

THE MULTI-CURENCY COLLATERAL LOAN: AN INTERNATIONAL INVESTMENT TECHNIQUE

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ABSTRACT

This paper presents a discussion of the relevant issues and concerns associated with an investment technique in international banking, and analyzes the prospects for employing this investment methodology. The investment technique is referred to in this report as the multi-currency collateral loan (MCCL). The purpose of this report is to explain the mechanic of the MCCL, why it exists, and the investment potential of this technique. A basic description of the MCCL and a few fundamental facts about international banking are presented. The concept of a European private bank is addressed and how the services they offer make the MCCL possible. This is followed by a discussion of risk and return; examples of available returns on this investment method are analyzed as well as the potential systematic risks. Finally, the advantages and disadvantages in utilizing a MCCL are summarized.

KEY FUNDAMENTALS

The collateral loan is an investment device that allows a person to take advantage of the interest rate differentials between various currencies. An overseas banker will automatically lend an investor money using his deposit at that same bank as collateral. This loan can then be converted into a currency that offers a higher rate of interest than the rate required on the loan. The high interest currency is then placed on deposit with the very same bank that made the loan in the first place. The collateral loan is unique in that the bank will grant such a loan in any major currency desired.

The rate of interest for both deposits and loans is dictated by local conditions in the country of the currency that is borrowed or deposited. These local conditions depend on supply and demand, government monetary policy and international views of the strength of the currency. Due to interest rate differentials and currency parity fluctuations, the MCCL offers some interesting opportunities. For example, currently one can borrow Swiss francs from the Royal Trust Bank in Vienna, Austria at 7%. Austrian dollars can then be deposit at the same bank at 15%. The profit gained is the difference between the interest rate on the loan and the rate on deposit (8%), as well as any changes in the foreign exchange (FOREX) rates. Actually, several combinations of three events each have probabilities of occurrence: first, the value of the Austrian dollar may rise, decline or remain unchanged versus the Swiss franc; second, the borrowing rate on Swiss francs may rise, decline or remain unchanged; and third, the deposit rate on Austrian dollars may rise, decline or remain unchanged. This is not the forum to calculate all possible combinations. However, it will suffice to say that over the short-term any rate changes on borrowed or deposit funds will have a negligible impact on the investment. Therefore, in this example, the best case scenario involves a gain from the appreciation of the Austrian dollar versus the Swiss franc as well as a profit from the interest rate spread. The risks implied by this discussion will be explained in more detail in the later section.

EUROPEAN PRIVATE BANKS

European private banks offer a variety of financial services and have very high standards of safety and service. It is this spread of different financial products that makes the MCCL possible. Private banks are banks that specialize in managing money for private individuals (the name "private bank" is derived from the fact that the bank deals mainly with private individuals, rather than corporate commercial clients). These institutions operate mainly as investment counselors and derive their income from fees, commissions, and interest on collateral loans. Most of the loans they make are made to clients of the bank, and these loans are secured by assets the client has on deposit. Private banks act as deposit takers, bullion dealers, stock and bond brokers, commodity and option dealers, fiduciaries, safe keeping depositories, and foreign exchange dealers and lenders.

It would appear to be unprofitable for the bank to lend money at a low rate and pay a higher rate on the deposit. However, most major banks have bank accounts in foreign countries (called correspondent banks), which allow them to borrow for less and deposit at a higher rate than an individual can (the wholesale rate). Therefore, the bank profits four times regardless of whether its client profits, loses, or break even. The bank profits on the Swiss franc loan. It profits again when the client converts francs into dollars. It makes money the third time when the client puts dollars on deposit, and profits the fourth time when the client converts dollars back into francs to pay off the Swiss franc loan.

RETURNS

Although there are many European private banks that have the facilities to provide loans and investments necessary to create an MCCL program, Denmark's fourth largest bank (Jyske Bank), offers a well organized plan that includes three MCCL programs: Invest-loan, Dollar-Invest, and Euro-Invest. The following potential returns are available by investing in these programs depending on the amount of leverage utilized. All yields are given on an annualized basis.

