SECTION - D

INTERNATIONAL FINANCIAL MANAGEMENT

The International Financial Environment 14

This Module Includes:

14.1 International Financial Institutions and Markets

14.2 Sources of Foreign Currency

The International Financial Environment

SLOB Mapped against the Module

To develop a detail understanding of the sources and impact of risks to which an organisation is exposed to in a dynamic business environment at national and international level and the techniques for managing the same to sustain competitive advantages. (CMLO 3b, 3c)

Module Learning Objectives:

After studying this module, the students will be able to -

- Understand the role of International Financial Institutions
- Develop an understanding of different sectors of International Financial Market
- Acquire adequate knowledge about various sources of foreign currency

International Financial Institutions and Markets

14.1

Around the world, financial markets are getting integrated. People and firms are entering into more and more cross-border financial deals. In order to make these transactions feasible, a system for determination of the amount and method of payment of the underlying financial flows is needed. Since each country has a currency different from the other, the flows should take place in some mutually acceptable currency. The parties involved will then need to convert the amount involved into their domestic currencies. However, there must be well defined rules, regulations and procedures to enable such conversion. The set of rules, regulations, institutions and mechanisms which determine the rate at which this conversion takes place (called the exchange rate) and the movements in the exchange rate over a period is called the international monetary system. In addition, the system also includes intermediary and facilitating institutions and well-integrated markets to support international trade and finance. All these elements together form the international financial environment.

14.1.1 International Financial Institutions

As mentioned earlier, international financial institutions play the role of a facilitator and intermediary. An international financial institution (IFI) is basically a financial institution that has been established by more than one country, and hence is subject to the international law. Its owners or shareholders are generally the national governments, although other international institutions and other organisations also occasionally figure as shareholders. Generally, IFIs are the creations of multiple nations, although some bilateral financial institutions (created by two countries) do exist and should also technically be termed as IFIs.

The idea of IFIs was first conceived of under the Bretton Woods System post the World War II. The Second World War effectively stopped all international economic activities. Global economic growth was severely affected. On one hand, the warring nations suffered huge damages on account of the war, and on the other hand, most of the countries were suffering from hyper-inflation. The continuing war also made any co-operation on the economic front absolutely impossible. In this scenario, the need was felt for an economic system which would restore international trade and investments. For this, however, a system of stable exchange rates was required, which would also ensure that the countries do not get any incentive by following inflationary policies. In addition, there was a need for some arrangement which would help countries to tide over their short-term balance of payments problems and help them remain within the system without causing undue turmoil in their economies.

In 1944, representatives of 44 countries assembled in Bretton Woods, New Hampshire, USA, and signed an agreement to establish a new monetary system which would address all these issues. This system came to be known as the Bretton Woods System.

Accordingly, two new institutions were established, namely, the International Monetary Fund (IMF) and the World Bank. International Monetary Fund was established to promote international monetary cooperation, exchange rate stability, and orderly exchange arrangements; to accelerate economic growth and facilitate high levels of employment; and to provide temporary financial assistance to countries to help balance of payments adjustment.

On the other hand, World Bank was established to help countries in reconstructing their economies in the post-World War-II scenario and to help the developing countries improve their economic growth rate. Though the Bretton Wood System failed subsequently, these two IFIs are still playing significant role in the international monetary system. Also, a number of other IFIs have been established over the time. The IFIs are discussed below.

A. International Monetary Fund (IMF)

The IMF was conceived in July 1944 at the United Nations Bretton Woods Conference in New Hampshire, United States. The 44 countries in attendance sought to build a framework for international economic cooperation and avoid repeating the competitive currency devaluations that contributed to the Great Depression of the 1930s.

The IMF's primary mission is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries and their citizens to transact with each other. Accordingly, IMF promotes international financial stability and monetary cooperation. It also facilitates international trade, promotes employment and sustainable economic growth, and helps to reduce global poverty. The IMF is governed by and accountable to its 190 member countries.

At the top of IMF's organizational structure is the Board of Governors. The daily operation of the IMF is overseen by its 24-member Executive Board, representing the entire membership and supported by IMF staff. The Managing Director is the head of the IMF staff and Chair of the Executive Board. He/she is assisted by four Deputy Managing Directors.

Resources for IMF loans to its members on non-concessional terms are provided by member countries, primarily through their payment of quotas. Each member of the IMF is assigned a quota, based broadly on its relative position in the world economy. The IMF regularly conducts general reviews of quotas to assess the adequacy of overall quotas and their distribution among members. Multilateral and bilateral borrowing (New Arrangement to Borrow or NAB and Bilateral Borrowing Agreements or BBA) serve as a second and third line of defense, respectively, by providing a temporary supplement to quota resources. These borrowed resources played a critical role in enabling the IMF to support its member countries during the global economic crisis.

The IMF has three main functions: overseeing economic development, lending, and capacity development.

