(i) Interest rate swaps

(ii) Currency swaps

(iii) Coupon swaps

(iv) Purchase of interest rate caps/collars

(v) Forward rate agreements

Corporates may refer to RBI's Circular No. A.D. (M.A. Series) Circular No. 12 dated August 5, 1996 (Annex. I).

Procedure for Seeking ECB Approval

31. Applications for approval up to USD 10 million will be considered by the Exchange Control Department of RBI, Mumbai, w.e.f. 01/01/1999.

32. Applications for amount more than USD 10 million and under structured obligation may be submitted by the borrowers in the prescribed format (Annex. II) to the Joint Secretary (ECB), Department of Economic Affairs, Ministry of Finance, North Block New Delhi-110 001.

33. The application should contain the following information :

i) An offer letter from the lender giving the detailed terms and conditions;

ii) Copy of Project Appraisal Report from a recognised Financial Institution/Bank, i applicable;

iii) Copies of relevant documents and approvals from Central/State Governments, wherever applicable, such as FIPB, CCEA and SIA clearances, environmental clearance, techno-economic clearance from Central Electricity Authority, valid licenses from Competent Authorities, no objection certificate from Ministry of Surface Transport, evidence of exports/foreign exchange earnings from the statutory auditor based on the bankers realisation certificate, registration with RB in case of NBFCs, approval for overseas investment from RBI etc.

It has been decided that regional offices of RBI will take Loan Agreements on record of all approvals once these have been approved by the GOI/RBI as the case may be. RBI would send a copy of loan document/taken on records to DEA.

Review

34. The ECB guidelines and procedures will be periodically reviewed by the Governmen in the light of prudent management of external debt, changing market conditions, sectoral requirements etc.

35. The ECB policy and procedures outlined above is operative from 1st April, 1999.

36. Guidelines are available at web site <http://finmin.nic.in>

ECB approvals on automatic route

The Government had decided, in principle, to place fresh ECB approvals upto USD 50 million and all refinancing of existing ECBs under automatic route. Necessary software and institutional arrangements are being developed to operationalise automatic route. RBI is being requested to work put modalities for implementation.

Source : Government of India, Ministry of Finance website.

UNIT 11 DEPLOYMENT OF RESOURCES

Objectives

The objectives of this unit are to :

- understand scope and purpose of deploying resources.
- appreciate various modes of international financing.
- describe the mechanism of financing international trade,
- familiarise various cautionary aspects of resource deployment.

Structure

11.1 INTRODUCTION

In ordinary domestic commercial transactions, which are reasonably simple, well-prescribed means of resources in the event of non-payment or other causes of disagreement between parties. For example, the courts can be used to reclaim goods when buyers refuse to pay or are unable to pay the deployed resources. We find that the situation is substantially more complex with international commercial transactions, which by necessity involve more than one legal jurisdiction. In addition, a seller might not receive payment, not because the buyer does not want to pay, but because, for example, the buyer's country has an insurrection, revolution, war or civil unrest and decides to make its currency inconvertible into foreign exchange. In order to handle resources deployed and/or to be deployed and other related difficulties faced in this regard, a number of practices and institutional arrangements have been developed and put to practice.

In this unit we will explain different practices and institutions for ensuring payment and delivery in international versus domestic trade, national and international institutions which have been established to finance and facilitate international trade. Besides, we will explain practices such as syndicated loans, project finance, leasing, asset securitisation, forfaiting and counter trade that gained unique importance in the conduct of international trade.

11.2 SCOPE FOR DEPLOYMENT OF RESOURCES

Banks have become more global in their reach and in the diversification of their portfolio. They operate with greater freedom than before. Furthermore, there is more universal banking today than in the past. International lending can be basically divided into two types – government lending, and deployment of funds in the private sector:

Government Sector

Government loans have a variety of purposes – general borrowings for the Treasury, loans to finance imports or projects in the private sector, loans to develop infrastructure viz. roads, ports, or irrigation systems or power sector and loans for many other purposes including oil, fertiliser and defence equipments imports, etc., that governments need funds. Actually, the purpose of a government loan is primarily one of interest to the extent that it will provide more insight to that country's future balance of payments; **i.e.,** does the loan produce foreign exchange or will it save foreign exchange for the country in the future? In the simplest terms all foreign government loans are undertaken to fill or replenish that country's holdings of foreign exchange, regardless of the project purpose that is attached to it. Foreign currencies e.g. dollars are not needed for local projects except to that extent that such projects include import of foreign goods or services.

