in the name of a New Zealand company at the US bank.

The New Zealand bank receiving the Euro-dollar deposit may employ the funds in 3 principal ways. Firstly, it may re-deposit the funds with another bank including an American banking branch located outside the USA. Secondly, it may lend the funds to a final non-bank user. Thirdly, if it is placed with an American branch, the latter may transfer the Euro-dollar deposit to its Head Office in the United States.

The re-depositing of Euro-dollars with another banking office outside the United States creates additional book-keeping entries raising both the assets and liabilities of the second bank. Such re-depositing may continue through a third or fourth bank with equal increases in debits and credits, but such inter-bank re-depositing involves nothing more than successive transfers of ownership of the original deposit in the United States, without any real expansion of credit, but it creates an accumulation of Euro-deposits.

If the money is lent to a final non-bank user, for instance a multinational corporation, credit expansion may occur.

The third possibility is of transferring the funds from an American branch outside the United States to its US Head Office. No increase occurs in US bank resources as a result of this transfer, only a shift of resources from one US bank to another, as the original deposit is merely transferred from the original US bank to the Head Office of the bank whose overseas branch accepted the deposit.

How did the Euro-dollar market develop?

There is no universal agreement as to why this pool of funds developed, but most experts trace its origin to the substantial US balance of payments deficit in the sixties; the interest rate premium over US held dollars which Euro-dollars have offered to the depositor, and the US exchange control regulations which have obliged US and overseas borrowers to raise finance overseas which previously could be borrowed in the United States. Whatever the reason may have been, the result was a gradual build-up of dollar deposits abroad. Rather than keeping the dollars on deposit with Central banks or commercial banks, the thought occurred that they could lend those dollars directly to users outside United States, and that, in itself, is the actual creation of the Euro-dollar market. That market is now very large and liquid, namely around \$1,655 billion in deposits with an average maturity of eight months.

Why did London become the centre of this activity?

The creation had to be in a financial centre where borrowers and lenders came together and that was actually the case in the London market. The presence of many large institutions in that city and an excellent communications network permit fast commitments. London's regulatory

tradition of encouraging a free market in international deposits and loans has made the City ever more attractive, as national authorities in other countries have attempted to regulate the foreign operations of local institutions by imposing leverage ratios, foreign exposure limits, reserve requirements on loans and deposits and the like.

Is London the only Euro-dollar currency centre?

Although London is the main centre, other growing centres are Singapore and Hong Kong, which have developed in the late 70's; possibly New York will become one in the not-too-distant future, because it has had an offshore banking centre since December 1981. Worth noting is that earlier Euro-currency originated in Asia were called Asian currencies, but in the seventies that name was changed into the more internationally accepted name of Euro-currency.

As mentioned earlier, a Euro-bank's source of funds is generally not customer deposits, but the inter-bank market, where any financial institution with an accepted name can obtain funds within a narrow differential of a free determined market cost. The bank prices its loans not on a cartel or prime rate basis, as is the case domestically, but according to a marginal relationship over its cost of funds for a particular maturity. This assures the lender of a pre-set interest spread, provided that he matches the maturity of his loan with a corresponding deposit. Loans have been made at a certain spread above the certain rate called LIBOR Rate. This stands for London Interbank Offered Rate, and this refers to the interest rate that banks charge one another on loans of dollars or other currencies. That rate corresponds with the national interest rate of that currency, but adjusted to regulatory factors - such as the reserve requirement - which affect domestic rates.

As we all know, Euro-currency loans are now widely accepted and syndication of major loans among several banks has become standard practice. The objective of a loan syndication is spreading risks, earning a useful management fee and publicity for the managing bank, and also establishing mutually profitable relationships with other banks in the market. From the borrower's standpoint, syndications establish potential banking relationships with a large number of banks.

How strong is the Euro-dollar market?

