Capital hill

This has been a watershed year for bank capital-raising. Years of cultivation and development of the sector certainly started paying dividends for one US investment bank. For its commitment and all-round ability in the international capital securities market, Merrill Lynch is the IFR Capital Securities House of the Year.

Merrill Lynch has built up a global capital securities business, but it was far from an overnight success story. "Merrill Lynch has a real history with the product," said Jimmy Quigley, co-head of global debt markets at Merrill Lynch. "In 1984 we set up a capital markets group that has developed over time into the premier capital securities franchise. Today's strength is built upon a solid foundation, which has enabled Merrill Lynch to be at the cutting-edge in innovation in the capital securities market."

The capital securities market is now a global business. After years of discussion and structuring, institutionally targeted transactions burst onto the scene to complement the traditional US retail-oriented deals. This year saw new issuers tap the international private client (retail) investor base and the institutional global market.

The culmination of these developments was the globalisation of the product. Banca Commerciale Italiana (BCI) and ABN AMRO launched Tier 1 capital deals during 1998 that were (respectively) the first institutional and retail global offerings. Merrill Lynch's credentials in the sector were clearly highlighted. On BCI, the US firm was sole-lead manager and bookrunner, while on the ABN deal, Merrill was the joint arranger and joint bookrunner.

BCI launched three classes of preference shares. Bonds totalling E500m and £120m were sold to European institutional investors, and US institutions were offered a US$200m tranche under Rule 144a. This gave a total issue size of around US$950m.

The euro transaction sold well to Italian, French and German institutional accounts. The sterling tranche was naturally well bid by UK funds. Some 75% was placed in the

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Merrill Lynch

UK and 15% in the Benelux region, with the remainder split between Italian, French and Spanish institutional investors. The US tranche sold to US insurance companies, fund managers and asset managers.

By simultaneously tapping three different markets BCI was able to meet its total funding objectives and maximise the cost-effectiveness of the total offering. The paper was widely distributed among international investors despite the extremely difficult market conditions prevailing at the time of launch. The issue set a benchmark in both the US and the European market for future issuance by other European banks.

The transaction also involved resolving complex cross-border legal, regulatory and taxation issues. These were smoothed over by the careful planning and liaison work done by Merrill Lynch with the Bank of Italy. Overall the BCI transaction was the best regarded capital securities deal of the year.

The ABN AMRO transaction was not far behind. Again, as joint-arranger and bookrunner on the deal, Merrill Lynch worked closely with ABN and various authorities to develop an innovative transaction structure that enabled the Dutch bank to achieve its key objectives.

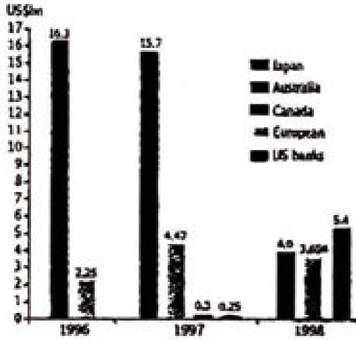
In the end, US$1.25bn was raised, making it the largest preferred securities transaction by a European bank to date. Merrill Lynch led the distribution process, taking up the largest single allotment (11m shares or US$275m) within the syndicate. The securities were placed through the bank's global network of retail financial consultants, who sold more than 33% of their allotment to non-US investors. The transaction was also the first dual-listed offering, being listed on the New York Stock Exchange and the Luxembourg Bourse.

The deal was structured by Damian Chunilal, managing director at Merrill Lynch. Chunilal heads up Merrill Lynch's financial institutions group in London. With a team of 10, the group is focused on devising strategies for banks to access the capital securities market.

"The ABN AMRO transaction was a model transaction for us," said Chunilal. "We could leverage our strengths in the regulation, technology and structuring areas to formulate the ideal structure for ABN AMRO. This unified approach gives both issuers and investors a fair amount of confidence in Merrill Lynch's ability in the bank capital securities market."

The unified approach has certainly appealed to issuers over the course of 1998. Merrill Lynch has been the clear leader in Tier 1 capital issuance during the year. Of the 14 international Tier 1 bank capital deals in 1998, Merrill has led six. Competitive advantage has been established on a firm base. Merrill Lynch has been the dominant market leader in terms of innovation and placement since the international market's inception of Tier 1 in 1995, when Merrill Lynch lead-managed a DM200m transaction for Argentaria.