Invest-Loan is a program whereby an investor can borrow up to 400% of the amount on deposit. However, instead of placing the entire loan in one currency, it is deposited into CD's of multiple currencies. The benefit from this type of plan is that the investor gains diversification by spreading the risk that a deposited currency will decline in value. The Jyske Bank actually helps in the currency decision process by recommending which currencies they feel are best to borrow and which are best for deposit, promoting their plan as a long-term investment vehicle. There are three generic strategies for using the Invest-Loan depending on the amount of risk assumed: a dollar strategy, European strategy, and US to European Strategy.

1) **Dollar Strategy:** Invest \$21,000 US dollars, convert to ECU and put on deposit at 9.62%. Borrow an additional \$63,000 at 4.87%, which can be converted to Australian dollar bonds that pay 9.06%, Canadian dollar bonds that yield 8.29%, and New Zealand dollar bonds that pay 8.57%. This investment strategy will yield 20.92% if none of the currencies fluctuate versus the US dollar:

	<u>Yield</u>		<u>Cost</u>	<u>Net</u>	<u>Net\$</u>
33.3% Australian dollar bonds	9.05%	-	4.87%	4.18%	878
33.3% Canadian dollar bonds	8.29%	-	4.87%	3.42%	718
33.3% New Zealand dollar bonds	8.57%	-	4.87%	3.70%	777
ECU Deposit	9.62%			9.62%	<u>2,020</u>
TOTAL YIELD					<u>4,393</u>

2) **European Strategy:** Invest \$21,000, convert those dollars to ECU and put on deposit at 9.62%. Borrow 147,000 Norwegian Kroner (\$84,000: 400% of deposit) at 6.5% and invest as follows:

	<u>Yield</u>		<u>Cost</u>	<u>Net</u>	<u>Net\$</u>
25% Portuguese Escudos	11.75%	-	6.50%	5.25%	1,103
25% Spanish Pesetas	12.12%	-	6.50%	5.62%	1,180
25% Swedish Kroner	8.12%	-	6.50%	1.62%	340
25% ECUs	9.62%	-	6.50%	3.12%	655
ECU Deposit	9.62%			9.62%	<u>2,020</u>
TOTAL					<u>5,298</u>

3) **US to European Strategy:** This has the greatest risk and profit potential. Invest \$21,000, convert to ECU and put on deposit at 9.62%. Borrow an additional \$84,000 at 4.87% and invest as follows:

	<u>Yield</u>		<u>Cost</u>	<u>Net</u>	<u>Net\$</u>
25% Australian dollar bonds	9.05%	-	4.87%	4.18%	878
25% Portuguese Escudos	11.75%	-	4.87%	6.88%	1,445
25% Mexican Peso bonds	12.43%	-	4.87%	7.56%	1,588
25% Swedish Kroner	8.12%	-	4.87%	3.25%	683
ECU Deposit	9.62%			9.62%	<u>2,020</u>
TOTAL					<u>6,614</u>

Dollar-Invest requires the investor to deposit a minimum of US\$25,000, which is used as collateral for a \$150,000 loan (six times leverage) at 4.87%. The entire \$175,000 is then invested into a special mutual fund formed by Jyske Bank that invests in New Zealand, US, Australian, and Canadian bonds. This mutual fund has been yielding approximately 7.95%, so the investor yields 7.95% on the \$25,000 invested, plus 3.08% on the \$150,000 of borrowed funds for a total yield of 26.4%:

$$\begin{aligned}
 & \$ 25,000 @ 7.95\% = \$1,987 \\
 & \$150,000 @ 3.08\% = \underline{\$4,620} \\
 & \qquad \qquad \qquad \$6,607/\$25,000 = 26.4\%
 \end{aligned}$$

As far as the bond mix, 50% of the mutual fund is invested in BB+ or BBB quality US dollar bonds, and 50% is invested in New Zealand, Canadian, and Australian dollar bonds rated A+ or AA. Therefore, the investor gains bond diversification due to the various types of bonds held, as well as reduced foreign exchange risk, since the foreign currencies used are closely related to the US dollar.