It was feared that the Euro-dollar market might collapse stemming from the common notion that an original Euro-dollar deposit pyramided throughout the system via a series of inter-bank deposits, leaving in its wake an accumulation of deposit liabilities in the Euro-banks through which it passed far in excess of a single New York asset from which it originated. The fear is that if one of these Euro-banks were to default in its obligation to repay Euro-dollars to a preceding bank, that that preceding bank may be caused to default as a result of that, culminating finally in a general breakdown of the system. The risk of default and ultimate collapse of the Euro-dollar market is in theory there, but we should bear in mind that all the participants of the Euro-dollar market, being the Euro-banks, are all governed by their own country's Central Bank's regulations. Although the Euro-dollar market is in theory unrestricted, it is very unlikely that in case a major bank of country Y was in default the Central Bank of that country would not intervene, because it would tremendously affect the confidence in the banking control system of that country. In addition, it must be remembered that in speaking of Euro-banks, one is referring to the world's most respected and highest quality banking institutions, and it is inconceivable that these institutions would ever allow themselves to default on their maturing Euro-dollar liabilities because they had unwittingly loaded their asset portfolios with too many long term

Euro-dollar loans. Moreover, bear in mind that it is the practice to match assets and liabilities and maturities in their balance sheets. A completely matched balance sheet is one in which, for aggregate deposits of a certain maturity in a currency, there are assets of the same amount, currency, and maturity. A matched balance sheet, however, is all very well in theory but when large banks are involved simply the numbers make it impossible that they cannot repay one specific Euro-currency deposit. Also one should bear in mind that the infra-structure in the Euro-dollar centres makes it possible to obtain deposits in minutes. The inter-bank market does serve as a lender of last resort to an individual Euro-bank. Virtually every Euro-bank's asset portfolio contains some call or sight deposits with other Euro-banks.

Limitation of Borrowings in New Zealand by Overseas Persons

Before going into the various forms of off-shore borrowings, which is today's topic of discussion, it may be worthwhile to mention that the Overseas Investment Act and Regulations stipulate that any overseas person is limited in its domestic borrowings and must make an application for consent before borrowings in New Zealand dollars are allowed. (An overseas person is defined as a company which is 25% or more overseas owned or controlled. This is a simplified statement, because the actual definition is more complicated.)

In other words, when the financing needs of an overseas person exceed its domestic availability, that person must arrange off-shore financing for the excess.

Exempt from the Regulations are local borrowings up to a total of NZ\$300,000 and consent to borrow up to that amount is not required.

The Overseas Investment Commission (OIC) closely linked with the Reserve Bank of New Zealand, has given the following guidelines which are currently applicable.

The restrictions with regard to the amount of domestic borrowings come into force when the foreign ownership is 50% or greater. When the company is predominantly New Zealand owned and controlled, there are no restrictions, but prior approval has to be obtained.

There is a limitation, however, when the company is 50% or more overseas owned or controlled. In that case the domestic borrowings may never exceed the sum of 15% of total turnover in the previous financial year, plus an additional 20% on export sales therein. If a company is less than 75% overseas owned or controlled, additional borrowings are permitted as long as an amount proportionate to their overseas ownership or control is also raised overseas, for instance, if a company is 60% foreign owned it may increase its local borrowings by \$4.00 for every \$6.00 raised overseas.

When a company is exactly 50-50 New Zealand/Overseas owned and controlled, their local borrowings may raise even further, namely with \$3.00 for every \$1.00 raised overseas.

This OIC regulation clearly outlines the need for foreign subsidiaries to have offshore borrowings available.

Conversely, the general rule of the Reserve Bank of New Zealand is that without the consent of the OIC, no person shall borrow any money outside New Zealand. The Reserve Bank regulation is that whenever a person requires approval for off-shore borrowings, it will be given only, and then subject to specific conditions relating to the transaction, when the repayment is due after 12 months.

The principal exemption from this regulation is when the money borrowed shall be used for the purpose of financing exports from New Zealand or imports into New Zealand by that company and that the term of the borrowing will be less than 12 months.