IMF oversees economic development by encouraging international trade, fostering global monetary cooperation and securing financial stability.

All IMF members are eligible to access the Fund's resources in the General Resources Account (GRA) on non-concessional terms, but the IMF also provides concessional financial support (currently at zero interest rates through June 2021) through the Poverty Reduction and Growth Trust, which is better tailored to the diversity and needs of low-income countries. IMF lends to its member countries under various schemes.

B. World Bank Group

In addition to IMF, the Bretton Wood System also proposed the establishment of the World Bank. World Bank is structured like a cooperative that is owned and operated for the benefits of its member countries. It was established in July, 1944.

The World Bank is made up of two unique development institutions owned by the member countries. These two institutions are –

(a) **The International Bank for Reconstruction and Development (IBRD):** It lends to governments of middle-income and creditworthy low-income countries. It has 189 member countries.

(b) **The International Development Association (IDA):** It provides interest-free loans (called credits) and grants to governments of the poorest countries. It has 174 members.

The World Bank Group, however, includes three more institutions –

(a) **The International Finance Corporation (IFC):** It is the largest global development institution focused

exclusively on the private sector. We help developing countries achieve sustainable growth by financing investment, mobilizing capital in international financial markets, and providing advisory services to businesses and governments.

(b) The Multilateral Investment Guarantee Agency (MIGA): It was created in 1988 to promote foreign direct investment into developing countries to support economic growth, reduce poverty, and improve people's lives. MIGA fulfills this mandate by offering political risk insurance (guarantees) to investors and lenders.

(c) The International Centre for Settlement of Investment Disputes (ICSID): It provides international facilities for conciliation and arbitration of investment disputes.

The World Bank generally makes medium- and long-term loans for infrastructure projects. It is also lending to countries having BoP problems, if they are willing to adopt growth-oriented economic policies. It requires a government guarantee for making these loans. For these activities, it raises funds through subscriptions from member countries and by issuing bonds which are generally meant for private subscription.

C. Regional Development Banks (RDBs)

Regional development banks provide funds for the financing of manufacturing, mining, agricultural, and infrastructure projects essential for development. They tend to support projects that promote regional cooperation and economic integration. In most of the cases, repayment terms for the loans are over a 5 to 15 year period at favorable interest rates. The leading regional development banks include the following:

- **European Investment Bank (EIB):** The EIB offers financial assistance for certain public and private projects in European and other nations associated with the Common Market. It emphasizes loans to the lesser-developed regions in Europe and to the associated members in Africa.
- **Inter-American Development Bank (IADB):** The IADB is an important source of long-term capital in Latin America. It provides loans to joint ventures, both minority and majority foreign-owned, and also provides small amounts of equity capital. One initiative was to act as a catalyst for further private sector funding for Latin American infrastructure projects. By partially guaranteeing commercial bank loans and directly lending to infrastructure projects, the IADB aims to bring funding to many projects for which commercial bank loans might not otherwise be available.
- **Atlantic Development Group for Latin America (ADELA):** ADELA is an international private investment company working towards the socio-economic development of Latin America. Its objective is to strengthen private enterprises by providing capital and entrepreneurial and technical support.
- **Asian Development Bank (ADB):** The ADB guarantees or makes direct loans to member states and private ventures in Asian/Pacific nations and helps develop local capital markets by underwriting securities issued by private enterprises.
- **African Development Bank (AFDB):** The AFDB makes or guarantees loans and provides technical assistance to member states for various development projects. Beneficiaries of AFDB loans and activities are normally governments or government-related agencies.
- **Arab Fund for Economic and Social Development (AFESD):** The AFESD is a multilateral Arab fund that actively searches for projects (restricted to Arab League countries) and then assumes responsibility for project implementation by conducting feasibility studies, contracting, controlling quality, and supervising the work schedule.
- **European Bank for Reconstruction and Development (EBRD):** The EBRD was founded in 1990 with an initial capital of about $13 billion. It is supposed to finance the privatization drive in Eastern Europe.

Among the other regional development banks are Islamic Development Bank Group (IsDB), West African Development Bank, Development Bank for Central African States etc.

The Regional Rural banks are generally the multilateral development banks. In addition to this, there may be

Bilateral Development banks as well. A bilateral development bank is a financial institution set up by one individual country to finance development projects in a developing country and its emerging market. Examples include:

- the Netherlands Development Finance Company FMO, headquarters in The Hague is one of the largest bilateral development banks worldwide.
- the DEG German Investment Corporation headquartered in Cologne, Germany.
- the French Development Agency and Caisse des dépôts, founded 1816, both headquartered in Paris, France.
- the CDC Group, a development finance institution owned by the UK Government headquartered in London.

D. National Development Banks (NDBs)

Some national development banks concentrate on a particular industry or region; others are multipurpose. These are mostly public institutions. However, there are several privately controlled development banks as well. The characteristics for success, however, are the same: they must attract capable, investment-oriented management; and they must have a large enough supply of economically viable projects to enable management to select a reasonable portfolio of investments.

