UNIT 209 – UPSC - World Financial Markets and International Banking

In present business scenario, international trade activities have increased at great pace which augmented the importance of global finance market. Global finance market mainly focuses on lending and borrowing in foreign currencies to finance the foreign trade transactions. Global finance market operate outside the domain, directive and legislature framework of a country. The numerous components of global finance market include euro currency market, export credit facility, International bond market, and institutional finance. Global finance market is dominated by issues and investors in bond. The choice of currency has important role in the area of global finance market. The most chosen currencies for global finance market is US dollars, pond, sterling, Japanese yen. The contributors in global finance market are multinationals, corporate enterprises, and government.

Factors responsible for global finance market are:

1. Deregulation
2. Science and technology: Technological advancement for monitoring world market, executing orders and analysing financial opportunities.
3. Institutionalization: Shift from retailing to increase institutionalization of investors in financial market.
4. Competition: There is global competition which force government to deregulate various aspects of international financial market.
5. Information flow: There is a free and unlimited flow of market information around the world owing to advancement in telecommunication.

The benefits of Global finance market are flexibility and wide dispersal. Global finance market also witness some innovative instruments such as swaps which are of two types, namely, interest swaps and currency swaps. There is debt equity swap also which is popular in Global finance market (Gurusamy, 2009).

Major Global Finance Markets

1. The US financial market: It is biggest and most versatile financial market around the globe. It offers wide range of funding options and is characterized by some of the sophisticated and innovative financial institutions. The dominant place of the Dollar in the international financial field makes it more significant. The financial system of US finance market include the network of commercial banks, domestic and foreign international banks, non-bank financial institution, insurance companies, pension funds, mutual funds, savings, and loan associations. Three authorities such as comptroller of currency the Federal Reserve board and the federal deposit insurance corporations regulate the commercial banks in the US (Gurusamy, 2009).

2. Euro market is composed of Euro dollar bond, FRNs, NIFs. Euro dollar bond accounts for large share of euro bond issues. Syndicated euro loans are available which borrows in developing countries for frequent access (Gurusamy, 2009). The main factor that makes the Eurocurrency market so attractive to both depositors and borrowers is its lack of government regulation. This allows banks to offer higher interest rates on Eurocurrency deposits than on deposits made in the home currency, making Eurocurrency deposits attractive to those who have cash to deposit. The lack of regulation also allows banks to charge borrowers a lower interest rate for Eurocurrency borrowings than for borrowings in the home currency, making Eurocurrency loans attractive for those who want to borrow money. In other words, the spread between the Eurocurrency deposit rate and the Eurocurrency lending rate is less than the spread between the domestic deposit and lending rate. The Eurocurrency market has two disadvantages. First, when depositors use a regulated banking system, they know that the probability of a bank failure that would cause them to lose their deposits is very low. Regulation maintains the liquidity of the banking system. In an unregulated system such as the Eurocurrency market, the probability of a bank failure that would cause depositors to lose their money is greater (although in absolute terms, still low). Thus, the lower interest rate received on home-country deposits reflects the costs of insuring against bank failure. Some depositors are more comfortable with the security of such a system and are willing to pay the price. Second, borrowing funds internationally can expose a company to foreign exchange risk. For example, consider a US company that uses the Eurocurrency market to borrow euro-pounds, perhaps because it can pay a lower interest rate on euro-pound loans than on dollar loans. Imagine, however, that the British pound subsequently appreciates against the dollar. This would increase the dollar cost of repaying the euro-pound loan and thus the company's cost of capital. This possibility can be insured against by using the forward exchange market but the forward exchange market does not offer perfect insurance. Consequently, many companies borrow funds in their domestic currency to avoid foreign exchange risk, even though the Eurocurrency markets may offer more attractive interest rates.