Private Sector

Loans to the private sector generally fall into two classes – loans to finance the movement of goods (i.e. imports or exports) or loans to finance the multitude of other projects in which businesses get involved. Loans for imports provide the importer **(and** the country) with the foreign exchange to pay for the import. Loans to finance exports give the exporter the foreign exchange proceeds a little faster than they would receive it in the normal course. Loans are granted to finance other projects such as the construction of a new plait or the expansion of inventory.

Loans to the private sector may be to purely local companies or to subsidiaries of foreign companies – with or without support of the parent. Occasionally, loans are made to individuals for personal or investment purposes. In the context of US, private sector loans also include loans directly to foreign commercial banks for a variety of purposes. These might appear either as a loan to the bank or as a deposit depending on arrangements concluded for such transactions.

11.3 HEADS OF RESOURCE DEPLOYMENT

Banks deploy the resources keeping in view their lending policy under various heads/ activities as under :

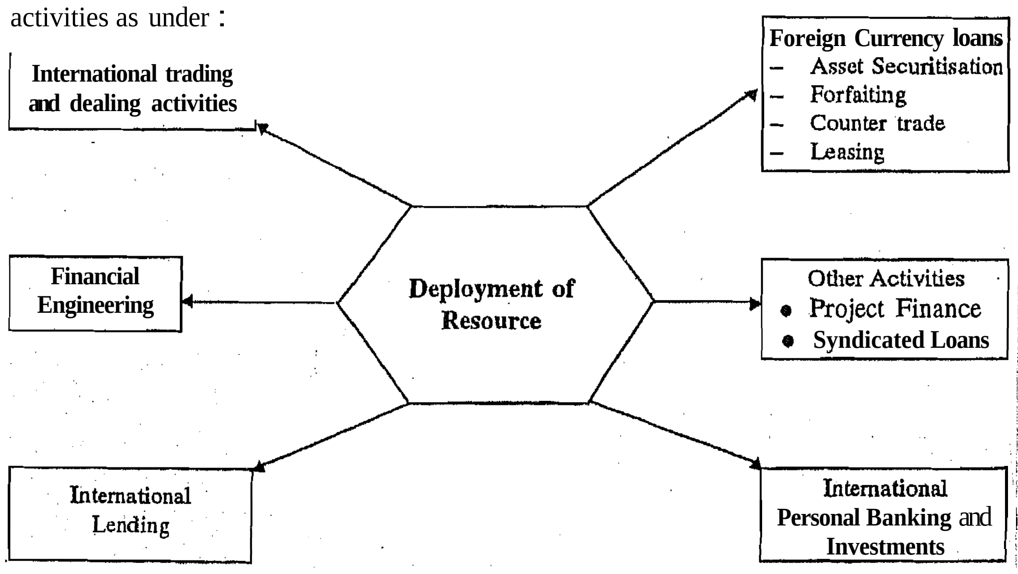

Figure 11.1 Heads of Deployment of Resources

International Trading and Dealing Activities

Banks do deploy funds in international trading and dealing activities – in foreign currencies, deposits, forward exchange contracts, financial futures and options, gold and other commodities – all functionally linked to position in the institution to profit from shift-in markets within acceptable limits of exposure to risk. A major determinants of profitability is the management of sources and uses of funds – mismatching the maturity structure of a part of the institution's assets and liabilities in the light of the shape of the yield curve expectation about future interest rate movements and anticipatory liquidity needs. The financial institution must anticipate market developments more correctly and consistently than the completion and it must move faster if it is to earn more than a normal return on its capital. The counter parties that it trades with the money and foreign exchange dealings for example must have different interest rate and exchange rate expectations or he slower and less sophisticated (and the institution itself has to be correct most of the time) if it is to excel in this activity. All this must be accomplished in an environment in which, each important player has simultaneous access to the same information. It is a fiercely competitive and highly risky business.

Financial Engineering

A technique that uses pay off profiles to show the consequences of different strategies. The profiles can he combined to show the outcome of different strategies.

International Lending

International Lending as an opportunity to deploy funds remains a mainstream of the banking industry, It includes secured and unsecured loans to local corporations, banks, government, international enterprises and individuals domiciled outside the home country either in local or foreign currencies; competition in this area varies from exceeding intense in the Euro markets. Returns tend to vary with the degree of competition prevailing in the local environment, the complexity and riskiness of the deal and the worthiness of the borrowers. Specific dimensions of competitiveness in this area include the initiative and maintenance of contacts with borrowers or other customers, the quality of credit evaluation and question of country risk. Specialised forms of international lending include syndicated loans and financing of the projects.