E. Other Regional Financial Institutions

These are financial institutions of neighbouring countries established themselves internationally to pursue and finance activities in areas of mutual interest; most of them are central banks. Example include –

- **The Bank of International Settlement (BIS):** Established in 1930, the BIS is owned by 63 central banks, representing countries from around the world that together account for about 95% of world GDP. Its head office is in Basel, Switzerland. Its medium-term strategy, Innovation BIS 2025, leverages technology and new collaboration channels to serve the central banking community in this fast-changing world.
- **The European Investment Bank (EIB):** It is the European Union's investment bank and is owned by the EU Member States. It is one of the largest supranational lenders in the world. The EIB is a not-for-profit organisation which funds projects that achieve the policy aims of the European Union through loans, guarantees and technical assistance.
- **International Investment Bank (IIB):** It is a multilateral development institution with headquarters in Budapest, Hungary. It was established in 1970 and operates as an international organisation. IIB specializes in medium- and long-term financing of projects aimed at supporting the economies of its members that would have a significant positive social, economic and environmental impact. IIB offers direct financing and provides loans in partnership with other financial institutions as well as through partner banks.
- **The European Central Bank (ECB):** It is the prime component of the Eurosystem and the European System of Central Banks (ESCB) as well as one of seven institutions of the European Union. It is one of the world's most important central banks.

14.1.2 International Financial Markets

International financial markets may be defined as the markets that operate worldwide and facilitate international trade and finance. Due to growth in international business over the last 50 years, various international financial markets have been developed which cater to specific needs of the participants. These markets can broadly be categorized into the following –

- Foreign Exchange Market
- International Money Market
- International Credit Market
- International Bond Market
- International Stock Market

Sources of Foreign Currency 14.2

An organisation may obtain foreign currency financing either by Debt Route or by Equity Route. Various instruments under each of them are discussed below:

14.2.1 Debt Route

The avenues available under Debt route are as follows:

A. Eurobonds

Eurobonds are bonds denominated in a currency other than that of the country in which they are issued. A bond denominated in Japanese Yen and issued in the UK, or a bond denominated in US dollars and issued in France or the UK are examples of Eurobonds. London is the preeminent market for Eurobonds along with other types of bonds.

Many companies borrow in the international capital markets via Eurobonds. Investors purchase such bonds from foreign issuers, in addition to buying bonds from domestic issuers to gain exposure to international markets. Eurobonds should not be confused with bonds that are issued in a foreign country but in the same currency as the investor. For example, a yen-denominated bond sold by a non-Japanese issuer (such as a French company) in Japan, or a US dollar-denominated bond sold by a German company in the US.

Eurobond issue structures can be classified into two broad categories; Fixed rate bonds (also known as straights) and Floating Rate Notes (FRN).

Straight Debt Bonds are fixed interest-bearing securities which are redeemable at face value. These unsecured bonds which are floated in domestic markets or international markets, are denominated in the respective currency with interest rates fixed on the basis of a certain formula applicable in a given market. The bonds issued in the Euro-market referred to as Euro-bonds, have interest rates fixed with reference to the creditworthiness of the issuer. The yields on these instruments depend on short-term interest rates. LIBOR is the most commonly used benchmark for measuring the yields on these bonds. The interest rate on dollar denominated bonds is set at a margin over the US treasury yields. On the other hand, FRNs can be described as a bond issue with a maturity period varying from 5-7 years having varying coupon rates - either pegged to another security or re-fixed at periodic intervals. Conventionally, the paper is referred to as notes and not as bonds. The spreads or margin on these notes will be above 6 months LIBOR for Eurodollar deposits. FRNs are restructured into the different types, such as, Flip-Flop FRNs (where the investors have the option to convert the paper into flat interest paying instrument at the end of a particular period), Mismatch FRNs (these notes have semi-annual interest payments though the actual rate is fixed monthly) and Mini-Max FRNs (These notes include both minimum and maximum coupons).

Eurobonds account for approximately 30% of the global bond market. Often very large companies (multinational companies and supranational organisations) and countries prefer to issue Eurobonds denominated in that currency (for example, the US dollar) that can offer the most attractive interest rate.

An advantage of Eurobonds is that they are relatively easy to sell, have relatively low risk and are a fairly safe

investment alternative. Another advantage is that Eurobonds remain outside the purview of official regulation of the country of the currency in which they are denominated.

