

Federal National Mortgage Association¹ Global Notes due July 10, 2002

“Yes, Mehmood, the bonds are trading very well,” said Martin Scheck, Executive Director of SBC Warburg’s Debt Origination team.² He was talking to Mehmood Nethani, Treasurer of Federal National Mortgage Association (FNMA), with whom he had negotiated an unusual Australian dollar \$1,000,000,000 five-year global note issue the day before, which had been swapped into U.S. dollars. FNMA, a triple-A rated U.S. government-affiliated mortgage-finance corporation, was one of the largest issuers of debt in the world.

“There is comment from *Euroweek*, which I have faxed to you. The deal has generated quite a bit of favorable publicity within the industry. Indeed, it was oversubscribed, and investors are already expressing interest in more deals along the same line. We’ll talk to you about that soon,” said Scheck, ending the conversation.

He leaned back in his chair, satisfied that there was a good chance that this successful offering would lead to more business between SBC and FNMA in the future. Scheck was sure that Nethani was happy with the deal. SBC Warburg had shown its ability to recognize a market opportunity in the Australian debt market, structure a transaction to fit the opportunity, and execute the deal on a global scale. FNMA’s proceeds from the deal totaled U.S. \$751 million, which translated to an “all-in” cost of borrowing of approximately 6.45% – comparable to what FNMA would have borrowed at in the US dollar market. This cost included interest on the bonds, banking fees, and the cost of swapping the Australian dollars into US.

Completing a deal of this size and complexity – a huge Australian dollar deal for a US issuer sold globally by a Swiss/British banking firm – was clearly a feather in the cap for SBC Warburg, particularly when the deal had been “snatched right out from under the noses of the big American investment bankers.” Consolidation in the industry had greatly increased the level of competition among global banks, and the ability to design, sell and execute innovative transactions like this was becoming increasingly important. This deal clearly demonstrated SBC Warburg’s capabilities as an integrated global bank, Scheck thought, and it was also valuable because it could lead to an expansion of the

¹ This case was prepared by Victor Sack, under the direction of Prof. Roy C. Smith, at the Stern School of Business, New York University, in May 1998. For classroom use only. Not to be reproduced without permission..

² SBC Warburg was renamed Warburg, Dillon Read after this issue was completed. Swiss Bank Corporation, the firm’s parent company, announced plans in early 1998 to merge with Union Bank of Switzerland to create Switzerland’s largest bank, UBS. In May 2000 the firm was renamed UBS Warburg.

relationship with Fannie Mae, one of the largest private issuers of debt in the world.

Pouncing on an Opportunity

The basic idea for the deal was developed in May and June 1997 through a series of conference calls between Scheck's Debt Origination team in New York, and SBC Warburg's Rates Origination teams in London and Sydney. These teams were in constant touch with each other, conducting numerous global transactions on a daily basis. In addition to these transactional conversations, the teams also discuss long-term market trends, and the opportunities that could arise from these trends. On the FNMA deal, the focus of the discussions revolved around a number of events occurring in Australia that were affecting both the supply and demand for government and quasi-government debt securities in the Australian markets, include:

- A change by the Australian authorities in the required reserve requirement for inter-bank lending from 6% to 3%. This freed up a large block of capital that would need to be invested in low-risk securities, increasing total investor demand.
- The significant growth of funded pension plans in Australia, which was creating increased demand for low-risk securities.
- An overall general decline in the supply of Australian government bonds due to increased fiscal rectitude on the part of the government, also decreasing supply.
- The pending maturity of several key government bonds in the five-year maturity range. As yet, there were no plans to issue new bonds to replace those that were maturing. This served to decrease the supply of bonds at the same time that demand was increasing.

The convergence of these events was creating a "soft spot," in the domestic market for high-grade Australian fixed-income securities. This demand was strong, and would last awhile, the SBC Warburg team believed. But it was not strong enough by itself to supply a large, liquid market for global Australian dollar denominated securities. For this to happen, the Australian market would have to be supplemented by attracting non-Australian investors.

