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The Eurobond Market—Its Use and Misuse

This *Letter* discusses the growth, structure, and attributes of the Eurobond market. An aspect of this market that has attracted relatively little attention is the attractiveness of Eurobonds arising from motives related to tax evasion.

What's a Eurobond?

A Eurobond is a bond issued by a corporation or public agency outside the national jurisdiction of any country, and generally not registered in or subject to regulation by any government. It may or may not be denominated in the same currency as that of the issuer's home country. The Eurobond market sprang up in the mid-1970s, and grew rapidly in scope until recently, particularly between 1981 and 1986. In 1987, issuance tapered off somewhat, leading to speculation about the demise of the market. However, like Mark Twain, reports of its demise are premature.

Because Eurobonds are issued outside of the country of the issuer, they generally are exempt from most regulations, restrictions, and taxes that would apply to comparable domestic bonds. It is estimated that about \$750 billion of Eurobonds currently are outstanding (including non-dollar bonds), with daily turnover in the secondary market of about \$13 billion.

Initially, Eurobonds were issued primarily in fixed-rate form and denominated primarily in U.S. dollars. Since the early 1980s, increasing numbers of new issues are denominated in other currencies. Eurobonds also increasingly include floating interest rate pricing (with and without "caps" and "collars"), conversion features, and warrants, among other things. Eurobonds frequently are combined with swap agreements by the issuers.

The market for Eurobonds

The primary market for Eurobonds is a direct placement market. Issuers generally sell directly to investors without a public auction for the securities. Unlike domestic bonds, Eurobonds are bearer bonds; the identity of the investor is not recorded. Moreover, because Eurobonds are not

subject to the same registration requirements and other regulations as domestic bonds, Eurobonds can be issued on very short notice. An entire issue may be underwritten by a single commercial or investment bank, and the secondary market is well developed.

Issuers of Eurobonds almost exclusively have been large highly-rated corporations and governmental agencies. In most cases these issuers also are active borrowers in their own domestic markets. Even though "Euro" and domestic bond markets often handle issues by the same firms in the same currencies, there is evidence that the Euro and domestic markets nevertheless are segmented. Researchers have demonstrated that instruments in the two markets are imperfect substitutes. Considerable spreads between rates on otherwise comparable instruments issued in the domestic and the Euro markets often prevail. Sometimes these spreads are positive, and sometimes negative. "Clientele effects," where issuers and investors are imperfectly mobile across markets, seem to play a role in determining the magnitude and sign of these spreads.

Several factors may help to explain why these clientele effects exist. First, there is the question of legal jurisdiction, recourse, and enforcement. It may be more difficult for the holder of a Eurobond than a domestic bond to sue the issuer or to force the issuer into bankruptcy. Indeed, it is not even clear how and where such legal proceedings would take place. This question of legal enforceability of claims may be the reason that Eurobonds generally contain few, if any, restrictive covenants. The legal questions also may explain why the Eurobond market is dominated on the issuers' side by highly-rated borrowers.

Differences in registration and disclosure requirements are another factor explaining both the existence of Eurobonds and the differences between the pricing of these bonds and domestic bonds. The U.S. Securities and Exchange Commission provided impetus to the development of the Eurobond market when it announced in 1964

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that any public offering would be exempt from U.S. registration if it "is made under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States," and is carried out "in a manner which will result in the securities coming to rest abroad." Eurobond issues thus avoid the costs and delays associated with registration of domestic securities. Moreover, in practice, the SEC waives Eurobond registration as long as the security is not sold directly to U.S. investors during an initial 90-day "seasoning period." (Eurobonds brought back into the U.S. are supposed to be registered. It is possible that many are not.) Thereafter, the security may be traded in the U.S. Indeed, because Eurobonds are bearer bonds, it probably is quite easy for a U.S. investor to purchase the security at issue (during the seasoning period) through an intermediary.

The taxation of Eurobond interest

The third and perhaps most important feature that separates the Eurobond from the domestic bond market is the differing tax treatment of the two types of instruments. Unlike domestic bonds, Eurobonds issued by U.S. firms traditionally were (until 1984) exempt from U.S. withholding tax. Other Eurobonds often are exempt from withholding tax in other countries. A non-U.S. investor who buys a Eurobond issued before 1984 by a U.S. firm outside the United States essentially would be exempt from U.S. taxation. Bond earnings might be subject to taxation in the investor's own country, in the same way that U.S. investors' earnings on Eurobonds are subject to U.S. taxation of interest income.

In addition to legitimate business and investment reasons for holding Eurobonds, there may be investors who choose to hold Eurobonds to evade taxation. Because Eurobonds are in bearer form and the identity of the owner never is recorded, it is difficult to trace interest income on Eurobonds. Thus, investors may be able to avoid reporting income from this source and thereby evade taxation in their home country.