B. Foreign Bonds

These are relatively lesser-known bonds issued by foreign entities for raising medium-to long-term financing from domestic money centers in their domestic currencies. Different types of foreign bonds are as follows:

a. Yankee Bonds: These are US dollar denominated issues by foreign borrowers (usually foreign governments or entities, supranational and highly rated corporate borrowers) in the US bond markets. Reliance Industries Ltd. has been the most successful corporate to tap this instrument with a 50-year, $50 million Yankee Bond issue in 2013.

b. Samurai Bonds: These are bonds issued by non-Japanese borrowers in the domestic Japanese markets. Borrowers are supranational and have at least a minimum investment grade rating (A rated). The maturities range between 3-20 years.

c. Bulldog Bonds: These are sterling denominated foreign bonds which are raised in the UK domestic securities market. The maturity of these bonds will be either for very short periods (5 years) or for very long maturities (25 years and above). Bonds with intermediate maturity periods are rare. These bulldog bonds are generally subscribed by long-term institutional investors like pension funds and life insurance companies.

d. Shibosai Bonds: These are the privately placed bonds issued in the Japanese markets. The qualifying criteria is less stringent as compared to Samurai or EuroYen bonds. Shibosai bonds are offered to a different market segment that consists of institutional investors, including banks.

C. Foreign Currency Convertible Bonds

Foreign currency convertible bonds, as the name suggests, are bonds that are issued in a currency foreign to the investor. The name also suggests that the bonds are convertible in nature, indicating that investors not only receive principal and coupon payments but also offer the option of converting their bonds into stocks. Foreign currency convertible bonds are classified as quasi-debt instruments and tradable on the stock exchange. Investors are hedge-fund arbitrators or foreign nationals.

Benefits of FCCBs:

a) The coupon rates on FCCB's are generally lower than traditional bank interest rates, reducing the cost of debt financing for the issuer.

b) When converted, the issuer is able to reduce its debt gains additional, much-needed equity capital.

c) If there is a favorable move in the exchange rate, the issuer may benefit from a reduction in the cost of debt.

d) Investors have an assured minimum fixed rate of return.

e) Investors can participate in any price appreciation in the issuer's stock upon conversion.

f) Investors enjoy the flexibility in choosing to enter the capital market or receiving a stable stream of income through bond payments (coupons).

Limitations of FCCBs

a) If the stock market is down, the demand for foreign currency convertible bonds decreases.

b) If converted, ownership will be diluted, and earnings per share will decrease for existing shareholders.

c) If there is an unfavorable move in the exchange rate, the principal and coupon payments will become more costly.

d) These are subject to credit risk.

e) Bondholders have no control over the established conversion rates and prices.

D. Syndicated Credits

These are bank loans, usually at floating rate of interest with fixed maturity, arranged by one or more lead managers (banks) with a number of other banks participating in the loan. Generally, one, two or even three banks may act as the lead managers and distribute the loan among themselves and other participating banks. A typical Eurocredit we have maturity between five and 10 years, amortization in semiannual instalments, and interest rate every three or six months with reference to LIBOR.

Syndicates are classified into two types - club loans and syndicated loans.

The club loan is a private arrangement between lending banks and a borrower. Conventionally, the entry into Euromarkets for a funding deal is well-publicized. When the loan amounts are small and parties familiar with each other, lending banks form a club and advance a loan. Therefore, in view of this private arrangement, an information memorandum is not complied and neither is the deal publicized in the financial press.

Syndicated credits can be structured to incorporate various options. As in the case of FRNs, a drop-lock feature converts the floating rate loan into a fixed rate loan if the benchmark index hits a specified floor. A multicurrency option allows the borrower to switch the currency of denomination on a rollover date.

E. Euro Notes

Euronotes as a concept is different from syndicated bank credit and is different from Eurobonds in terms of its structure and maturity period. Euronotes command the price of a short-term instrument usually a few basis points over LIBOR and in many instances at sub-LIBOR levels. The documentation formalities are minimal (unlike in the case of syndicated credits or bond issues) and cost savings can be achieved on that score too. There are numerous-applications of basic concepts of Euronotes. These may be categorized under the following heads:

a. **Commercial Paper:** These are short-term unsecured promissory notes which repay a fixed amount on a certain future date. Euronotes, underlying CP, are unsecured and stand on the general creditworthiness of the issuers. Referred as Euro Commercial Paper, these papers are not underwritten and have maturities up to one year, mostly by way of three-month or six-month paper.

b. **Note Issuance Facilities (NIFs):** A NIF is a medium-term legally binding commitment under which a borrower can issue short-term paper, of up to one year. The underlying currency is mostly US dollar. In a typical NIF program, the issuer instructs the lead manager to issue Euro notes at desired intervals. Maximum and minimum amounts of each issue are also specified.

c. **Medium Term Notes:** MTNs are defined as sequentially issued fixed interest securities which have a maturity of over one year. A typical MTN program enables an issuer to issue Euronotes for different maturities, from over one year up to the desired level of maturity. These are essentially fixed rate funding arrangements.

F. Euro-bonds with Equity Warrants: These bonds carry a coupon rate determined by the market rates. The warrants are detachable. Pure bonds are traded at a discount. Fixed income funds' managers may like to invest for the purpose of regular income.

