International banking essay sample

Literature, Russian Literature

Q – Explain the origins, features, functions and importance of international banking?

The origin of international banking dates back to the 2nd century BC when Babylonian temples safeguarded the idle funds and extended loans to merchants to finance the movements of goods. The loans extended by the Florentine banking houses were the first instance of international lending. During the nineteenth century many innovations were witnessed in the international lending, leading to trade financing and investment banking. Trade financing started as short term lending. Of the two investments banking accounted further great bulk of the international lending and financial companies acted as agents or underwriters for the placement of funds. By 1920, American banking institutions dominated international lending, and the European nations were the major borrowers. There was perfect international banking system existing till the time of First World War. The Bretton system had installed a secured financial framework and revolutionized the economic life by creating a global shopping center. International banking speeded up after the first oil crisis in 1973. Progress in the telecommunications sector across the world supplemented the growth of international banking.

Reasons for the Growth of International Banking

There are number of explanations or theories provided to support the growth in international banking operations. International banking theories explain the reasons behind the banks choice of a particular location for their banking facilities, maintaining a particular organizational structure, and the underlying causes of international banking. Certain theories are as such:-

Follow the leader, explanations suggests that banks expand across national borders to continue to serve customers by establishing branches or subsidiaries abroad. Expansion abroad has a pervasive effect on competition.

Banks use management technology and marketing knowhow developed countries for domestic uses at very marginal cost abroad. Banks can take ownership-specific and location-specific advantages while operating abroad. Market imperfections due to domestic rules, regulations and taxations along with the drastic reduction in the cost of communications prompt the banks to set up operations abroad. Inter-country differences in the cost of capital attract banks to set up their operations in different countries. The multi-lateral system of payments came into existence after the creation of the IMF and the World Bank. Resources were new raised through financial markets for financing the development projects in member countries. Effectively it was the commercial banks which mobilized savings and channelized them to these institutions for development use. With the introduction of the flexible exchange rate system, exchange rates were determined by market demand-supply forces. Since all transactions went through the banking system involved with International Banking were ideally placed to establish the demand supply equilibrium. The role of establishing exchange rate was therefore transferred from central banks to commercial banks.

Characteristics and Dimensions

Though international banking concept is quite old, it has acquired certain new characteristics and dimensions. The maturities have risen considerably

and now the average maturities are about ten years. Banks have started diversifying their sources of funds along with the assets. Apart from the above, two kinds of overseas bank operations characterized international bank expansion in the late 1960s and 1970s. A multinational consortium bank, was created by several established by parent banks, and; The shell branch, which is not really a bank but a device to get around the domestic government regulation, was created. Features of International Banking

International banks are organized in various formal and informal ways from simply holding account with each other to holding common ownership. CORRESPONDENT BANKING – This represents an informal linkage between banks and its customers in different countries. The linkage is setup when banks maintain correspondent accounts with each other and facilitates international payments and collections for customers. BANK AGENCIES – The agencies mostly deal in the local currency markets and in the foreign exchange markets, arrange loans and clears cheques. FOREIGN BRANCHES – These are operating banks and are subject to local banking rules and the rules at home. These branches most of the time offer quality services and safety that are provided by a large bank to the customers in small countries.

Recent Trends

In the past two decades, people around the world have come across complex developments in the financial sector which have evolved gradually. The increasing domination of securities of markets by financial institutions managed by professional bankers has led to the institutionalization of markets. Globalization has affected the financial markets in the world almost

entirely. Foremost among the global trends in the world’s financial industry are consolidation and convergence. These two encompass financially driven mergers within domestic market.

Q – Explain Asset Liability management in Banks?