The following types of offshore borrowings will be discussed:

Eurocurrency loans

Eurobonds

Bankers Acceptances

Eurocurrency Loans

This can be divided into two sections, namely -

1. short term transactions, and
2. medium term credit.

The short term transactions are for commitments by a Euro-bank for one year or less, while medium term credit is for a period between one year and ten years. In both cases the borrower arranges a facility with his bank, the lender, to raise funds from the Euromarket at a pre-arranged margin over the inter-bank offered rate (that can be London, Singapore, or Hong Kong or even any other major international money market etc) or in some cases pre-arranged margin over the costs of funds of the lender.

1. For short term transactions, the loan is, as the name already indicates, a one-off transaction. This means that there is no interest review and no rollover.
2. Medium Term Credits can be divided into two principal types of Medium Term Euro-dollar credits, namely -
 - (a) revolving credits, and
 - (b) term loans.

A revolving Euro-currency commitment is a confirmed line of credit beyond one year, whereby the bank enters into a firm commitment to make available to the borrowing company a fixed amount for an agreed period. This form of credit is frequently used by

the borrowing company as a reserve line of credit to cover unforeseen needs. The funds are drawn down by the borrower in the form of short term renewable advances, usually against 90 days or 180 day notes. Under such revolving credit arrangements, the amounts outstanding can fluctuate with the needs of the borrower. Quite often a revolving credit is converted into a term loan by simply eliminating the revolving feature and setting up an appropriate repayment schedule. The rate adjustments are normally every 180 days. In exceptional cases the bank is prepared to make fixed rate loans available, but that is only the case when the bank can finance the loan with a matched deposit.

Both revolving credits and term loans have quite often a multi-currency option in the agreement. This means that the borrower can at the interest review date convert his borrowings from one currency into another. This multi-currency option enables the borrower to take advantage of the interest rate differences between the various currencies as well as the relative weaknesses of the currencies involved.

(Below I will refer to the exchange risk and what to do to avoid those).

Euro-Bonds

Flotations in the Euro-bond market involve a number of special problems for prospective borrowers. For instance, choice of currency denomination can become an important element in the borrowing company's long term foreign risk exposure. International composition of Euro-bond underwriting syndicates complicates preparation of new issues.

Tax and regulatory considerations have led companies to issue Euro-bonds through financing subsidiaries, often created solely for the purpose of floating an international bond. The tax consideration is quite often the withholding tax, namely that the country of the borrower charges withholding tax on interest to be paid. The financing subsidiary is established in tax friendly countries such as the Netherlands, Antilles or Luxembourg. The normal function of such financing subsidiaries is to re-lend the funds derived from a Euro-bond issue to operating affiliates of its parent company. Since the financing subsidiary usually possesses too low a capitalisation to provide an acceptable credit risk for investors in the Euro-bond market, the payment of interest and principal is almost uniformly guaranteed by the parent corporation.

The market of Euro-bonds is quite extensive and it has been increasing due to its reliance on no single city or stock exchange. Both the London and Luxembourg stock exchanges - which are the most frequently used for Euro-bonds - have requirements for quotations, but they have no difficult registration procedures, onerous disclosure or continuing reporting requirements. Both normally require a suitable summary of audit figures of the borrower and guarantor.

The market is operated by a large number of commercial banks and investment banks, but the role is mostly as a broker between a borrower and the ultimate investor. A common characteristic of private and corporate investors is that they frequently have offshore funds outside the jurisdiction of their countries, either because they find opportunities more attractive outside their own countries or because they are reluctant to repatriate the funds. The tax free bearer nature and consequent anonymity of Euro-bonds is an essential element which attracts their investment.