3. Japanese market: Japanese financial system was integrated with the international market since 1970s. The main components of Japan's financial system are much the same as those of other major industrialized nations: a commercial banking system, which accepted deposits, extended loans to businesses, and dealt in foreign exchange; specialized government-owned financial institutions, which funded various sectors of the domestic economy; securities companies, which provided brokerage services, underwrote corporate and government securities, and dealt in securities markets; capital markets, which offered the means to finance public and private debt and to sell residual corporate ownership; and money markets, which offered banks a

source of liquidity and provided the Bank of Japan with a tool to implement monetary policy. Ministry of finance closely monitors the Japanese financial system. Japan's securities markets increased their volume of dealings rapidly during the late 1980s, led by Japan's rapidly expanding securities firms. There were three categories of securities companies in Japan, the first consisting of the "Big Four" securities houses (among the six largest such firms in the world): Nomura, Daiwa, Nikko, and Yamaichi. The Big Four played a key role in international financial transactions and were members of the New York Stock Exchange. Nomura was the world's largest single securities firm; its net capital, in excess of US$10 billion in 1986, exceeded that of Merrill Lynch, Salomon Brothers, and Shearson Lehman combined. In 1986, Nomura became the first Japanese member of the London Stock Exchange. Nomura and Daiwa were primary dealers in the United States Treasury bond market. The second tier of securities firms contained ten medium-sized firms. The third tier consisted of all the smaller securities firms registered in Japan. Many of these smaller firms were affiliates of the Big Four, while some were affiliated with banks. In 1986 eighty-three of the smaller firms were members of the Tokyo Securities and Stock Exchange. Japan's securities firms derived most of their income from brokerage fees, equity and bond trading, underwriting, and dealing. Other services included the administration of trusts. In the late 1980s, a number of foreign securities firms, including Salomon Brothers and Merrill Lynch, became players in Japan's financial world. Japanese insurance companies became important frontrunners in international finance in the late 1980s. More than 90% of the population owned life insurance and the amount held per person was at least 50% greater than in the United States. Many Japanese used insurance companies as savings vehicles. Insurance companies' assets grew at a rate of more than 20% per year in the late 1980s, reaching nearly US$694 billion in 1988. The life insurance companies moved heavily into foreign investments as deregulation allowed them to do so and as their resources increased through the spread of fully funded pension funds. These assets permitted the companies to become major players in international money markets. Nippon Life Insurance Company, the world's largest insurance firm, was reportedly the biggest single holder of United States Treasury securities in 1989. The Tokyo Securities and Stock Exchange became the largest in the world in 1988, in terms of the combined market value of outstanding shares and capitalization, while the Osaka Stock Exchange ranked third after those of Tokyo and New York. Although there are eight stock exchanges in Japan, the Tokyo Securities and Stock Exchange represented 83% of the nation's total equity in 1988. Of the 1,848 publicly traded domestic companies in Japan at the end of 1986, about 80% were listed on the Tokyo Securities and Stock Exchange.

4. German market: The Deutshe mark denominated German market. It occupies an important place in the entire gamut of euro market. Since 1985, Germanys' financial system was attuned to world financial order marked by liberalization and deregulation. Universal banking is popular in Germany.

5. Swiss financial market: It is well developed banking system especially for the foreign investors who made the Swiss market global player in global financial market (Gurusamy, 2009). Presently, an estimated one-third of all worldwide offshore funds (funds held outside their country of origin) are kept in banks within Switzerland. Banking in Switzerland is regulated by the Swiss Financial Market Supervisory Authority (FINMA). FINMA is responsible for supervision of Swiss banks, stock exchanges and insurance companies. FINMA is functionally and institutionally independent from the central federal administration and reports directly to the Swiss parliament.