Over the last few years the Indian financial markets have witnessed wide ranging changes at fast pace. Intense competition for business involving both the assets and liabilities, together with increasing volatility in the domestic interest rates as well as foreign exchange rates, has brought pressure on the management of banks to maintain a good balance among spreads, profitability and long-term viability. These pressures call for structured and comprehensive measures and not just ad hoc action. The Management of banks has to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. Banks are exposed to several major risks in the course of their business – credit risk, interest rate risk, foreign exchange risk, equity / commodity price risk, liquidity risk and operational risks. 2. This note lays down broad guidelines in respect of interest rate and liquidity risks management systems in banks, which form part of the Asset-Liability Management (ALM) function. The initial focus of the ALM function would be to enforce the risk management discipline viz. managing business after assessing the risks involved. The objective of good risk management programmes should be that these programmes will evolve into a strategic tool for bank management. 3. The ALM process rests on three pillars: • ALM information systems => Management Information System

=> Information availability, accuracy, adequacy and expediency • ALM organisation

=> Structure and responsibilities

=> Level of top management involvement • ALM process

=> Risk parameters

=> Risk identification

=> Risk measurement

=> Risk management

=> Risk policies and tolerance levels. 4. ALM information systems

Information is the key to the ALM process. Considering the large network of branches and the lack of an adequate system to collect information required for ALM which analyses information on the basis of residual maturity and behavioral pattern it will take time for banks in the present state to get the requisite information. The problem of ALM needs to be addressed by following an ABC approach i. e. analyzing the behavior of asset and liability products in the top branches accounting for significant business and then making rational assumptions about the way in which assets and liabilities would behave in other branches. In respect of foreign exchange, investment portfolio and money market operations, in view of the centralized nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined over time as the bank management gain experience of conducting business within an ALM framework. The spread of computerization will also help banks in accessing data. 5. ALM organization

5. 1 a) The Board should have overall responsibility for management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks. b) The Asset – Liability Committee (ALCO) consisting of the bank’s senior management including CEO should be responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of the bank (on the assets and liabilities sides) in line with the bank’s budget and decided risk management objectives. c) The ALM desk consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to bank’s internal limits. 5. 2 The ALCO is a decision making unit responsible for balance sheet planning from risk – return perspective including the strategic management of interest rate and liquidity risks. Each bank will have to decide on the role of its ALCO, its responsibility as also the decisions to be taken by it.

The business and risk management strategy of the bank should ensure that the bank operates within the limits / parameters set by the Board. The business issues that an ALCO would consider, inter alia, will include product pricing for both deposits and advances, desired maturity profile of the incremental assets and liabilities, etc. In addition to monitoring the risk levels of the bank, the ALCO should review the results of and progress in implementation of the decisions made in the previous meetings. The ALCO would also articulate the current interest rate view of the bank and base its

decisions for future business strategy on this view. In respect of the funding policy, for instance, its responsibility would be to decide on source and mix of liabilities or sale of assets. Towards this end, it will have to develop a view on future direction of interest rate movements and decide on a funding mix between fixed vs floating rate funds, wholesale vs retail deposits, money market vs capital market funding, domestic vs foreign currency funding, etc. Individual banks will have to decide the frequency for holding their ALCO meetings.

Q- Discuss advantageous of Euro Bonds to Investors and Borrowers?

Today’s multinational corporations (MNC) can’t rely on just a panel of banks to meet all of their funding needs, especially when those banks decide to cut back on lending to the MNC’s business sector or they become cash constrained. One alternative, and significant source of debt finance, is the eurobond market. This subset of the global capital market is also called the international capital market or wholesale market, because it usually caters to companies, banks and governments rather than individuals.

What Is a Eurobond?

The name “ eurobond” is a misnomer, as a eurobond is a bond that can be denominated in any currency, not just euros. The prefix “ euro” indicates that the currency borrowed by issuing the bond is held outside the country corresponding to that currency. So, a euroyen bond is a bond to borrow yen from outside Japan in the euroyen market. A eurodollar bond is a bond to borrow U. S. dollars from outside the U. S. in the eurodollar market.

Bonds issued inside a country, and in its corresponding currency, and by foreigners, are separate from the eurobond market. So, there are many distinct markets for issuing bonds, and the eurobond is one of the oldest and largest. (Learn more about bond markets in our article, The ABCs Of The Bond Market.)

The eurobond market is generally restricted to large, single issues ($50 million or more), and is limited to large companies, banks or governments. Maturities are usually around 10 years or less. However, there are programs available for MNCs to issue smaller amounts, and for shorter periods.

Issuing eurobonds can help an MNC raise foreign-denominated debt in large amounts, for long periods of time, and usually at a fixed interest rate. This profile would be suitable for financing large, long-term, overseas developments – for example, establishing an overseas subsidiary.