Letters of Credit and Banker's acceptance

Loans for the movement of goods comprise a substantial amount of total international lending. Such loans have developed complex practices and terminology and include devices such as letters of credit and banker's acceptances. An export from India could arise from a purchase order in dollars from a company in, say, Italy. If the exporter is comfortable with the credit standing of the buyer and the likelihood that the buyer can obtain dollars in Italy to pay on the due bate, he will ship the goods and await payment. On the other hand, he may be unsure of the credit standing of the buyer and ask that the buyer have his bank write the exporter a letter saying that the bank will guarantee payment.

Letter of Credit: A letter of credit arises which in usage has become very formalised and is surrounded with an extensive list of traditional practices and an extensive legal framework. The cost of the guarantee of payment is paid by the importer, but it forms a part of the total transaction cost and is allocated between buyer and seller somewhere in the transaction negotiation while concluding the agreement, A further variation is a case where the exporter might not feel comfortable even with a letter from the Italian bank and insist that the letter be sent to his local Indian bank which in turn will add its confirmation (guarantee) at a fee to be paid by the importer/exporter depending on the terms of the contract.

Usance period: Usually, the Indian exporter will want his money when the goods are shipped and will draft upon his Indian bank (in the case immediately above). However, the importer may desire time to receive the goods before paying and ask for a period of 90 days, or more. If a 90 day period is agreeable to all parties a 90 day time draft (usance bill) will be presented by the exporter to his Indian bank after the goods are shipped. The Indian bank will affix its guarantee to the draft by marking it "accepted" with the bank's name and an authorised signature. The bank has now created a banker's acceptance, which in essence is an IOU of the bank. The exporter can either hold the draft until the maturity date, can sell it in the market through a broker anytime before the maturity date, or sell it to the accepting bank at the market rate of discount; the bank can then either hold it as an investment or sell it in the market. The interest cost of discounting the acceptance is usually borne by the exporter, but if the term of the acceptance is longer than his usual practice for domestic sales, he may adjust the price of the goods to compensate.

Lines of Credit: In handling the above transactions, the Indian bank has to establish lines of credit (or atleast internal limits) for the foreign banks for which it confirms letters of credit or creates acceptances. Obviously, the Indian bank will have to perform the usual credit analysis on the banks, as well as analysis of the risks of the countries in which the banks are domiciled.

In the case of an import by an Indian company, an Indian bank may be asked to present a letter of credit to a foreign exporter (directly or through a foreign bank) and the entire process is reversed. However, if acceptance financing is desired to finance the goods while enroute and the transaction is denominated in dollars, the Indian bank will provide it. In that event, as far as the Indian bank is concerned, all of the credit risk in the case of an import lies with the local importer.

The above discussion is a thumbnail sketch of handling transactions involving the movement of goods. If a bank undertakes this business, it is well advised to have on its staff a person competent in handling letters of credit and related aspects. The need to analyse foreign banks and countries cannot be over-emphasised. A familiarity with the import practices in foreign countries is also necessary for exporters, as some countries require letters of credit to be issued by a local bank before any import can legally be undertaken, or else the necessary foreign exchange will not be made available to pay for the import. However, such a letter of credit is not an iron clad guarantee that the exchange will be available but, it is more an expression of intent. Analysis of the country must also be performed in advance to determine the likelihood of exchange being available.

Standby Letter of Credit : Standby Letter of Credit covering the issuance of debt by private firms and public sector entities, as well as construction and related projects, have become an insurance related and fee earning activity that is not based on enlarging the balance sheet and hence can be attractive to banks. As a result of renewed interest in international trade services, competition between the banks in this area has once again become heated in part in view of lucrative business opportunities.

Foreign Currency Loans

At times Indian banks might make a loan in a currency different from the currency used to fund the loan; for example, a Deutsche Mark loan made from funds secured as US Dollars or a Japanese Yen loan funded with US Dollars. If a bank should exchange dollars for a foreign currency and use the foreign currency to make a loan, it has the option of selling in the foreign exchange future market the proceeds it expects to receive from collecrion of the loan. In the case of a Deutsche Mark loan funded with dollars the interest rate for Deutsche Marks would be lower than the Indian interest rate in today's markets, and the bank would probably try to increase its yield from the spread between the current market/dollar/Deutsche Mark exchange rate and that rate in the forward market. In the case of Japanese Yen loan funded with dollars, it would cost the bank X percent to sell the Yen forward. The bank may choose to cover the exchange risk or carry the exposure until the due date of the note.

In both the cases described above there is an element of interest earned as well as a foreign exchange earning or cost. It is strongly suggested that all loan operations run a balanced position with the loans and the funding being in the same currency. If they are not, it is suggested that the lending department obtain an internal foreign exchange contract with its own foreign exchange desk at prevalent rates. This will sort out the true interest earned on the loan from the foreign exchange income or expense. It will also put the foreign currency exposure on the recoids of the exchange trading department where it can be carried without a cover, or hedged, depending on its trading policy. Of importance is the consideration that the foreign exchange dealers will monitor any open positions constantly and be in a better position to take protective action than if the exposure is filed away somewhere in the loan records.