This does not mean that all or even most Eurobond investors are tax evaders. But it does mean that the market may be misused for tax evasion by some. It also means that tax evasion has significance for the structure of and pricing in the Eurobond market.

Prior to July 1984, non-U.S. investors holding U.S. domestically-issued securities were subject to withholding tax. This provided an impetus for the issuance of Eurobonds through financial intermediaries outside the United States. Eurobonds issued by U.S. firms in the Netherland Antilles enabled foreign investors to purchase U.S. securities comparable to domestic securities, but exempt from withholding. In many instances, foreign investors could have recovered the U.S. withholding tax on comparable domestic securities by meeting certain conditions, including demonstrating that taxes were being paid on the interest to the investor's home government. However, many foreign investors in domestic bonds preferred not to recover taxes withheld, presumably because they were not reporting the income at home. This suggests both that the "expense" of reporting outweighed the loss due to withholding, and that many overseas investments in dollar bonds may have been held for purposes of tax evasion.

The U.S. withholding tax for foreign investors in U.S. securities was repealed in July 1984. Yet Eurobond issuance continued to grow, perhaps in part because it still is easier to hide the identity of investors in unregistered Eurobonds than in domestic securities. Many investors in Eurobonds make purchases through custodian accounts at Swiss banks. It has been estimated that in the past 40 to 60 percent of all Eurobonds were held in such portfolios. Some of these funds undoubtedly were savings that went undetected and untaxed in their countries of origin. The Eurobonds may provide both tax-free interest to such portfolios as well as an absence of a paper trail leading to the savers who deposited the original principal.

Eurobond investment may represent a large flow of undetected and untaxed income for Americans. But the misuse of Eurobonds probably is an even more serious problem in other countries, particularly newly developing countries. Eurobonds may be the destination for some of the "flight capital" leaving such countries. In other cases, funds invested in Eurobonds may originate in criminal activity. Eurobonds are attractive to these investors because they offer the security of low default risk and protection from high inflation and currency depreciation, together with discretion and secrecy.

A Fourth of July firecracker

The bulk of Eurobonds issued by U.S. firms traditionally were issued through financial subsidiaries in the Netherlands Antilles. Generally, such Eurobonds were issued with a provision stating that the bond becomes callable in the event of any change in tax laws or treaties that would affect the bond, including withholding taxes. On July 4, 1987, the U.S. Treasury Department announced a 30 percent withholding tax on Eurobonds that had been issued by U.S. firms in the Netherlands Antilles before 1984, ending a 40-year old tax treaty. The new rule was reversed a week later, however, when the wholesale exercise of the tax call provisions in these Eurobonds and the consequent liquidation of a large segment of the market became a real threat.

The call provision is an interesting example of strategic planning on the part of issuers. It has enabled them to forestall any moves toward taxation by tax authorities. The Treasury Department's aborted decision and the threatened exercise of call provisions did leave behind a certain amount of nervousness in the Eurobond market, though.

While short-term Euronotes, medium-term floating-rate Euronotes and Euro-CDs have different features from Eurobonds, the lack of registration and their usefulness in hiding the identity of investors may be important in those markets as well. Eurodollar deposits also may be purchased by those hoping to evade tax scrutiny. In the case of most bank liabilities, the issuing bank at least knows the identity of the investor. In such cases tax authorities may be able to subpoena such information. Even Swiss banks have exhibited willingness to release such information in certain cases.

Alive and well

Over the past year, the Eurobond market declined sharply and returned to its 1985 levels. The 1987 decline was related to a number of factors, including the October stock market crash, the fall of the U.S. dollar, high real interest rates on bonds, diminishing Eurobond profit margins, and some complaints about trading and marketing procedures. The July 4 action of the U.S. Treasury compounded the jitters in this market. Even so, the non-U.S. dollar segment of the Eurobond market actually grew in 1987, and U.S. dollar Eurobonds issued by non-U.S. firms held fairly steady. The big decline was only in Eurobond issuance by U.S. firms.

The market clearly is alive and kicking. The recent decision by Japan to tax savings there may even lead to a new influx of Japanese investors and issuers into the Eurobond market.

The Eurobond market continues to represent a market where investors and borrowers from all over the world do business. Its major economic advantage is the low regulatory and registration costs associated with Eurobond issuance and trading. Thus its continued unfettered operation is desirable. Abuse of this market by those who would use Eurobonds as an instrument for tax evasion should be controlled through administrative, regulatory, and legislative coordination on an international scale, but with a view towards maintaining the efficient workings of this market.

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