Why a Company Might Issue a Eurobond

Many major MNCs, (for example, Wal-Mart) that want to expand to another market on a large scale (say, Thailand) would need plenty of that country’s currency (in this example, Thai baht) and plenty of time in order to reach their goal. In order to contain interest costs, borrowing should be done at a fixed interest rate. The solution, in this example, would be for Wal-Mart is to issue a eurobond denominated in Thai baht.

However, the subsidiary, set up in Thailand to manage the operations, is unlikely to have the necessary borrowing reputation directly in the eurobond market, and would likely ask its U. S. parent, which would have a good credit

rating, to issue the eurobond instead. The proceeds would then be passed through as an internal loan to the subsidiary, and denominated in Thai baht.

The Thai baht would be provided to the parent by investors who have Thai baht in accounts at banks outside of Thailand. In return, investors receive a eurobond and coupons in pre-determined increments, and at a fixed interest rate.

If the Thai subsidiary grows according to plan, it will generate earnings, which will be used to pay its loan interest to the parent. The parent then uses these receipts to meet its obligations to pay interest on the Thai eurobond. Bond principal is usually not paid until maturity, either from the sale of the Wal-Mart expansion stores to another company or by issuing another eurobond.

Risk Reduction

By issuing the eurobond in Thai baht the U. S.-based parent does not have currency risk because its Thai baht liability (the bond) is offset by a Thai baht asset (its internal loan). Similarly, the Thai subsidiary’s liability to pay interest in Thai baht to its parent is matched by Thai baht income from its local superstores.

As an alternative to issuing in a foreign currency, some MNCs issue a bond in another currency, and then use currency and interest rate swaps to convert the currency and interest rate basis into the desired form. The exchange then provides the protection against currency and interest rate mismatches.

MNCs often use this alternative method, depending on their reputation in certain currency types, and are able to issue at a lower cost. (Readers unfamiliar with swaps should refer to An Introduction To Swaps.)

How MNCs Issue Eurobonds

To increase investor interest, a MNC can have its eurobond issue underwritten by a bank, which obligates those banks to provide any shortcoming in principal. In addition, banks are paid fees to distribute the eurobonds to investors, to attend road shows to generate investor interest and to prepare an information memorandum and prospectus, setting out details of the eurobond, the MNC and the purpose for the funds. The bonds give an investor a possibility of achieving a higher yield on investments as compare to investing in most shares, bank and building society accounts, money market placements, etc.

It is a " safe" investment in the sense that the full value of the bond will be replayed when the bond matures. Conclusion

Eurobonds provide MNCs with simplified international operations. Though new obstacles arise, the advantages far outweigh the reliance on third-party entities for smooth transactions. Because the eurobond market is restricted to large well-known and reputable MNCs and other issuers, investors tend to accept less strict covenants and do not require security.

Q- Explain Interest Rate Parity Theory?

Interest rate parity is a no-arbitrage condition representing an equilibrium state under which investors will be indifferent to interest rates available on

bank deposits in two countries.[1] Two assumptions central to interest rate parity are capital mobility and perfect substitutability of domestic and foreign assets. The interest rate parity condition implies that the expected return on domestic assets will equal the expected return on foreign currency assets, due to equilibrium in the foreign exchange market resulting from changes in the exchange rate between two countries.

Interest rate parity takes on two distinctive forms: uncovered interest rate parity refers to the parity condition in which exposure to foreign exchange risk (unanticipated changes in exchange rates) is uninhibited, whereas covered interest rate parity refers to the condition in which a forward contract has been used to cover (eliminate exposure to) exchange rate risk. Each form of the parity condition demonstrates a unique relationship with implications for the forecasting of future exchange rates: the forward exchange rate and the future spot exchange rate Interest Rate Parity (IPR) theory is used to analyze the relationship between at the spot rate and a corresponding forward (future) rate of currencies.