However, these investors were discouraged by the fact that investing in Australian issuers involved a withholding tax. Non-Australian issuers (which were exempt from the tax) on the other hand, had hardly any requirement for

Australian dollar liabilities, so if they chose to finance in A\$, they would need to swap them into their own currencies for such an issue to make sense to them. For qualified issuers, under normal conditions, the payment of the market rate of interest plus the cost of swapping the proceeds back into dollars would make borrowing in Australian dollars more expensive than borrowing in their own currencies.

Structuring the Deal

Scheck and his team realized that the opening in the Australian market might be just enough to attract a major non-Australian issuer whose paper could also be sold to investors in the US and Europe in a liquid, global issue. The deal would have to be priced very aggressively, however, so that the costs, including the swap arrangements, would still be competitive. The soft-spot in the Australian market, Scheck thought, might just be enough to capture the necessary pricing advantage. Still, the market could change or other issuers move ahead more quickly and the opportunity could disappear. The SBC Warburg team decided that they would give it a try, focusing intensely on:

- Finding the right borrower—the issuer would have to be practically risk-free, and seen as virtually equivalent to the debt rating of the Australian government. They could not go out to too many prospective borrowers for fear of getting more mandates than they could handle, or letting the word of their idea leak out to competitors. They would have to float the concept with the target as a “proprietary” idea that SBC Warburg would hold for the issuer, but about which the target issuer was pledged to silence. Thus, selection of the right target was very important.
- The size of the offering – the issue would aim to combine domestic and international demand for Australian dollar investments, but how big could it be? To get the best rates for the client, the bond offering would have to be large enough to support highly liquid secondary-market trading in all key markets around the world. But if the team promised more than it could deliver, the issue might be a disaster for the underwriters.
- Any offering from a foreign borrower in A\$ would have to be hedged by swapping the currency exposure back into the issuer’s home currency. Equally, some of the investors would want to swap their contract to receive Australian dollars in the future into US dollars or other currencies. Very large swaps involving Australian dollar bond offerings were rare, and the cost of the swap transaction would have to keep the overall cost of the financing (in US dollars) fully competitive. SBC Warburg, however, could turn to its parent, Swiss Bank Corporation, a AA rate bank of high international standing, to

serve as the swap transaction counterparty. But that would mean getting separate approvals from Switzerland.

- The total package – the global offering, the hedge, and the swap would have to be combined into one seamless instrument, for issuers and investors and subsequent market-makers – which was quite a challenge for any bank

Early on, they identified FNMA as a potential client with the size, risk characteristics, and name recognition that could fully maximize the nature of the opportunity. Additionally, over the prior few months Nethani and his colleagues had informally communicated to its bankers that it were interested in becoming a more visible issuer of bonds in different currencies. In so doing, FNMA was not only looking to borrow at lower rates, but was seeking to broaden its sources of funding in order to increase its name recognition as a global borrower, as well as to diversify the risk from being overly exposed to one capital market. It was particularly interested in swapped-deals in currencies that had been accepted by global institutional investors. A recent FNMA issue in New Zealand dollars had proved quite a success, and highlighted interest among the institutional investors for a similar Australian dollar offering. When approached by Scheck, Nethani confirmed Fannie Mae's interest and asked for a proposal.

Scheck had been excited by the prospect, and hurried to respond. However, a number of key issues remained to be decided.

How to price such an issue? Despite the favorable markets, spreads on outstanding bonds issued in the Australian dollar market were trading at a premium to US corporate spreads, but were these even comparable to a global offering from an issuer like Fannie Mae, given the uniqueness of the deal?

Should this be a bought deal, or subject to overnight price confirmation? In a bought deal, SBC Warburg would commit to a fixed price, and be held to that price even if it meant buying the bonds themselves should the demand for the notes be disappoint. However, in a "fixed-price re-offer" deal the notes could be "offered" on an overnight basis, and once market interest was gauged, a price could be set that would appear to allow the bonds to clear the market. Then this price, once agreed to by the issuer, would be fixed. Obviously Fannie Mae would prefer the assurance of a bought deal, but that would put a lot of pressure on the underwriters, possibly affecting their pricing.

