Capital Markets - II

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Complexities for firms that operate internationally

- Revenues/Profits/Assets may be measured in different currencies
- Differing legal requirements, e.g., tax laws, depreciation rules and government controls
- Institutional restrictions: Ability to raise capital is restricted by the types of markets and institutions
- Major dimension of foreign operations: Multiple currencies

Foreign exchange (FEX) terminology

- Selling rate or Asked rate: Rate at which the FEX dealer is prepared to sell foreign currency (FC)
- Buying rate or Bid rate: Rate at which the FEX dealer is prepared to buy FC
- Commodity Currency: Currency that is expressed on a per unit basis.
- In a Direct Quote, the price of one unit of FC is quoted in terms of domestic currency, e.g., $1=Rs. 43.
- Thus, in a Direct Quote, the Commodity Currency is the FC
- Example of an Indirect Quote: Re. 1= $0.02326

Types of transactions in the FEX market

- Spot: One currency is exchanged for another "immediately."

- Forward: Promises (contractual) delivery at a specified future date of one currency for a specified amount of another currency. The exchange rate is determined at the time of entering into the contract.

Why Forward Contracts?

- Exchange rate risk arises from the fact that the spot rate on a future date is unknown today
- Exchange risk exists when a contract is denominated in FC
- Exchange risk may be hedged through forward contracts, Futures Contracts, Options, Rollover Contracts and Swaps
- A forward contract benefits both the buyer and the seller, because of the reduction of uncertainty. This benefit has to weighed against the potential loss that either party may incur.

Implications of currency movements

- When a firm owns assets in FC, it is in a Net Asset position, i.e., the firm is long in the currency
- When a firm owes in FC, it is in a Net Liability position, i.e., it is short in the currency

	Long	**Short**
FC rises	Gain	Loss
FC falls	Loss	Gain

Management of currency exposure

- When a FC is expected to depreciate, a firm that is long in that currency may protect itself by:
- Reducing cash holdings
- Avoid granting long-term credit
- Increase liabilities, e.g., accounts payables and loans (depending on relative interest rates)

How is the (theoretical) forward rate determined?

- By adjusting the Spot Rate for interest differentials prevailing on two currencies
- Suppose that Euro 1 = $1.25 and that interest rates in Germany and the U.S. are 8% and 6% p.a., respectively. What is the three-month forward rate as per the Interest Rate Parity Theorem?

Covered Interest Arbitrage

- What happens if the forward rate in the market differs significantly from the theoretical forward rate?

- Answer: Covered interest arbitrage will drive the (market) forward rate towards the theoretical rate

Categories of Exchange Rate Risk

- Transaction Exposure (short-term): Potential for change in the value of a FC denominated transaction, due to an exchange rate change
- Economic (Operating) Exposure (long-term): Impact of unanticipated exchange rate changes on a firm's future operating cash flows. This is the most feared.
- Translation Exposure: Changes in a firm's financial statement, as a result of changes in currency values
- How does one deal with the above risks?

Some aspects of International Capital Markets

- Eurocurrency Market: International market in bank deposits and loans residing outside of the domestic currency, e.g., Eurodollar deposits --- dollar deposits held in a country other than the U.S.
- LIBOR: London Inter-bank Offer Rate; Average of rates at which a group of London-based banks are prepared to lend Eurocurrencies to one another
- LIBOR is an important benchmark rate

Features of the Eurocurrency Markets

- No reserve requirements
- No interest rate regulations or caps
- No withholding taxes
- No deposit insurance requirements
- No regulations influencing credit allocation decisions
- Less stringent disclosure requirements

Some international capital market instruments

- Foreign Bonds: Bonds that are issued in a domestic market by a foreign borrower and denominated in the domestic currency, e.g., Yankee Bonds, Bulldog Bonds and Samurai Bonds
- Eurocurrency Bonds: Long-term debt securities that are denominated in a currency other than the currency of the country in which they are issued
- Note Issuance Facility: An arrangement for obtaining medium-tem financing by issuing short-term notes which are rolled over
- Foreign Currency Convertible Bonds: Bonds denominated in a foreign currency which are convertible into equity shares
- Global Depositary Receipts: A negotiable instrument that represents a certain number of shares of a foreign-based company (ADR: American Depositary Receipt)