G. Euro Convertible Bonds: Euro Convertible Bonds are quasi debt securities (unsecured) which can be converted into Depository Receipts or local shares at a fixed price after the minimum lock-in period. Price of Equity Shares at the time of conversion will have a premium element. Bonds carry a fixed rate of interest, and the payment of interest is made in US Dollars.

Issue of these Bonds carry options —

Call Option: Right to the Company to convert the ECB into Equity before maturity. Pre-Mature conversion is generally done, when the market price of the shares exceeds a particular percentage of the conversion price.

Put Option: Put Option allows the investors to get his money back before maturity.

Company desirous of issuing ECB, should obtain the prior permission of Ministry' of Economic Affairs. Certain restrictions are imposed on the eligibility norms such as good financial track record, nature of industry etc.

Proceeds of ECBs can be applied only for the following —

(a) Import of Capital Goods,

(b) Retiring Foreign Currency Debts,

(c) Capitalizing Indian Joint Venture Abroad,

(d) Application for Working Capital and Others is restricted to 25% of total proceeds.

H. Euro-Convertible Zero Bonds: These bonds are structured as convertible bonds. No interest is payable on the bonds, but the conversion of bonds takes place on maturity at a pre-determined price. Usually there is a 5 years maturity period and they are treated as a deferred equity issue.

14.2.2 Equity Route

The avenues available under Equity route are as follows:

A. Depository Receipts

A depositary receipt (DR) is a type of negotiable (transferable) financial security that is traded on a local stock exchange but represents a security, usually in the form of equity, that is issued by a foreign publicly listed company. The DR, which is a physical certificate, allows investors to hold shares in equity of other countries. One of the most common types of DRs is the American Depositary Receipt (ADR), which has been offering companies, investors and traders global investment opportunities since the 1920s.

Since then, DRs have spread to other parts of the globe in the form of global depositary receipts (GDRs) (the other most common type of DR), European DRs and international DRs. ADRs are typically traded on a U.S. national stock exchange, such as the New York Stock Exchange (NYSE) or the American Stock Exchange, while GDRs are commonly listed on European stock exchanges such as the London Stock Exchange. Both ADRs and GDRs are usually denominated in U.S. dollars, but can also be denominated in euros.

Working of DR

The DR is created when a foreign company wishes to list its already publicly traded shares or debt securities on a foreign stock exchange. Before it can be listed to a particular stock exchange, the company in question will first have to meet certain requirements put forth by the exchange. Initial public offerings, however, can also issue a DR. DRs can be traded publicly or over-the-counter.

Pricing and Cross-Trading

When any DR is traded, the broker will aim to find the best price of the share in question. He or she will therefore compare the U.S. dollar price of the ADR with the U.S. dollar equivalent price of the local share on the domestic market. For example, if the ADR of the Russian gas company is trading at US$12 per share and the share trading on the Russian market is trading at $11 per share (converted from Russian rubles to dollars), a broker would aim to buy more local shares from Russia and issue ADRs on the U.S. market. This action then causes the local Russian price and the price of the ADR to reach parity. The continual buying and selling in both markets, however, usually keeps the prices of the ADR and the security on the home market in close range of one another. Due to this minimal price differential, most ADRs are traded by means of intra-market trading.

A U.S. broker may also sell ADRs back into the local Russian market. This is known as cross-border trading. When this happens, an amount of ADRs is canceled by the depository and the local shares are released from the custodian bank and delivered back to the Russian broker who bought them. The Russian broker pays for them in Rubles, which are converted into dollars by the U.S. broker.

The Benefits of Depository Receipts

The DR functions as a means to increase global trade, which in turn can help increase not only volumes on local and foreign markets but also the exchange of information, technology, regulatory procedures as well as market transparency. Thus, instead of being faced with impediments to foreign investment, as is often the case in many emerging markets, the DR investor and company can both benefit from investment abroad.

Benefits for the Company:

A company may opt to issue a DR to obtain greater exposure and raise capital in the world market. Issuing DRs has the added benefit of increasing the share's liquidity while boosting the company's prestige on its local market ("the company is traded internationally"). Depositary receipts encourage an international shareholder base, and provide expatriates living abroad with an easier opportunity to invest in their home countries. Moreover, in many countries, especially those with emerging markets, obstacles often prevent foreign investors from entering the local market. By issuing a DR, a company can still encourage investment from abroad without having to worry about barriers to entry that a foreign investor might face.

Benefits for the Investor:

Buying into a DR immediately turns an investors' portfolio into a global one. Investors gain the benefits of diversification while trading in their own market under familiar settlement and clearance conditions. More importantly, DR investors will be able to reap the benefits of these usually higher risk, higher return equities, without having to endure the added risks of going directly into foreign markets, which may pose lack of transparency or instability resulting from changing regulatory procedures. It is important to remember that an investor will still bear some foreign-exchange risk, stemming from uncertainties in emerging economies and societies. On the other hand, the investor can also benefit from competitive rates the U.S. dollar and euro have to most foreign currencies.