Assumptions

Interest rate parity rests on certain assumptions, the first being that capital is mobile – investors can readily exchange domestic assets for foreign assets. The second assumption is that assets have perfect substitutability, following from their similarities in riskiness and liquidity. Given capital mobility and perfect substitutability, investors would be expected to hold those assets offering greater returns, be they domestic or foreign assets. However, both domestic and foreign assets are held by investors. Therefore,

it must be true that no difference can exist between the returns on domestic assets and the returns on foreign assets. That is not to say that domestic investors and foreign investors will earn equivalent returns, but that a single investor on any given side would expect to earn equivalent returns from either investment decision. Interest Rate Parity Flowchart

Examples

For our illustration purpose consider investing € 1000 for 1 year. We'll consider two investment cases viz:

Case I: Domestic Investment

In the U. S. A., consider the spot exchange rate of $1. 2245/€ 1. So we can exchange our € 1000 @ $1. 2245 = $1224. 50

Now we can invest $1224. 50 @ 3. 0% for 1 year which yields $1261. 79 at the end of the year. Case II: Foreign Investment

Likewise we can invest € 1000 in a foreign European market, say at the rate of 5. 0% for 1 year. But we buy forward 1 year to lock in the future exchange rate at $1. 20025/€ 1 since we need to convert our € 1000 back to the domestic currency, i. e. the U. S. Dollar. So € 1000 @ of 5. 0% for 1 year = € 1051. 27

Then we can convert € 1051. 27 @ $1. 20025 = $1261. 79

Thus, in the absence of arbitrage, the Return on Investment (RoI) is same regardless of our choice of investment method. There are two types of IRP.

1. Covered Interest Rate Parity (CIRP)

Covered Interest Rate theory states that exchange rate forward premiums (discounts) offset interest rate differentials between two sovereigns. In

another words, covered interest rate theory holds that interest rate differentials between two countries are offset by the spot/forward currency premiums as otherwise investors could earn a pure arbitrage profit. Covered Interest Rate Examples

Assume Google Inc., the U. S. based multi-national company, needs to pay it’s European employees in Euro in a month’s time. Google Inc. can achieve this in several ways viz:
Buy Euro forward 30 days to lock in the exchange rate. Then Google can invest in dollars for 30 days until it must convert dollars to Euro in a month. This is called covering because now Google Inc. has no exchange rate fluctuation risk. Convert dollars to Euro today at spot exchange rate. Invest Euro in a European bond (in Euro) for 30 days (equivalently loan out Euro for 30 days) then pay it’s obligation in Euro at the end of the month. Under this model Google Inc. is sure of the interest rate that it will earn, so it may convert fewer dollars to Euro today as it’s Euro will grow via interest earned. This is also called covering because by converting dollars to Euro at the spot, the risk of exchange rate fluctuation is eliminated. 2. Uncovered Interest Rate Parity (UIP)

Uncovered Interest Rate theory states that expected appreciation (depreciation) of a currency is offset by lower (higher) interest. Uncovered Interest Rate Example
In the above example of covered interest rate, the other method that Google Inc. can implement is: Google Inc. can also invest the money in dollars today and change it for Euro at the end of the month. This method is uncovered

because the exchange rate risks persist in this transaction. Covered Interest Rate Vs. Uncovered Interest Rate

Recent empirical research has identified that uncovered interest rate parity does not hold, although violations are not as large as previously thought and seems to be currency rather than time horizon dependent. In contrast, covered interest rate parity is well established in recent decades amongst the OECD economies for short-term instruments. Any apparent deviations are credited to transaction costs. Implications of Interest Rate Parity Theory

If IRP theory holds then arbitrage in not possible. No matter whether an investor invests in domestic country or foreign country, the rate of return will be the same as if an investor invested in the home country when measured in domestic currency. If domestic interest rates are less than foreign interest rates, foreign currency must trade at a forward discount to offset any benefit of higher interest rates in foreign country to prevent arbitrage. If foreign currency does not trade at a forward discount or if the forward discount is not large enough to offset the interest rate advantage of foreign country, arbitrage opportunity exists for domestic investors.

So domestic investors can benefit by investing in the foreign market. If domestic interest rates are more than foreign interest rates, foreign currency must trade at a forward premium to offset any benefit of higher interest rates in domestic country to prevent arbitrage. If foreign currency does not trade at a forward premium or if the forward premium is not large enough to offset the interest rate advantage of domestic country, arbitrage opportunity

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