6. Australian market: Australian dollar became very popular in the offshore market on the issue of bonds. The Australian bonds are popular in American market. Financial markets in Australia expanded very speedily in the 1980s, following deregulation. They have continued to grow in the 1990s, but at a pace more in line with world financial markets. Relative to the size of the economy, Australian financial markets are large by international standards, and well developed. While Australia ranks around fourteenth in the world in terms of GDP, many of its financial markets rank more highly. By turnover, the foreign exchange market. Directed mainly at meeting the needs of the domestic economy, in contrast to markets in London, Singapore and Hong Kong, where most of the trading is international, rather than related to the domestic economy. The dominant participants in Australian markets are banks, especially in foreign exchange and derivatives. As a consequence, supervision of the banking system carries with it the supervision of a large part of the activity in financial markets. The Australian foreign exchange market has grown powerfully since the early 1980s, in terms of trading in both Australian dollars and other currencies. There were two phases of growth. Between 1985 and 1990, the market grew very rapidly, with average daily turnover rising from a little over $A5 billion to $A44 billion, an average annual increase of around 50 per cent. Growth stopped at the start of the 1990s as the financial system experienced a period of consolidation, but turnover picked up at a moderate pace from 1992. By 1995, turnover had reached around $A50 billion per day, an average annual increase of around 3 per cent during the five-year period.
Many factors have contributed to this growth. The deregulation of Australian markets, specifically the floating of the exchange rate and the removal of exchange controls was the major factor in the mid to late 1980s. Following that burst in activity, the expansion of the Australian foreign exchange market has been driven largely by the growth in global foreign exchange trading.
It has been observed that Australia has become progressively integrated into the global foreign exchange market, helping to bridge the time gap between the close of the New York market and the opening of the major Asian markets of Tokyo, Hong Kong and Singapore. In global context, the Australian foreign exchange market accounts for around 2.5 per cent of world turnover, ranking ninth among world trading centres. The UK, US and Japan are the three largest foreign exchange markets; between them they accounted for around 55 per cent of total turnover in April 1995.

7. Indian financial market: Indian financial market is one of the prominent financial markets of the world. It is organised early during the 19th century with the name of SEBI (Security exchange board of India). During the 1960s, there are eight security exchanges in India which has mainly three in Mumbai, Ahmadabad and Kolkata. In spite of these boards there are also boards in other cities also such as Madras, Kanpur, Delhi, Bangalore and Pune. Indian economy had remained steady because of the cost-effective control and after 1991 generally when the liberalization has been started in India which made Indian security market boom and helped Indian economy in its growth. There were also many new companies which revolving around many industries segment which are also helping in flourishing the business. After launching NSE (National stock exchange) and OTCIE (Over the counter exchange of India) especially in the mid-1990s which have also helped in the smooth trading and the transparency from the trading of the securities.
Characteristics of financial market in India:

i. Foreign investment - Foreign debt database which is being composed by BIS, IMF, OCEO, World Bank and investment internationally.
ii. Insurance

iii. Loans
iv. Mutual funds
v. Foreign exchange.
vi. National and international markets relation
vii. Financial news markets
viii. Fixed income in sectors - Corporate Bond Prices, Interest details, Money Market, Public sector debts, External debt services, etc.
ix. Currency indexes, etc.

8. Sterling market: It has significant place in global financial market.

International Banking

An international bank is a financial unit that provides financial services, such as payment accounts and lending opportunities, to foreign customers. These foreign clienteles can be individuals and companies, though every international bank has its own strategies which decide with whom they do business. International banks can be characterised by the type of services they provide that distinguish them from domestic banks. International banking empowers people who live or work abroad to manage their finances in one central location. International banking keeps customer's money in one place, it allows them to make transfers and payments in several currencies from a stable and secure offshore jurisdiction. International banking provide a link between all of customers banking arrangements so that they can have complete control of their money, wherever they live in the world (Gurusamy, 2009).

Major functions of international banking:

i. Facilitate imports and exports of their clients -trade financing.
ii. Arrange for foreign exchange - cross-border transactions and foreign investments
iii. Assist in hedging exchange rate risk
iv. Trade foreign exchange products for their own account.
v. Borrow and lend in the Eurocurrency market
vi. Participate in international loan syndicate - lending to MNCs- project financing and to sovereign governments - economic development
vii. Participate in underwriting of Eurobonds and foreign bonds issues.
viii. Provide consultancy and advice on hedging strategies, interest rate and currency swap financing and international cash management services.

Types of International Banking Offices

1. Correspondent bank: Banks located in different countries establish accounts in other bank. It provides a means for a bank's MNC clients to conduct business worldwide through his local bank or its contacts. It also provides income for large banks. Smaller foreign banks that want to do business.