Euro-Invest provides the advantages of the MCCL technique, but differs in that the bank manages the selection of currencies for the investor. The money is placed in a fund that invests in certificates of deposit and medium term bonds, 80% of which must be denominated in European currencies. Jyske Bank follows the market trends closely and manages which currencies are held in the fund. Therefore, investors are provided the opportunity to put their money into high yielding currencies without having to closely follow currency markets. Yield for this type of investment are similar to returns realized on Jyske Bank's invest-loan/European strategy, depending on the amount of leverage utilized. Investors have the option of investing in the fund with or without leverage. Without leverage, the investment minimum is low: \$8,000. With leverage, the fund can be used in conjunction with the invest-loan program. In this case, the investment minimum is \$21,000 and the bank will lend up to four times the investment in the currency of choice.

RISKS

There are several inherent risks in the utilization of the MCCL. These risks include foreign currency risk, interest rate risk, risk due to additional leverage, and bond default risk.

The greatest risk in the MCCL is that the foreign exchange value of the borrowed currency will appreciate against the currency on deposit, or the deposited currency will depreciate. A stop-loss order will reduce or eliminate such as loss. A stop-loss order allows the investor to close the position on the MCCL if the value of the borrowed currency rises past the point at which the interest spread profit is zero (breakeven point). However, the foreign exchange risk can be completely hedged due to the existence of the forward exchange market. The exchange rate to be used is already set in terms of the forward contract, so the amount of dollars to be received is guaranteed.

The risk of rising interest rates on the borrowed currency or a falling interest rates on the deposited currency is far less dangerous than an unhedged or uncovered currency risk and much more manageable. If unfavorable interest rate fluctuations eliminate the interest spread profit, the MCCL position can be closed-out with minimal losses.

The additional profit in the MCCL comes from low cost leverage. Risk is incurred by borrowing up to the maximum loan/value limit (four times the amount on deposit). Any unfavorable parity change between the borrowed currency and the funds on deposit will decrease the investor's collateral and increase the loan commitment. When the bank's loan/value limit is exceeded, the bank will require the investor to put up more money or else will liquidate the MCCL position.

When utilizing the Dollar-Invest program, the investor faces default risk on the bonds. The US dollar portion of the Dollar-Invest package invests in lower-end investment grade bonds. Some BB+ or BBB grade rated companies may fail over the next few years, resulting in the bonds of these companies becoming worthless.

CONCLUSION

Although astute investors have been using the principles of interest rate arbitrage for generations, there are some new variations of this approach that have just been introduced by banks in Europe. These techniques were presented in this report as the Invest-Loan, Dollar-Invest programs. Each offers unique advantages based on the investors risk level, the amount of leverage used, and the desire of the investor to actively or passively manage the selection of currencies. However, the returns on an MCCL position are not available without incurring some measure of risk. In fact, there can be considerable risk at times, especially if the investor is using total leverage and borrows the maximum of four times the amount on deposit. Other risks were discussed and include currency risk, interest rate risk, and default risk on foreign and domestic bonds. The total risk that is inherited in the various MCCL techniques may actually be too high for the risk averse investor. In addition, transaction costs must be taken into consideration. In order for interest rate arbitrage to proceed, there must be a net profit available on the transaction after the deduction of bank fees that will be charged. The largest fee should be the foreign exchange cost of changing the borrowed currency to the currency of deposit and back. This cost is the result of the spread between the bid and ask rates on foreign currencies. Consequently, the MCCL decision-making process requires the investor to follow the interest parity, the currency parity, as well as the cost of the transaction. In consideration of the principles presented in this report, the MCCL appears to be a timely investment, and will most benefit the investor with basic knowledge of economic factors that affect foreign currency fluctuations and strategic currency choices.