Bankers Acceptances

An Acceptance is a promise by the drawee of a draft or bill of exchange that the instrument will be honoured at maturity. Where the drawee is a merchant, the instrument is known as a 'trade acceptance'; where the drawee is a bank, it is known as a 'bankers acceptance'. The principal purpose of a bankers acceptance is to provide current financing; it permits one person to use the credit of another person - being the bank - to raise a financing. Historically, the credit of a bank has been preferred to that of merchants, with a consequence that the market for bankers acceptances has developed virtually independently from the market in which mercantile obligations are traded and entirely distinct from the securities market. There is a well established market for the acceptances, which, in the USA, is stimulated and a large measure regulated by the Federal Reserve system. Acceptances can readily be sold to dealers or actually to the bank which has accepted. Since the US\$ is still the major international currency it is attractive to know that the bankers acceptance creates an efficient and relatively easy means of utilising the US capital market. Also important to know is that the acceptance financing need not be limited to trade transactions with the US. Important for the saleability of bankers acceptances in the US market is that they should be accepted by "Prime Name" US Banks. The acceptance stamp of a "Prime Name" bank is known to all major US market brokers and without such a stamp it becomes less saleable paper. The mechanics for arranging a bankers acceptance finance are as follows:

- The company negotiates a facility in US dollars with an American bank and opens an account with that bank.
- That company will sign in blank a parcel of numbered bills of exchange to be held in safe custody by that US bank.

Whenever the company intends to utilise the facility it informs the American bank

- a) description of the goods being exported
- b) the value of the goods being shipped and financed
- c) the port of origin and destination of the shipment
- d) the date of shipment, which must be within three days of planned acceptance and discount of draft
- e) the date on which the draft should be accepted and discounted by the American bank,
- f) the tenor of the drafts which must be for a minimum of 30 and a maximum of 180 days

FOREIGN EXCHANGE EXPOSURE MANAGEMENT

An extremely important factor in off-shore borrowings is the foreign exchange exposure and what means are available to avoid, or at least minimise your foreign currency exposure risk.

An important consideration, of course, on deciding to protect a company against the risk of foreign exchange exposure is the cost involved i.e. the cost of hedging must be measured against the foreseen loss due to a given currency exchange rate change.

There are a number of alternatives available to protect, or at least partially protect, against foreign exchange changes.

The one which comes to everybody's immediate mind is to take out a forward contract. If a company borrows, for instance, US dollars it sells those dollars in the spot market, but at the same time negotiates the contract to buy them back at a future date at a pre-determined exchange rate. In this situation the borrower knows exactly how much this US borrowing will cost him. Namely, the interest charge of borrowing the US dollars plus or minus the forward cover costs. This type of foreign exchange protection is ideal for a so-called transaction exposure, which means that the company needs the funds only for a limited period, which can be entirely covered by a forward contract. Effectively this means that the offshore borrowing should not be longer than 12 months, because that is in practice the maximum period one can arrange a forward contract.

When borrowings for longer periods are arranged forward contracts also protect the borrower against foreign exchange fluctuations, but only partly. The reason is that at the maturity date of a forward contract generally a new forward contract has to be arranged and it is most likely that there will be a difference between the contract forward rate and the spot rate at the time the contract matures. In New Zealand it is the Reserve Bank which stipulates that forward contracts are limited to one year. In other countries contracts for longer periods can be arranged, but that depends on the currencies involved.

Another alternative to actual hedging is to create a foreign exchange reserve.

The amount of the reserve is determined by the Company Treasurer's view on the fluctuation of the currency they deal in. As an example, one can base the amount of the reserve on the average percentage monthly change of that currency or currencies.

Other alternatives to protect against foreign exchange exposure involve third parties, but they can be equally adequate and possibly less expensive. The three alternatives involving third parties are:

parallel and back to back loans

currency swaps

simulated currency loans

Parallel and Back to Back Loans

Those loans involve two entities with headquarters in different countries and each having a subsidiary in the other's country.

