UNIT - IV

International capital markets

Capital market is a market where savers can transfer their funds to borrowers in exchange of a promise to receive an amount higher than what they have transferred. These markets have now become international where foreigners can both borrow and lend money. These markets are also available to multinationals to finance their operations. Any capital market can develop into an international capital market provided i) local regulations permit it and ii) potential users are attracted to it. The most important financial centres are London and NewYork. Other important centres are Frankfurt, Tokyo, Zurich, Luxembourg, Singapore, Hongkong, the Bahamas and Bahrain.

Currency markets of the world are knit into a global market. Global finance has helped global production. It is increasingly becoming difficult to identify the nationality of many a product traded in the world. Tremendous growth in international banking and finance has taken place. International investors and foreign institutional investors are looking outside their countries as they are faced with stagnant domestic economies.

India has began to make use of international capital markets and external commercial borrowings has emerged as a significant source of external finance.

International financial markets denote a totality of all international financial operations. International financial operations involve –

1. Exchange deals – buying and selling of currencies
2. Banking transactions – accepting deposits and lending to corporate bodies
3. Capital market operations – issuance of securities
4. Handling fund flows on account of trade between countries
5. Payments for services rendered
6. Servicing of capital market offerings e.g. merchant banking

Raising foreign exchange finance:

The sources of finance can be broadly classified as official and private channels.

The official channel constitutes a) the bilateral funding arrangements between the governments of two countries and b) the funding arrangements from the multilateral financial institutions. The private channel or the commercial channel can be bifurcated into commercial debt channel and commercial equity channels. The commercial debt market constitutes a) the Euro currency market, b) the National financial markets and c) buyers/suppliers credit. The commercial equity market constitutes a) Euro-equity issues, b) Off shore funds, c) Portfolio investments and d) Foreign Direct investments.

Euro currency and Eurobond markets:

Euro currency markets are off shore markets where financial institutions conduct transactions which are denominated in currencies other than the currency of the country where such institutions are located. A Euro currency deposit is a dollar or other convertible currency deposited in a bank outside its country of origin. As such a practice was started in European countries, the prefix éuro’ continued to stay. Such deposits are also called as Euro currency deposits or foreign currency deposits.

Examples: A dollar denominated account maintained in a London bank becomes a Eurodollar deposit. The bank could be a US branch located in London. It may be a Euro Swiss Franc or Euro Yen. But Euro dollars are the largest segment of this market.

Euro-equity and FCCBS in the Indian context:

The Indian corporate have been permitted by the Government of India to approach the foreign market for issue of ordinary shares and issue Foreign Currency Convertible Bonds (FCCBs). Indian companies have raised billions of dollars through this.

Reasons for growth of International capital movements:

1. Developments in information communications technology which have made it possible to operate in different markets and time zones at the same time.
2. Restoration of markets’ confidence in the safety of international financial transactions.
3. Rapid increase in the demand for international financial services that accompanied the growth of international trade and MNC activity.
4. Private Banks responded quickly to the global financial imbalances.
5. Market innovations that were created in the increasingly competitive atmosphere such as currency and interest rate futures, options and swaps also reduce the effective risks and costs of international financial operations.

Types of Eurobonds:

An Euro bond is a foreign bond issue denominated in a currency other than the currency of the country of the initial issue. Foreign bond is issued by foreign borrowers and is denominated in the currency of the country in which it is issued.

The Eurobond products can be classified into following types:

1. Straights: Straight bonds are fixed rate debt instruments and are issued at par or at slight discount. They normally pay annual coupons. The maturity is usually 3 to 7 years.
2. Floating rate notes (FRNs) have coupons that are paid and reset on a quarterly or half-yearly basis. Most floaters have a floor – a minimum rate that will apply if the reference rate falls below a certain level. Some have a cap – where the coupons cannot exceed the level pre agreed. Some FRNs have a collar – both a floor and a cap, minimum and maximum coupon rates are thus pre arranged.
3. Convertibles: Some FRNs are convertible into fixed rate bonds.
4. Bonds with warrants: FRNs with warrants give the holder the option to purchase fixed rate bonds of the issuer at a later date.
5. Synthetics: Synthetics are the combination of any of the above modes.

Special features and innovations in the international bond market:

1. The Euro bond market is an offshore operation not subject to national controls.
2. Euro bond issues are not subject to the costly and time consuming registration procedure.
3. Eurobonds are issued in bearer forms, which facilitates their negotiation in the secondary market.
4. Eurobonds offer investors exemption from tax-withholding provisions applicable to domestic and foreign bonds.
5. The issuance of convertible bonds or bonds with warrants attracts investors across the world.
6. Due to volatility of interest rates, international bonds as been issued in the forms of FRNs with collar.
7. A multiple currency bond entitles the holder to request payment of the interest and principal in any of certain specified currencies.

Foreign Currency Convertible Bonds (FCCBs):

The FCCBs are designed for long term investments. A convertible bond is partly debt and partly equity. It is a true hybrid. For the investor, a convertible offers the safety of income and principal protection that bonds offer, as well as the growth potential of equity.   
For the issuer, a convertible bond offers the possibility of selling stock at a premium and the attraction of low cost debt.

Volatility: Convertibles are less volatile than the average equity shares. Despite this reduced risk, convertibles usually provide total returns that are competitive with equity capital.

Safety: Convertible bond is a certificate of debt issued by a corporation to the bond holder with promises to pay interest on a regular basis and repay the principal at maturity. It may be exchanged at the option of the holder, into shares of the issuing company.

Eurobond versus Euro currency loan:

Cost of borrowing:

Euro bonds are issued in both fixed rate and floating rate forms. Interest rate on a Euro currency loan is variable which benefits borrowers when rates decline but hurts them when rates rise.

Maturities:

The period of borrowing in the Euro bond is longer than euro currency loans.

Size of the issue:

Euro bond market can easily accommodate financing of large size than currency market.

Flexibility:

In the case of a Eurobond issue, the funds must be drawn in one sum on a fixed date and are repaid according to a fixed schedule. A Euro currency loan, with a multi currency clause, enables the borrower to switch currencies on any roll over date.

Speed:

Internationally known borrowers can raise funds in the Eurocurrency market very quickly, often within 2 to 3 weeks of first request. Euro bond financing generally takes more time.