Giving you the opportunity to add the benefits of foreign investment while bypassing the unnecessary risks of investing outside your own borders, you may want to consider adding these securities to your portfolio. As with any security, however, investing in ADRs requires an understanding of why they are used, and how they are issued and traded.

Sponsored and Unsponsored DRs

Companies have a choice of four types of Depository Receipt facilities - unsponsored and three levels of sponsored Depository Receipts.

Unsponsored Depository Receipts are issued by one or more depositories in response to market demand, but without a formal agreement with the company. Today, unsponsored Depository Receipts are considered obsolete and, under most circumstances, are no longer established due to lack of control over the facility and its hidden costs. Sponsored Depository Receipts are issued by one depository appointed by the company under a Deposit Agreement or service contract. Sponsored Depository Receipts offer control over the facility, the flexibility to list on a national exchange in the U.S. and the ability to raise capital.

Sponsored Level I Depository Receipts

A sponsored Level I Depository Receipt program is the simplest method for companies to access the U.S. and non-U.S. capital markets. Level I Depository Receipts are traded in the U.S over-the-counter ("OTC") market and on some exchanges outside the United States. The company does not have to comply with U.S Generally Accepted Accounting Principles ("GAAP") or full Securities and Exchange Commission ("SEC") disclosure. Essentially, a Sponsored Level I Depository Receipt program allows companies to enjoy the benefits of a publicly traded security without changing its current reporting process.

The Sponsored Level I Depository Receipt market is the fastest growing segment of the Depository Receipt business. Among the Depository Receipt programs currently in opertaion, the vast majority of the sponsored programs are Level I facilities. In addition, because of the benefits investors receive by investing in Depository Receipts, it is not unusual for a company with a Level I program to obtain 5% to 15% of its shareholder base in Depository Receipt form. Many well-known multinational companies have established such programs including: Roche Holding, ANZ Bank, South African Brewery, Guinness, Cemex, Jardine Matheson Holding, Dresdner Bank, Mannesmann, RWE, CS Holding, Shiseido, Nestle, Rolls Royce, and Volkswagen to name a few. In addition, numerous companies such as RTZ, Elf Aquitaine, Glaxo Wellcome, Western Mining, Hanson, Medeva, Bank of Ireland, Astra, Telebrás and Ashanti Gold Fields Company Ltd. started with a Level I program and have upgraded to a Level II (Listing) or Level III (Offering) program.

Sponsored Level II and III Depository Receipts

Companies that wish to either list their securities on an exchange in the U.S. or raise capital use sponsored Level II or III Depository Receipts respectively. These types of Depository Receipts can also be listed on some exchanges outside the United States. Each level requires different SEC registration and reporting, plus adherence to U.S. GAAP. The companies must also meet the listing requirements of the national exchange (New York Stock Exchange, American Stock Exchange) or NASDAQ, whichever it chooses.

Each higher level of Depository Receipt program generally increases the visibility and attractiveness of the Depository Receipt.

Private Placement (144A) Depository Receipt

In addition to the three levels of sponsored Depository Receipt programs that trade publicly, a company can also access the U.S and other markets outside the U.S through a private placement of sponsored Depository Receipts. Through the private placement of Depository Receipts, a company can raise capital by placing Depository Receipts with large institutional investors in the United States, avoiding SEC registration and to non-U.S. investors in reliance on Regulations. A Level I program can be established alongside a 144A program.

a. American Depositary Receipts (ADR)

An American Depositary Receipt (ADR) is a certificate that represent shares of a foreign stock owned and issued by a U.S. bank. The foreign shares are usually held in custody overseas, but the certificates trade in the U.S. Through this system, a large number of foreign-based companies are actively traded on one of the three major U.S. equity markets (the NYSE, AMEX or Nasdaq).

Investors can purchase ADRs from broker/dealers. These broker/dealers in turn can obtain ADRs for their clients in one of two ways: they can purchase already-issued ADRs on a U.S. exchange, or they can create new ADRs.

To create an ADR, a U.S.-based broker/dealer purchases shares of the issuer in question in the issuer's home market. The U.S. broker/dealer then deposits those shares in a bank in that market. The bank then issues ADRs representing those shares to the broker/dealer's custodian or the broker-dealer itself, which can then apply them to the client's account.

A broker/dealer's decision to create new ADRs is largely based on its opinion of the availability of the shares, the pricing and market for the ADRs, and market conditions.

Broker/dealers don't always start the ADR creation process, but when they do, it is referred to as an

unsponsored ADR program (meaning the foreign company itself has no active role in the creation of the ADRs). By contrast, foreign companies that wish to make their shares available to U.S. investors can initiate what are called sponsored ADR programs. Most ADR programs are sponsored, as foreign firms often choose to actively create ADRs in an effort to gain access to American markets.