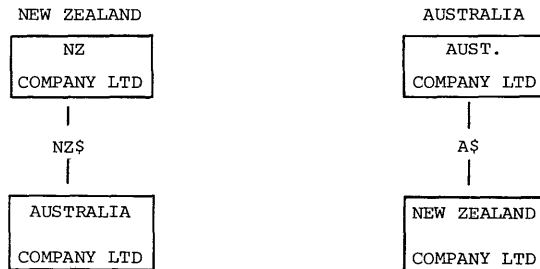
Suppose a New Zealand parent company, with a subsidiary in Australia, has a surplus of New Zealand dollars, but the Australian subsidiary would like to borrow Australian dollars. At the same time, there may be an Australian company which has surplus of Australian dollars with a New Zealand subsidiary which would like to borrow New Zealand dollars. These requirements can be met by either a back to back loan or a parallel loan in which the New Zealand company lends New Zealand dollars to the New Zealand subsidiary of the Australian company, and the Australian parent company does the same to the Australian subsidiary of the New Zealand company.

Parallel loans differ from back to back loans only in that parallel loans do not include a right of offset, or cross collateralisation between loans.

Interest rates on these type of loans are usually set at a fixed rate corresponding to commercial rates prevailing for each currency at the time of closing, and are subject to local governmental regulations. Since two multinational companies are involved, only the actual difference in rate is of importance, and therefore, both lending companies can agree to charge the borrower a below market interest rate.

The maturities of these loans vary between six months and ten years.

The below example illustrates the back to back or parallel loan.



There are three main steps to be taken by a company which wishes to enter into a back to back loan,

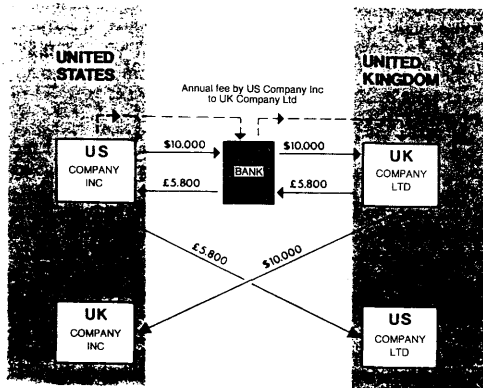
- a) search for a partner: quite often an intermediary, in most cases a bank with many contacts inside and outside New Zealand, will arrange for finding the missing party abroad.
- b) Negotiation of terms: loan agreements must be prepared, parties must agree on the periods, amounts and interest rate etc.
- c) Application for consents and permissions: OIC approval and possibly Reserve Bank approval in the other country have to be obtained. Also here an intermediary can be of assistance in obtaining the required permissions on behalf of both parties.

With regard to interest the importance is actually the differential being the difference in rates between the two loans

With regard to the agreement it is important to know that back-to-back loan is normally evident by two separate loan agreements, but the provisions of each being so interlinked that the borrower from one country has an effective right to set off should the borrower from the other country default in his obligation to repay.

Currency Swaps

Also this involves two different parent companies with subsidiaries in the other's country, and also both agree to arrange the others subsidiary's needs for financing, but not in the form of a loan to that subsidiary, but rather the two parent companies agree to sell to each other their respective currencies, with an agreement to reverse this sale in the future by a forward exchange contract. The parent company then immediately lends his subsidiary the amount they have purchased in the subsidiary's currency. The interest rate must be in accordance with the relevant country's regulations. The parent companies pay a negotiated annual fee in case there is an interest differential between the two currencies involved. For instance, if the interest charge in New Zealand is 20% while it is in Australia 18% then the New Zealand parent will pay the 2% per annum interest to the Australian parent company. The following example outlines a currency swap with a bank intermediating.