2. Representative office: A small service facility staffed by parent bank personnel that is designed to assist MNC clients of the parent bank in dealings with the bank's correspondents. It looks for

foreign market opportunities and serves as a liaison between parent and clients. It is useful in newly emerging markets. Representative offices also assist with information about local business customs, and credit evaluation of the MNC's local customers. It is useful when the bank has many MNC clients in a country.
A foreign branch bank operates like a local bank, but is legally part of the parent, not a separate entity. Foreign branches are not subject to Canadian reserve requirements or deposit insurance to compete with host country banks at the local level. It is most popular means of internationalizing bank operations. Subsidiary and Affiliate Bank: A subsidiary bank is a locally incorporated bank that is either wholly owned or owned in major part by a foreign parents. An affiliate bank is one that is only partially owned, but not controlled by its foreign parent. Both subsidiary and affiliate banks operate under the banking laws of the country in which they are incorporated. They are allowed to underwrite securities.
Offshore Banking Centre: A country whose banking system is organized to permit external accounts beyond the normal scope of local economic activity. The host country usually grants complete freedom from host-country governmental banking regulations. Banks operate as branches or subsidiaries of the parent bank. Primary credit services provided in currency other than host country currency. Reasons for offshore banks include low or no taxes, services provided for non-resident clients, legal regime that upholds bank secrecy.

There are many advantages to opening an international bank account:

1. Safe and secure global access to your money 24/7.
2. Quick and easy transfers in multiple currencies gives customers greater flexibility over their finances.
3. Simple and convenient to operate and offers one central location for all banking requirements of customers.
4. Unlimited access to foreign exchange.
5. Provides security against exchange rate fluctuations.
6. Grow and protect money in a stable offshore jurisdiction.
7. Confidential service wherever customers are in the world.

Features of international banking:

1. Currency risk and complexity of credit risk besides typical banking risks.
2. Competition for market share among banks (typically spreads very narrow) cyclical nature, with periodic crises.
3. Competition for bank loans from the international bond market (close substitutes for loans).

There are two important aspects of the role of international banks in the global economy.

First, international banking has been major component of a broader process of financial globalisation and integration. Earlier, it has expanded in concert with international trade and has performed key functions for the business of international firms. In addition, the local operations of foreign banks have spurred the development of financial systems in emerging markets and helped to alleviate information problems via close and sustained customer relationships. The demand for financial services from multinational corporations and rapidly growing emerging

markets promises to shape international banking and its contribution to economic progress in the future. A change of trade flows and multinational production towards emerging market economies may quicken financial integration. This could result in both increased participation in these economies by foreign banks and greater international activity by locally headquartered banks. Thus, banks from developing market countries may play an increasingly prominent part in future cross-border consolidation in the financial sector.

Second, the role of international banks in the international economy is related to international financial markets. As they execute complementary functions, both forms of financial intermediation are indispensable, together with a resilient market infrastructure, for smooth functioning of the financial system. Deep international capital markets often ease the funding strains of large corporations when bank credit contracts. By contrast, banks are the main source of external financing for households, as well as for small and medium-sized companies, whose access to credit markets tends to be restricted by unequal information issues.

Reasons for International Banking

In the period of globalization, clients or people usually migrate from one place to another for job and other purposes. Migration of domestic customers, particularly MNEs growing foreign activities is major reason for opening account in international banks.

Development of major financial centres offering benefits to banks:

- Business contacts
- Location of customers
- Pool of skilled labour
- Trades and professions
- Liquidity and efficiency of markets (thick market externalities)
- Interrelation of markets (e.g. derivatives and underlying)

Potential for increasing returns to scale and self-sustaining growth of centres

International banking activity occurs today via sophisticated international communication facilities that help in interbank communications such as chips and swift. Chips stands for clearing house interbank payment system. It is a US based concern for New York clearing house association since 1070. Chips is entirely automated and meets the need of New York money centre bank. It is responsible for moving among banks, an estimated 90% of the US dollar exchange in international commerce. It works globally (Gurusamy, 2009).

Swift stand for Society for worldwide interbank financial telecommunication. It was founded in Belgium in 1973. European, North American and Japanese banks in 15 nations own it. It is the largest in world financial telecommunication network. It is non-profit earning cooperative society that links member banks worldwide through a data processing and transmission network (Gurusamy, 2009).

SWIFT has an important contribution in international banking in the form of standardization of international interbank communication and cash management services. Swift services are used by EURO clear bond clearing system, master card international (Gurusamy, 2009).