ADRs are issued and pay dividends in U.S. dollars, making them a good way for domestic investors to own shares of a foreign company without the complications of currency conversion. However, this does not mean ADRs are without currency risk. Rather, the company pays dividends in its native currency and the issuing bank distributes those dividends in dollars-net of conversion costs and foreign taxes – to ADR shareholders. When the exchange rate changes, the value of the dividend changes.

Advantages of ADRs: ADRs provide the following advantages -

(i) Access to Large Capital.

(ii) Access to Foreign Exchange.

(iii) No Change in the Shareholding / voting pattern.

(iv) Increased recognition for the Company internationally by bankers, customers, etc.

(v) No Exchange Rate risk since the Company pays interest and dividends in Indian Rupees.

Limitations of ADRs:

(i) High cost of Issue.

(ii) Requirement as to large size of issue.

(iii) Stringent compliance requirements.

b. Global Depository Receipt

These are a class of investment which allows international investors to own shares in foreign companies where the foreign market is hard to access for the retail investor, and without having to worry about foreign currencies and tax treatments. Global Depository Receipts are issued by international investments banks as certificates (the GDR) which represents the foreign shares but which can be traded on the local stock exchange. For example, a UK investor may be able to buy shares in a Vietnamese company via a GDR issued by a UK investment bank. The GDR will be denominated in GB Pounds and will be tradable on the London Stock Exchange. The investment bank takes care of currency exchange, foreign taxes etc. and pays dividends on the GDR in GB Pounds.

The concept originally started in the USA with the creation of American Depository Receipts which were created so that US retail investors could buy shares in a foreign company without having to worry about foreign exchange, or foreign taxes.

It should be noted that although the risks of owning the foreign shares directly have been removed, there is now a risk of third-party default, because the investment bank owns the underlying assets, and may not be able to pass on the benefits to ADR holders if they get into financial difficulty.

Global Depository Receipts (GDRs) are negotiable certificates issued by depository banks which represent ownership of a given number of a company's shares which can be listed and traded independently from the underlying shares. These instruments are typically used by companies from emerging markets and marketed to professional investors only.

GDRs can be listed on either the Main Market via a Standard Listing or on the Professional Securities Market. A GDR will be used to access two or more markets, usually London and the US. They are often launched for capital raising purposes, so the US element is generally either a Rule 144(a) ADR or a Level III ADR, depending on whether the issuer aims to tap the private placement or public US markets.

These securities are generally traded in US dollars on the Exchange's Electronic Trading Service the International Order Book (IOB). Associated dividends are paid to investors in US dollars. GDRs are settled in either DTC or Euroclear Bank enhancing their cross-border liquidity. The more liquid IOB securities have central counterparty clearing ensuring pre and post trade anonymity as well as mitigation of counterparty risk.

Features of GDRs

(a) Underlying Shares: Each GDR may represent one or more underlying share, which are physically held by the Custodian appointed by the Depository Bank.

(b) Entry in Company's Books: In the Company's books, the Depository Bank's name appears as the holder of the shares.

(c) Returns: Depository gets the dividends from the Company (in local currency) and distributes them to the holders of the Depository Receipts after converting into dollars at the going rate of exchange.

(d) Negotiable: GDRs are exchangeable with the underlying share either at any time, or after the lapse of a particular period of time, generally 45 Days.

(e) Globally Marketed: GDRs are marketed globally without being confined to borders of any market or country as it can be traded in more than one country.

(f) Settlement: GDRs are settled through CEDEL & Euro-Clear International Book Entry Systems.

Impact of GDRs on Indian Capital Market

(a) Track of Worldwide Events: Arbitrage possibility in GDR Issues has created additional responsibility on the investors. Investors are now required to keep track of world-wide economic events, and how the Company's GDRs are being traded.

(b) Free Pricing: GDR can be issued for any price, and therefore retail investors can longer expect discounted rights or public issues.

(c) Flow of Foreign Investment into India: Since GDRs are sold primarily to institutional investors abroad, it serves as an easy way for flow of huge volume of foreign funds into Indian Capital Market.

Illustration 1: GDR Issue

A Ltd. is considering an expansion project in USA. For the proposed project, it requires an investment of $20 million (net of issue expenses/floatation cost). The floatation cost is estimated at 2%. The company has proposed to issue GDR to finance the project.

You have been appointed as the principal financial consultant for the project. Compute the number of GDRs to be issued and cost of the GDR with the help of following additional information.

(i) Expected market price of share at the time of issue of GDR is ₹500 (Face Value ₹100)

(ii) 2 Shares shall underly each GDR and shall be priced at 10% discount to market price.

(iii) Expected exchange rate ₹72/$.

(iv) Dividend expected to be paid is 20% with growth rate 10%.