Securitisation : The process of creating tradeable securities backed by a pool of assets. Also refers to the replacement of non-marketable loans and/or cash flows provided by financial intermediaries with negotiable securities issued in the capital markets.

Forfaiting : An Export Finance Option: Forfaiting is a mechanism of financing exports by discounting export receivables, evidenced by bills of exchange or promissory notes without recourse to the seller (exporter) on a *fixed* rate basis (discount) may be upto 100% of the contract value. Forfaiting is a non-recourse discounting of export receivables.

Eligibility	Requirement	Role of a bank	Cost involved	**Benefits**
• Goods exported on credit terms • Currency - any major convertible currency • Minimum value USD 500,000 equivalent • Acceptable country risk	• Receivables under a deferred payment contract evidenced by bills of exchange or promissory notes can be forfaited. • B/E or P/N backed by coacceptance (aval) of the foreign bank and assignment of proceeds by the exporter, without recourse, in favour of the forfaiting agency. • The B/E or P/N should be in the prescribed format. • The co-accepting bank must be acceptable to the forfaiting agency	• A facilitator between the Exporter and the overseas forfaiting agency. • Indicative and firm forfaiting quote is obtained. • Documentation • Conclusion of contract with forfaiter. • Communication to coaccepting bank. • Collection of discounted proceeds for credit of customers account.	**Commitment fee*** • Payable by the exporter to the forfaiter as commitment to execute a forfaiting transaction at a firm discount rate within a specific time. • Commitment fee generally ranges between 0.5% and 1.5% p.a. of the unutilised amount. * not applicable to short term transactions **Discount** Fee • Is the interest cost that is based on the relevant market rates, LIBOR + basis points (depends on the country risk) • The discount rate is applied to the aggregate amount due on its maturity. • The rate is upon at the time of entering into the contract. **Documentation Fee** • No documentation fee is incurred in straight forward forfait transactions. • Documentation fee is charged, if, extensive documentation and legal work is necessary. Bank's Service Fee Payable in Indian rupees.	• An approved method of export financing • Converts credit sales to cash. • Enhances liquidity and cash flow. • Frees the exporter from cross border political and/or commercial risk. • Finance upto 100% of export value is possible as compared to 80-85% financing available from conventional Export Credit Programmes. • As without recourse finance it does not affect the exporter's borrowing limits (MPBF) Thus, forfaiting represents an additional source of funding. • Provides fixed rate finance, hedges against interest and exchange risks. • Exporter is freed from credit administration and collection problems. • As forfaiting is transaction specific, a long term banking relationship with the forfaiter is not necessary. Saves on insurance costs as forfaiting obviates the need for export credit insurance.

In a forfaiting transaction, the exporter surrenders, without recourse, his rights to claim for payment on goods delivered to an importer, in return for immediate cash payment from the forfaiter. As a result a credit sale is converted into a cash sales with no recourse to the exporter or his banker. Hence, in Indian context this instrument operates as an addition to the existing bank schemes available to the corporates.

Counter Trade: Export financing can be defined as a mechanism for financing export sales. One of the terms of financing is counter trade. International trade practioners find counter trade as a generic word for international trade practice which runs counter to the multi-lateral arrangements stipulated international organisations like the World Trade Organisation (WTO), UNCTAD, International Monetary Fund (IMF) and the World Bank. The practice basically involves bilateral settlements in goods most often without the use of money as a means of exchange. Economists talk about inandated counter trade and define it as a policy to restrict unilateral imports In line with observed practices, it is suggested that an optimal counter trade policy with target high mark up imports and low mark up exports. By its implications, for global welfare are ambiguous and depend upon the exchange of a double coincidence for wants.

Counter trade as a theme can be variated in the points as under considering the modalities and relhted factors.

Counter Trade →
- Barter
- Buy back arrangement
- Compensation Trade
- Counter Purchase
- Switch deals

Barter : Direct exchange of goods between the buyer (importer) and the seller (exporter). Strictly speaking no exchange of money or use of third party is felt as per mechanism.

Buy Back Arrangement : Typically, these are contracts where the exporter, usually of a capital plant, commits himself to the purchase of turnkey projects. These contracts are not ideal as the risks involved are found to be substantial and pose difficulties in identifying the same.

compensation Trade : Under the compensation trade practices the importer pays for his purchases partly in cash and partly in goods. Normally, a single contract regulates the sale and repurchase obligations.