Capital securities fundraisings 1996–98



Source: Morgan Stanley DW

Then in March this year, Merrill was the bookrunner for the first ever multi-currency offering. Once again it was Argentaria that took advantage of swelling demand for capital securities among European investors to launch US$500m equivalent in perpetual non-cumulative preference shares denominated in US dollars and Deutsche marks. Argentaria's chairman, Francisco Gonzalez, said the issue would be instrumental in improving the bank's return on equity from a weak 10.4% to a more robust 15% by the end of 1999.

The issue built on the momentum of the first Tier 1 capital deal of the year, launched by fellow Spanish bank Banco Bilbao Vizcaya. Merrill Lynch was a joint-bookrunner on that deal. Another Spanish bank, Banco Santander, followed BBV and Argentaria, launching a US$300m equivalent preference share issue denominated in Deutsche marks and US dollars.

These issues enabled the Spanish banks concerned both to improve capital efficiency and to reduce the cost of that capital. The premium being placed on maximising shareholder value is the result of legislative changes as well as the European banking system's move ever closer to a single market with competition for funds throughout Europe.

This was the driving force behind Portuguese banking group Espirito Santo's institutionally-targeted, preference share issue in the summer. Merrill lead-managed the DM550m Tier 1 transaction, which sold to a broad range of European institutional investors, thereby diversifying the bank's investor base.

This activity in Europe was in stark contrast to the dearth of issuance in the US. In 1998, issuance of capital securities by US banks all but dried up, with only US$1.25bn of new paper, as American banks approached their regulatory limits on total issuance.

Elsewhere, four Japanese banks issued Tier 1 deals at the start of 1998, before the Japanese financial year end in March. These deals allowed the banks to shore up balance sheets ravaged by bad loan write-offs, capital losses brought about by the stock market's decline, and the fall in the value of yen capital bases relative to dollar-denominated assets. Merrill Lynch's involvement was only as co-manager on one of the transactions, the only dent in the bank's capital securities portfolio.

Dan Campbell, head of global capital product at Merrill Lynch, admitted there was not much defence to this criticism. "We were not in tune with the regulators and we felt the type of issuance that came was not allowed within the Japanese parameters," he said. This problem has now been rectified. The four deals have also caused a lot of concern for the Bank for International Settlements and there is some confusion as to whether the transactions actually can be classified as pure Tier 1 capital.

In the corporate sector, Merrill led the first non-rated corporate euro preference share issue in 1997, for Parmalat. The issue was then tapped in 1998. The deal was a rare European corporate preference issue, a market more commonly accessed by banks from Spain and Portugal. The issue from Parmalat offered investors a way to pick up well-regarded corporate paper with a higher yield by moving down the capital structure.

Merrill has also been active in other classes of subordinated debt. In March, the bank led an upper Tier 2 issue for the Royal Bank of Scotland. The FFr1bn deal followed hot on the heels of a Barclays Bank 10-year step-up issue, also led by Merrill. A similar structure was used by Merrill in May, when it led a FFr1bn subordinated issue for Spanish bank Banesto.

The bank was also involved in the longest subordinated bond in the Spanish debt market when it was joint-lead on a Pta14bn 30-year subordinated issue for Bankinter. Merrill also led a two-tranche subordinated transaction for HMV Media, a £135m and US$125m 10-year callable structure.

There is a reason why the majority of issuance in the market has come from the Iberian peninsula. Spain and Portugal are the only two European countries whose national regulators do not follow capital guidelines set out by the Basle Committee. The other countries have been frustrated by the regulatory hurdles imposed by domestic regulators with regard to Tier 1 issuance.

The Basle Committee on Banking Supervision has released the anticipated guidelines for synthetic Tier 1 capital and it is expected that this will finally herald the emergence of a pan-European Tier 1 capital securities market, which Merrill Lynch will be well-placed to take advantage of.

The bank can leverage the strengths developed through bringing these Portuguese and Spanish banks to the market during 1998. It also has experience in dealing with domestic regulators. This was shown by the ABN AMRO and BCI transactions, in which Merrill worked closely with domestic authorities to ensure the transactions met with regulatory approval.

Merrill Lynch's primary market strength is coupled with a unparalleled dominance of the secondary market in this segment. A firm commitment is made to secondary trading, with four pages on secondary spread levels available on trading screens. The global product development team constantly monitors secondary performance and passes investor and issuer feedback to the financial institutions group.

It is this sort of attention to detail that has made Merrill Lynch the clear leader in the capital securities industry.

James Griffiths