Solution:

Net issue size = \$20 million

Gross Issue = \$20 million ÷ (1 – 0.02) = \$20.408 million

Issue price per GDR in ₹ = ₹ (500 × 2 × 90%) = ₹900

Issue price per GDR in \$ = ₹900 ÷ ₹72 = \$12.50

Dividend per GDR (D_1) = ₹20 × 2 = ₹40

Net proceeds per GDR P_0 = ₹900 × (1 – 0.02) = ₹882

No. of GDRs to be issued = \$20.408 ÷ \$12.50 = 1.63264 million

Cost of GDR (K_e) = (D_1/P_0) + g = (40/882) + 0.10 = 14.54%

B. Warrants

A warrant is a security that entitles the holder to buy the underlying stock of the issuing company at a fixed exercise price until the expiration date. Some important characteristics to consider include the following:

- A warrant is exercised when the holder informs the issuer of their intention to purchase the shares underlying the warrant.
- A warrant's "premium" represents how much extra you have to pay for your shares when buying them through the warrant as compared to buying them in the regular way.
- A warrant's "gearing" is the way to ascertain how much more exposure you have to the underlying shares using the warrant as compared to the exposure you would have if you buy the shares through the market.
- If you plan on exercising the warrant, you must do so before the expiration date. The more time remaining until expiration, the more time for the underlying security to appreciate, which, in turn, will increase the price of the warrant (unless it depreciates). The expiration date is the date on which the right to exercise ceases to exist.
- Like options, there are different exercise types associated with warrants such as American style (holder can exercise any time before expiration) or European style (holder can only exercise on expiration date).

Sometimes, the issuer will try to establish a market for the warrant and to register it with a listed exchange. In this case, the price can be obtained from a stockbroker. Often, though, warrants are privately held or not registered, which makes their prices less obvious.

Exercise

Theoretical Questions

Multiple Choice Questions

1. Which of the following bonds are denominated in Yen?
   A. Yankee.
   B. Samurai.
   C. Shibosai.
   D. Both (a) and (c) above.
2. ___________ are underwritten and have a maturity of up to one year.
   A. Note issuance facilities
   B. Medium-term notes
   C. Commercial paper
   D. ADRs
3. __________ is a private arrangement between lending banks and a borrower.
   A. Club loan
   B. Multiple component facility
   C. Syndicated Euro credit
   D. All of the above
   4. A Yankee bond is
4. A dollar dominated bond issued for global market by a non-US entity
   B. A dollar denominated bond issued in the US by a non-US entity
   C. A dollar denominated bond issued by a US resident to a non-US investor
   D. A dollar denominated bond issued in US by a US resident
5. Shibosai bond is a bond
   A. Denominated in ¥ and issued outside Japan
   B. Denominated in a currency other than ¥ and issued in Japan
   C. Denominated in Japanese ¥ and issued under private placement in Japan
   D. Denominated in ¥ and issued by a overseas corporate to the public in Japan

Answer:

1	2	3	4	5
B	A	A	B	C

State True or False

1. A Bull-dog bond is issued in UK in Sterling by non-UK borrower and listed.
2. Eurobonds are bonds denominated in the currency of the country in which they are issued.

3. The World Bank was established in July, 1944.
4. IDA provides interest-free loans (called credits) and grants to governments of the poorest countries.
5. A foreign bond is issued by a borrower foreign to the country where the bond is placed.

Answer:

1	2	3	4	5
True	False	True	True	True

Fill in the Blanks

1. Syndicates are classified into two types - __________and syndicated loans.
2. Straight Debt Bonds are ___ interest-bearing securities which are redeemable at face value.
3. _________are short-term unsecured promissory notes which repay a fixed amount on a certain future date.
4. _________are bonds issued by non-Japanese borrowers in the domestic Japanese markets.
5. An___________ is a certificate that represent shares of a foreign stock owned and issued by a U.S. bank.

Answer:

1	club loans	2	fixed
3	Commercial papers	4	Samurai bonds
5	American Depositary Receipt		

Short Essay Type Questions

1. Discuss the various lending schemes of IMF.
2. Discuss the major initiatives of the World Bank.
3. What are the different types of foreign bonds? Discuss.
4. Write a short note on: Foreign Currency Convertible Bonds.
5. Write a short note on: Syndicated Credits.

Essay Type Questions

1. Discuss the different types of Euro Notes.
2. Discuss the benefits of Depository Receipts.
3. What do you mean by ADR? Discuss its advantages and limitations.
4. What is GDR? Discuss its features.
5. Discuss about international stock market.
6. Discuss about international bond market.

References:

1. Kim. & Kim. (2006); Global Corporate Finance (6e); Blackwell Publishing

2. Shapiro & Moles (2014); International Financial Management; Wiley

3. Jacque (2014); International Corporate Finance; Wiley

4. RBI Circulars on External Commercial Borrowings in India