Counter Purchase : Virtually it is the most common form of counter trade. In this mechanism two contracts are made : the first relates to the delivery of the goods and the second contract concerns the repurchase of the goods. Ideally, both contracts are to be made separately i.e. they should not be contained in a single contract document.

Switch Deals : Going by technicalities and knowing their implications, it is not true form of a counter trade. It involves financial transactions which put to use the balances from bilateral trade agreement. The available confirmed balances can be traded with convertible currency depending upon the scope and availability of opportunity.

Counter Trade : *Indian perspective* : Corporates and bankers in India need to upgrade their negotiating capabilities and commercial intelligence to undertake counter trade effectively and to add to the exchequer of India through a few banks which do have such exposure with the erstwhile **USSR**.

Leasing : In recent years leasing has become more popular as a financing device. This is probably one of the most complex types of international transactions, as it takes careful legal and tax planning to build a good transaction wherein the domicile of the lessor **may** be in a different tax environment than its parent, in a different country than the source of funds, in a different country than the lessee, and possibly the leased item may be in a fifth country.

Other Activities

Project Exports : The Financing of Project Export is a crucial element because of the time lag between the actual movement of goods or execution of a project and the receipt of funds. Revenues are earned after a gestation period. Such contracts may be concluded by way of Suppliers Credit. The exporter extends credit directly to the foreign buyer and has to arrange for finance from a commercial Bank/EXIM Bank. In a Buyers' Credit the EXIM Bank extends credit to the foreign buyer (either singly or in participation with commercial Banks) and the exporter receives payment from the financial institution on a non recourse basis, after fulfillment of the commercial terms of the contract. All buyer's credit proposals require prior approval of the Reserve Bank of India in Indian scenario. Commercial banks, in participation with EXIM Bank, also assist project exporters by sponsoring their applications to the Working Group and providing necessary counselling regarding the terms of payment, exchange fluctuations and country risk, etc. In order to enable the contractors to undertake projects abroad, Commercial Banks/EXIM Bank provide Bid Bond Guarantees, Performance Guarantees and Advance Payment Guarantees on behalf of their clients. Banks also establish Letters of Credit for import of raw materials/third country supplies. They also provide packing credit, negotiate export bills against LCs extend term export/deferred credit facilities, finance incentives/cash subsidies., guarantee the loans taken, to be taken by the buyers at the instance of the exporters.

In case of Software and pure Service Exports i.e. Consultancy Services, etc., normally there is no shipment of goods involved. However, the exporter requires finance for mobilisation of technical personnel and financing of services bill to be paid by the overseas employers. Banks extend post shipment finance against such services at concessional rate of interest as applicable to cash exports.

It will be in the long term interest of the project exporters to remain in constant touch with the Commercial Banks/EXIM Bank so that they are kept posted with the various developments that are taking place in the international scene.

Loan syndication : A flexible means of financing growth : Loan syndication is a multi-bank arrangement to deploy funds. It includes an agent bank (maybe SBI or Bank of Baroda) and one or more additional lenders. There are several advantages like:

- Loan syndication allows the borrower to access a greater amount of capital than a single bank can provide, while allowing the borrower to retain a primary relationship with the hank agent. Typically, syndicated loans are at least \$20 million and grow as large as multiple millions of dollars.
- Loan syndication provides a loan platform by providing a single set of documents, one proof of collateral, and one set of covenants. As a company's borrowing needs grow, additional hanks can be added easily and inexpensively.
- Loan syndication minimizes the borrower's legal and administrative expenses. By using a single document and communicating with a single agent bank, syndicated loans are much more cost effective than maintaining multiple, bilateral banking relationships.
- Syndicated loans mature in three to five years for revolving credits with no amortisation and in five to seven years for term loans, commonly with straight-line amortisation. In addition, syndicated loans are structured to accommodate projected financial conditions of the borrower-making it an effective way to finance substantial organic growth or growth via acquistion.
- Financial Report
- Business licenses and its amendments
- Feasibility Study on the financial projection
- Other general information regarding the company.

International Personal Banking and Investment Services

Banks do deploy their attention and sources towards international personal banking and investment banking services, fiduciary trust and investment activities for institutional clients and retail banking abroad. These services include the issue of traveller's cheques and travel related services, stock brokerage, securities custody and clearing, mutual funds and meeting the financial needs of the wealthy/high net worth individuals. Such business involves specialised financial services and unique forms of competitive and institutional cooperation, Retail banking in national financial markets abroad is not easy to penetrate but'product differentiation and infusion of new banking technologies can produce substantial returns to successful competition who are able to gain access to local marekts abroad.