It can be established that the last few decades have witnessed distinct growth in the ability of firms and countries to access the global capital markets. During this time span, access to capital (bank credit, equity and/or fixed income bond issuance) has become more copious and competitive. The international operation of a bank may be conducted in a separate division or department even though many of the activities parallel those performed elsewhere in the bank. Big banks typically operate an international division, which may include a network of foreign branches, subsidiaries, and affiliates. Smaller banks or those with limited international activity often use only a separate department in conjunction with a network of foreign correspondent banks.

International Activities

Lending: Banks involved in international lending are both geographically concentrated and numerically limited. Huge percentage of international credits originated at New York City institutions, with most of the remainder are negotiated in secondary money-market centres including Chicago, Miami, and San Francisco. A bank's major source of profit, both internationally and domestically, remains interest received from lending and securities instruments. Other international department activities, such as cable and foreign exchange operations, are necessary adjuncts to international banking and are part of the capability to service correspondent relationships. Nevertheless, few of these activities produce income after expenses, and if these were the only services of international banking, few banks would be attracted to the field. Among those banks that have made a substantive commitment to international activity, international loans have increased considerably in size, complexity, and geographical scope in recent years. Such loans are variously extended to foreign governments, foreign banks, foreign companies, multinational corporations, and U.S. importers and exporters.

Investments: Internationally, banks may periodically allocate capital and risk to investments in foreign debt securities and/or debentures. The debentures may be issued by a foreign bank, corporation, or sovereign government for their respective capital needs. Banks with foreign offices might hold securities of foreign governmental entities to meet various local laws or reserve requirements, reduce tax liability, or as an expression of goodwill. As with domestic bond issues, duration and maturity of the instruments will vary and, in the case of debentures, represent an unsecured obligation of the issuer.

Foreign Exchange: The Foreign exchange is the exchange of money of one country for money of another. Foreign exchange transactions arise out of international trade or the movement of capital between countries. Foreign exchange transactions can be conducted between any business entity, government, or individual; but banks, by virtue of their position as financial intermediaries, have historically been ideal foreign exchange intermediaries, as well. Banks are on one side or the other of the majority of the transactions in the foreign exchange market worldwide.

Bank foreign exchange transactions take place between other banks (referred to as interbank trading) and between banks and their customers (generally referred to as corporate trading). The volume of foreign exchange activity differs extensively among banks. The degree of a bank’s involvement is largely dictated by customer demand but increasingly is being driven by interbank trading for a bank’s own account. Multinational or global banks are the most active in terms of both trading volume and the number of currencies traded. These banks trade foreign exchange across virtually any currency. Other banks may trade actively in only a few currencies and having

only limited activity. While banks of any size can and do engage in foreign exchange transactions on behalf of their customers, generally only the world's largest banks and certain smaller banks specializing in international business enter into transactions for their own account.

Key Risks in International Banks

Country risk: Country risk is associated with the risk of investing or lending in a country, arising from possible changes in the business environment that may adversely affect operating profits or the value of assets in the country. For example, financial factors such as currency controls, devaluation or regulatory changes, or stability factors such as mass riots, civil war and other potential events contribute to companies' operational risks.

Credit Risk: A credit risk is the risk of default on a debt that may arise from a borrower failing to make required payments. It is type of risk associated with an investment where the borrower is not able to repay the amount to the lender. This can occur on account of poor financial condition of the borrower, and it represents a risk for the lender.

Currency Risk: Currency risk is a type of risk that initiates from changes in the relative valuation of currencies. These changes can result in unpredictable gains and losses when the profits or dividends from an investment are converted from the foreign currency into U.S. dollars. Investors can reduce currency risk by using hedges and other techniques designed to offset any currency-related gains or losses.

Foreign Exchange Risk: Foreign exchange risk is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the company. To summarize, global financial market is defined as financial market that are integrated and operated worldwide by using uniform trading practices. International banking is the banking transactions crossing national boundaries. International banking is a vibrant field that holds wide spectrum of financial services and practices. Many of the activities of an international department parallel those conducted in other areas of the bank. Expansion of international finance activities has caused marked expansion in international banking processes recently. This has resulted in new direction in international banking.