Who should the targeted investors be? Prior to offering a deal of this size it was important to understand who would be buying the paper, and what their motivations were. This would have implications on how the bonds will be registered, especially in the U.S.

Should the notes be registered with the SEC in the United States, or sold as a Rule 144a private placement? Registration would provide wide access to US investors, but would slow down the process and add to the cost. Alternatively, issuers could elect to offer notes under private placement rules that precluded registration, but limited the market to “qualified institutional buyers.”

Should there be “co-lead” managers on the deal? SBC Warburg would need to consider whether it should bring in other banks as co-lead managers to share the underwriting risks and assist in the placing of the notes. In deals of this size and uniqueness, greater placing power would be welcome. But adding other banks would dilute SBC Warburg’s credit in arranging the financing and its potential profits from the deal.

Over the following three weeks, Scheck and the origination team worked to iron out these issues. It was decided that the target pricing would initially be set at 18 to 20 bps over the comparable Australian government CGL 2002 (Commonwealth Government Loan) bond, a very low spread for the Australian bond market, reflecting the pent-up demand for an A\$ offering as well as the strong Fannie Mae name. The bonds would be non-callable, five year maturity securities, similar to the structure of the government bonds. It was also decided that, to be sure of their pricing they would offer FNMA the bonds on an overnight price confirmation basis. This meant that once a price had been set after the overnight marketing, the underwriters would have to sell the bonds at that price until SBC Warburg “released” them from this obligation and active bid/ask pricing could begin. This feature would help ensure that all the bonds would be sold, and that all participants would receive fair and equal treatment in the syndication process.

The offering would be targeted exclusively at institutional investors, both inside and outside Australia. Liquidity was of primary importance to these investors. The combination of the FNMA name, the strong underwriting syndicate, and the global size of the issue, promised to assure them of adequate liquidity and active trading markets. In the U.S., the bonds would be registered with the SEC, increasing their attractiveness to the large institutional buyers, and further increasing their liquidity in secondary market trading.

After consultation with colleagues in London and Zurich, SBC Warburg decided to invite Deutsche Morgan Grenfell (DMG) and Merrill Lynch to be “co-lead managers.” DMG was known for a strong presence and distribution capability in Australia. Merrill was selected based on its overall global strength in supporting and distributing global bond issues.

The Final Days

Nethani was kept well informed of the progress of the deal as syndication began. As word leaked out to the financial community, some of SBC Warburg's competitors told Fannie Mae that the deal was too big—that it would never work. Additionally, this would be the first issue in which Fannie Mae had worked with a single bookrunner. Regardless, Scheck and his team worked on, and by mid-June the last remaining obstacle was the construction of the hedge/ swap.

Under the terms of the swap, Fannie Mae would receive the proceeds of the deal in US dollars, and make coupon payments in US dollars. Swiss Bank Corporation, would handle the initial and subsequent coupon payments for FNMA as counterparty. The bank would also offer, through the SBC Warburg sales force, the reverse of this swap to non-Australian investors seeking to exchange US dollar receipts for Australian dollars. Pricing of the swap transactions was critical for the overall economic viability of the deal – FNMA did not want to pay more for the Australian dollar notes than it would have to pay for a note issue of comparable size in the United States.

Once FNMA gave the final go-ahead for the deal to proceed, it took the SBC teams about five days to finalize the swap and get the bonds ready for trading. On June 25th the bonds appeared on the screens of traders around the world, and the issue was launched. The success of the offering became apparent early on. Before the close of business in Australia, orders from investors worldwide exceeded A\$250 million, far more than expected. Throughout the day, as the issue opened in the major global bond markets demand continued to exceed expectations. By close of the day, total subscriptions had exceeded A\$1.5 billion globally, leaving the managers free to distribute the bonds to the highest quality investors (further increasing their liquidity). Key investors included all dedicated Australian dollar investment funds, global bond funds, and global portfolio managers (insurance and mutual funds). Approximately 9% of the bonds were distributed in Australia, 13% in the rest of Asia, 31% to fund managers in the UK, 21% in the United States, 12% in Germany, and 14% in the rest of Europe.

Case Question:

What things especially strike you as being significant in this case? Why?