11.4 TRANSLATION AND ANALYSIS OF FOREIGN STATEMENTS

We have to consider the following aspects in depth while taking.decisions to deploy our resources in international trade :

The basic objectives in analysing foreign financial statements are the same as in domestic lending. The lender wishes to understand the nature of the customer's business activity so that they can determine that the likely future cash flows will provide the funds to repay either short or long term loans. In addition, the lender wishes to understand the figures well enough to appraise the trends of the borrower, the character of the assets, and the actual or potential claims on the assets, so that a commercial judgement as to risks can be made.

With the globalisation and resultant expansion of the large Indian accounting firms there is a good influence on accounting conventions and practices. However there remains much to be done on translation of foreign bank statements.

The translation and analysis of foreign central bank statements is probably a useful exercise. However, since the central bank of a country is a government entity and its obligations are thereby directly or indirectly government obligations, the real analysis that must be pursued is the country's holdings of gold and foreign exchange and the trends of such holdings, Most central bank statements can be manipulated with "mirrors" - capital can he raised at will with the infusion of local government bonds, and bad assets can be switched to budget appropriations for other government entities, leaving the central bank in an apparently strong condition. Though understanding of a central bank's figures may provide some interesting information on the bank, the government, and the monetary process, but, as indicated above, repayment of foreign loans comes only from hard currencies. Hence cautious approach has to be followed.

,There can be a proposal when a foreign bank asks an Indian bank to lend to a foreign company with the guarantee of the foreign bank. Frequently, the information supplied about the borrower is meager, and the Indian bank is reluctant to insist on more detail. If the foreign bank is large and apparently sophisticated in its lending, the lack of detail might be excused. On the other hand, if the guarantor is less sophisticated, the Indian bank probably should study the credit fully and not hand over the guarantor a bad piece of paper if the Indian bank ultimately has to look to the guarantee,

1.5 COUNTRY RISK

Exposure to a government or one of its official entities are essentially to a country risk. Exposures to the private sector also contain varying documents of country risk. Few companies can operate completely independent of their environment, unless the borrower is a multinational concern with the ability to repay from external sources.

Analysis of country risk is usually classified as a combination of analysis of: (a) economic risk, and (b) political **risk.** However, because of its unique importance, the analysis of the country's international liquidity should be given the status of a separate category.

Caution should be exercised in analysing individual countries and arriving at final judgements on the acceptability of the composite of economic and political risk. Economic averages can be misleading as indicators of ability to repay. Norms for individual economic indicators cannot be applied to all countries. Each country analysis is a somewhat unique exercise to determine whether the economy seems to be functioning reasonably well, that the political mechanism seems to be in control, and that the trends suggest a continuance of reasonable performance and stability at least throughout the **life** of any proposed exposure.

11.6 ECONOMIC RISK

An approach to analysing a country should be done with the warning firmly in mind that the statistics of varying quality and reliability. However, the following economic indicators would be the minimum to be observed for a period of atleast last 2/3 years :

1. Gross National Product
   a) Annual total of GNP.
   b) Annual percent change of actual GNP.
   c) Annual percent change of real GNP; i.e, adjusted for inflation.
   d) Real GNP per capital
2. Industrial Production
   a) Index of level of industrial production
   b) Annual percent change of industrial production index.
3. Population
   a. Total population
   b. Rate of growth
4. Employment
   a) Unemployment percentage
   b) A comparison of agricultural and industrial employment to total population
5. Wages
   a) Index of wage level
   b) Annual percent change of wage index.
6. Money Supply
   a) Actual money supply.
   b) Rate of growth each year.
7. Inflation Indices
   a) Consumer price index
   b) Annual percent change in consumer price index.
   c) Wholesale price index.
   d) Annual percent change in wholesale price index.
8. In addition to the above indicators, other indicators that are specific to a given economy should be monitored closely; for example, tourism, or mining production and world prices of the commodities mined, or production of agricultural items, rubber, edible oils, tea, coffee, cocoa, etc., and its world price.

Economic trends can strongly affect political developments in a country. Poor economic performance might lead to substantial political change.

The analysis of international liquidity is undoubtedly part of the economic analysis of any country, but as mentioned above, it is of such importance that special emphasis is warranted. Indeed a country might be quite stagnant in its economic growth, or have severe inflation, and yet manage its international liquidity so as to meet all external obligations quite readily.