U.S Company Inc and UK Company Ltd enter into a spot exchange transaction at current exchange rates (e.g $\$1.72 = \pounds 1.00$); US Company Inc thus buys 5,800,000 against payment of \$10,000,000. Simultaneous with the spot exchange transaction, the same parties enter into a forward exchange agreement which will exactly reverse the swap made above at the same rate after 10 years. US Company Inc immediately lends to its UK subsidiary the 5,800,000 purchased. The interest rate on this loan must conform to relevant exchange control and tax regulations of both countries. UK Company Ltd also immediately lends to its subsidiary the dollars it received in the swap. As in the above case, an annual interest rate must be in accord with appropriate regulations. US Company Inc pays UK Company Ltd a negotiated annual fee in sterling approximating the interest differential between sterling & dollars of the same maturity (ie. the interest differential between sterling & dollars if the transaction had been accomplished as a parallel loan).

A parallel loan transaction and a currency swap are quite similar techniques to achieve the same objectives. However, four main differences should be noted which might influence a company's choice between parallel loans or a currency swap.

1. Accountants differ on how parallel and back-to-back loans should be reported by the parent company on its balance sheet. Even if there exists a right of offset, some accountants feel that both loans should appear in the balance sheet rather than being treated as off-balance sheet items. Such treatment inflates the company's balance sheet, may produce adverse consequences under outstanding indentures and may therefore make a currency swap preferable.
2. In a parallel loan transaction, each borrower has an unambiguous tax-deductible interest expense and each lender taxable interest income. In a currency swap, the annual fee paid by one party to the other (representing the interest differential between the long term rates in the respective currencies) may or may not be tax-deductible depending upon local law. Either a parallel loan transaction or a currency swap might be preferable depending upon the tax position of each counterparty.
3. An implied right of offset often exists in the case of a currency swap, whereas no such right exists between parallel loans. If this right of offset is important as a credit matter, a currency swap or back-to-back loan might be preferable.
4. If one counterparty is a trust, its trust instrument may permit it to enter into a parallel loan but not to engage in a currency swap.

Simulated Currency Loans

A simulated currency loan is a loan given in a certain currency whereby the interest charged and the amount of repayment is expressed in the terms of a second currency. These types of loans can be of interest to companies which have subsidiaries in countries, such as Spain, where limitations exist with regard to re-exporting of profits made. For example, a US multinational company has a successful subsidiary in Spain, which had blocked Spanish pesetas while a second US multinational would like to invest additional dollars into its Spanish subsidiary. A simulated dollar loan from the first subsidiary to the second would be denominated in pesetas, be repayable at maturity in pesetas in an amount equal to the original

dollar equivalent of the loan, and at a negotiated interest rate close to the London interbank offered rate for dollars. The interest can be payable either in pesetas or in dollars.

Simulated currency loans offer good opportunities to both the lender and the borrower. For the lender it converts an asset denominated in one currency into an asset in a second currency; in this case peseta balances were effectively converted into dollar receivable, and also it enables a company to actually use otherwise unused funds.

Also for the borrower it has interesting alternatives, for instance, the actual interest rate is lower than market rate, and also that the parent company of the subsidiary which is borrowing pesetas, which they otherwise had to transfer to Spain with a risk that they can never be reexported.

Taxation

Of paramount importance in the decision making process of hedging, borrowing or lending is the tax consequence of such a transaction. The tax becomes a factor in the timing, the amount, for how long, and where a loan or hedge should be lodged.

This taxation is something to be looked at on a case by case basis.

In 1975 with a deteriorating balance of payments and a contraction in the growth of money supply, it became necessary for New Zealand companies to raise funds offshore, on a scale much greater than in the past. This coincided with an increase in overseas interest rates to levels far greater than those prevailing on the local market. Official Government policy was to encourage the private sector to borrow offshore so as to increase capital inflows with a consequent benefit to the country's balance of payment figures. Government accordingly announced that, as a matter of policy, it would give an exemption from withholding tax on interest paid under offshore loans which met certain requirements. The exemption will not be given if the borrowings were used for, on-lending in consumer credit transactions or if the borrower and lender are associated persons. The reason for these two restrictions was first the desire not to stimulate consumer spending (which would inevitably result in increased imports) and the desire not to give exemption from withholding tax to subsidiaries of overseas companies on their "inter-group" financing.