11.7 POLITICAL RISK

While serious efforts are made by most international lenders to analyse the available economic data for a country, the analysis of political risk is more difficult as fewer quantitative indicators are available. Presumably, if a lender places funds in a country, they are satisfied with the government, its attitude toward debt, and its likely future administration of the country, whether it be a dictatorship or a government elected by the people. In countries where dictatorships prevail and control is dependent on the army or police force, the question of succession is apt to be quite uncertain. As indicated above, close information on the political situations in different countries is not difficult to develop. However, the electronic and news media, furthermore, tend to be shallow sometimes and with the help of mass media sensational in their reporting, if they choose to report certain events at all. The only recourse that a lender has is to make serious efforts to obtain information within the country itself and to cross check it with a hope that unexpected internal and external pressures do not develop to cause an unpredictable and undesirable series of events.

11.8 LEGAL PROBLEMS

Domestic lenders operate within a framework of laws that are a part of their daily routine, and with which they usually feel fairly comfortable. When loans are made across national borders, none of the legal framework of the foreign country can be taken for granted. Each foreign country has its own system of laws with its own roots, viz. English law or the Napoleonic Code. In translating any lending documents from one language to another it might be difficult or impossible to give exact translations. Words, commercial terms, and phrases may have unique and different legal significance in each country. At times it can seem nearly impossible to achieve a clear understanding of the legal circumstances surrounding an international loan.

Foreign laws affecting Indian lenders are best identified with the assistance of local legal counsel. They may include the need to register to determine tax status the need for borrowers to record the indebtedness with the government to ensure that the dollars will be made available for repayment, and very commonly the withholding of taxes on the interest paid on the loan.

11.9 FUNDING

The funding of international loans can come from domestic or foreign sources, such as Eurodollars. External Commercial Borrowings, NRI, OCBs, FIIs, FDI's funds or through offshore financing increased rapidly and now provides a substantial majority of the funding.

May be in the 1960s, particularly the early part of the decade, there was concern that the Eurodollar market was too new and uncertain to guarantee funding for longer term loans. It was then used as a source for shorter loans mainly, and foreign banks obtained standby commitments from American banks to insure availability of dollars over longer periods to back the funding for their longer term loans. Today it appears as if the Eurodollar market is "here to stay", in view of its efficiency, and apparent stability.

Certain borrowers will tend to swing from one market to the other to save borrowing costs, which can be inconvenient to the lenders, but it can also provide opportunities to the same lenders for cheaper funding at times.

If the reader would create a theoretical bank with only international loans, purchased deposits, stockholders' equity, and no operating expenses except interest, a trial and error computation would reflect that a spread of 0.25 to 1.5 percent over the cost of money i.e. LIBOR/MIBOR and over the costs of any required cash reserves) is the absolute minimum needed to produce a return on capital after taxes. However, every bank has some operating expenses and the minimum spread should be approximately 0.50 to 1.75 percent. It should reflect total compensation, including the effect of any free deposit balances.

11.10 MATURITY OF LOANS

Normally international lending is for a short term say upto six months or a year, and primarily for the movement of goods. Occasionally, a lender might grant an outright loan for as long as five to seven years, but only as an exception and for good compensation. Competition, and possibly a reach for earnings, caused maturities to lengthen. The lengthening of terms tended to ignore the underlying use of the funds and to look more at the country's overall balance of payments data, the merits of which can be supported by some good arguments when loans are to government entities.

The recessionary situations more conservative attitudes, and international loan maturities and contracted to a maximum of five years are observed.

The principal justification for long term loans seemed to be because interest rates were typically adjusted every six months, under floating rate system and therefore there was no rate risk. Obviously, this ignores the question of credit risk and the question of the role of a commercial bank and the need for liquidity in its assets. The long term bond market for international borrowings is not large and or well structured. Consequently, borrowers seeking longer maturities have found themselves dealing mainly with their banks and often inviting them to bid against each other for transactions. Bidding arrangements may not develop the close relationships that are of mutual interest to the lender and the borrower. The experiences have shown that customer loyalty cannot be purchased with the longest loan maturities, nor can the loyalty of lenders be gained by paying the lowest tolerable interest rates.

11.11 COUNTRY LIMITS

With the emergence of concern for bank capital adequacythe related question of concentrations of international loans and country limits has become topical..The questions basically are : Should there be a portfolio limit for a given country related to a percentage of a bank's capital (including or excluding capital notes?) Should there be sub-limits within the country limit for loans to the public and private sector? And should there be limits on the amount of term lending? Although it theoretically might be desirable, an Indian bank ordinarily has to concern itself with a country limit for taking exposures.

The optimum size of any country limit is a matter of judgement and is difficult to quantify. Decisions of management of one bank might leave another totally uncomfortable. Despite the difficulties, however, it would seem that every bank should have written country limits approved by the Board of Directors.

A bank management really cannot claim that limits are too complex to be set in exact terms; in such a case the policy is obviously one of having no limits.

Thus, so far no rule of thumb exists as to whether a bank should commit an amount equal to 10 per cent, 50 per cent or 100 per cent or more of its capital in a single foreign country. A practical consideration is whether, after tax considerations, a bank would care to lose as much as a year's earnings, or more, if unexpected developments should occur too quickly in a foreign country to reduce the total exposure significantly, Even in a highly developed country which appears to be quite stable, it is often very difficult to detect gradual changes in the economic or political structure that would prompt a reduction in country exposure. Experience has shown that, if a lender waits until the moment of crisis to seek a reduction in loans, it is usually impossible to achieve reductions in significant amounts. On the other hand, there is the risk that the problems' are apt to be temporary with substantial correction forthcoming, and suspension of business in that country might later be regretted.

Taking holistic view and anticipating events as above a prudent finance manager can ensure profitable deployment of resources with the knowledge of international events and certainly insulating the corporates from harmful ones.

Activity 1

a) Considering the modalities and related factors, some of the variants of counter trade are :

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b) The main advantages of Loan Syndication are :

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c) Some of the indicators of economic risk of a country are :

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11.12 SUMMARY

A knowledge of international finance helps in two important ways. First, it helps the financial manager decide how international events will affect a corporate and which steps can be taken to exploit positive developments and insulate the corporate from harmful ones. Second, it helps the managers to anticipate events and to make profitable resources deployment decisions before the event occurs. For it the financial manager resorts to various instruments normally used in international financing. This unit attempts to provide us various heads under which international resources can be deployed and the various issues concerned with it.

11.13 KEY WORDS

Acceptance draft : Cheque or draft for which documents such as the bill of lading are delivered upon acceptance of the draft by the payee's bank.

Banker's Acceptance : A time draft which has been guaranteed by a bank stamping it as accepted so that the draft can be sold at a bank related discount rate, not at a rate related to the risk of the issuer of the draft.

Bilateral Trade : Trade between two countries.

Buyer's Credit : Loans to buyers, especially importers from banks.

Counter Trade : A reciprocal agreement for the exchange of goods.

Country Risk : Uncertainty surrounding payment from abroad or assets held abroad due to possibility of war, revolution, asset seizure or other similar political, social or economic event.

Forfaiting : A form of medium-term non-recourse export financing. Involves a series of avalled time drafts.

Withholding tax : A tax applied to non-residents at the source of their earnings.

11.14 SELF ASSESSMENT QUESTIONS

1. What do you understand by deployment of resources ?
2. How Letters of Credit and Banker's acceptances facilitate international trade ?
3. Define counter trade. Examine mechanism of counter trade.
4. What do you understand by project finance ?
5. List out the benefits of syndication of loans.
6. Discuss country risk giving examples.

11.15 FURTHER READINGS

1. *Risk Management Systems in Banks,* Guidelines by Reserve Bank of India, 1999.
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4. Bhardwaj, H.P., *Foreign Exchange Handbook,* Bhardwaj Publishing Company, Mumbai.
5. Rajwade, A.V., 2000, *Foreign Exchange Risk Management and International Finance,* A.V. Rajwade & Co.
6. Joel Bessis, 1998, *Risk Management in Banking,* John Willey Sons, New York.
7. Maurice Levi, 1996, *International Finance : The Markets and Financial Management of Multi-national Business,* McGraw Hill, USA.

UNIT 12 TREASURY MANAGEMENT : AN INTRODUCTION

Objectives

The objectives of this unit are to :

- understand traditional activities of treasury.
- describe modern financial theory, planning, decision making and general responsibilities of treasury personnel.
- familiarise you with various treasury functions/transactions management' of treasury and policy of organisation.
- acquaint you with various risks in treasury operations.

Structure

12.1 INTRODUCTION

Treasury Management function has changed dramatically during the last decade. From a mere facilitator of transactions, with few analytical tools, the task of treasury management has become a dynamic, quantitative function, providing service and often additional profits to the entire organisation. The financial arm, today, is often the life blood of an organisation. Today, the strength of treasury operations is oflen what distinguishes a lackluster performance form stellar growth in quantity and quality of earnings. In this unit, we will explore that traditional functions in detail, with particular reference to their conceptual underpinnings. With these reference points, we will be able to see how treasury management has changed. The forces behind these changes will be explained and assessed for importance. We will also review some of the important new tools used by treasury managers to achieve the broader, more difficult tasks required in the modem, global business climate.

12.2 TRADITIONAL FUNCTIONS

To say that tinancial management is critical to all businesses is an obvious truism, But to observe that the task of financial management has changed dramatically in recent years is less obvious. In terms of products and technologies many industries evolve slowly. With