SBAA3015-INTERNATIONAL BANKING

COURSE OBJECTIVES

- To understand the basic concept of International Banking and Financial Institutions.
- To provide necessary knowledge of international banking operations and international payment arrangements.
- To introduce recent trends in international banking.

UNIT 1 INTERNATIONAL BANKING AND FINANCIAL INSTITUTIONS 9 Hrs.

Origin and Evolution of International banking - Global trends as reasons for growth of international banking -future prospects of International banking - Need for regulation of international banking in the current scenario. International financial institutions - International financial centres.

UNIT 2 RISK MANAGEMENT IN INTERNATIONAL BANKING 9 Hrs.

Risk Management in International Banking: Risk Management: Risks in Banking - Credit risk, Market risk, Settlement risk, Liquidity risk, Operational risk, and Legal risk - Need and importance of credit rating - Asset Liability Management (ALM) - Importance of ALM - off-Balance Sheet items - off-balance sheet risk - Asset/Liability and International Banking operations.

UNIT 3 INTERNATIONAL BANKING OPERATIONS 9 Hrs.

Off-shore financial centres - Rationale - Characteristics of offshore financial centres - Types of offshore centers - International Banking facilities - Special Economic Zones (SEZs) - Regulatory concerns. Correspondent banking -- clearing house functions - payments and collections - credit services - foreign exchange services - other facilities. Foreign Bank Branches' operations: Factors behind overseas branch expansion - Objectives of abroad branches - constraints faced by overseas operations.

UNIT 4 INTERNATIONAL PAYMENT ARRANGEMENTS 9 Hrs.

International Payment Arrangements - Society for Worldwide Interbank Financial Telecommunication (SWIFT) - SWIFT messaging. Payment methods in International Trade - Cash in advance - Letter of Credit (L/C) - Documentary collection - Open account or credit - Countertrade or Barter

UNIT 5 INTERNATIONAL BANKING - RECENT TRENDS

Basel III compliance by Banking Industry across the globe - Shadow Banking
performing assets - cross-border terrorism.

COURSE OUTCOMES

On completion of the course, student will be able to

CO1 - Examine the functions and operations of international banks.
CO2 - Assess the risk involved in International Banking.
CO3 - Describe the banking operations of International banks.
CO4 - Evaluate the sources of foreign exchange.
CO5 - Examine International Payment arrangements.
CO6 - Elaborate the contemporary trends in banking industry.

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SCHOOL OF MANAGEMENT STUDIES

Unit -1- INTERANTIONAL BANKING- SBAA3015

Origin and Evoluation of international banking- global trends as reasons for growth of international banking- future prospects of international banking – Need for regualtion of international banking in the current scenario. Interanational financail institiuions – international financial centres.

Meaning

International banking is just like any other banking service, but it takes place across different nations or internationally. To put it another way, it is an arrangement of financial services by a residential bank of one country to the residents of another country. Most multinational companies and individuals use this banking facility for transacting.

Example

Suppose Microsoft, an American company is functioning in London. It is in need of funds to meet its working capital requirements. In such a scenario, Microsoft can avail of the banking services in form of loans, overdrafts or any other financial service through banks in London. Here, the residential bank of London shall be giving its services to an American company. Therefore, the transaction between them is said to be a part of an international banking facility.

International markets, offer opportunities to the traders and corporate and multinational companies, to expand their business, across different parts of the globe. International investors explore more investment avenues for their investments.

The international markets in the financial sector offers a wide range of opportunities for expansion of trade and financial activities across the borders of nations. “International Banking” can be defined as a sub-set of commercial banking transactions and activity having a cross-border and/or cross currency element.

Multinational banking refers to the location and ownership of banking facilities in a large number of countries and geographic regions. International banking comprises a range of transactions that can be distinguished from purely domestic operations by (a) the currency of denomination of the transaction, (b) the residence of the bank customer and (c) the location of the booking office.

International Banking – features: –

Expansion: International Banking assists traders to expand their business and trade activities beyond the boundaries of a nation. Economic growth and conducive climate for carrying out the business activities in new nations are the factors because of which many enterprises are looking beyond the borders of their own nations for their business growth. Competitive advantages in respect of price, demand and supply factors, future growth opportunities, cost of production and operating costs, etc., are some of the other important factors for expansion of international trade and finance. In view of this, the presence of banks across the nations have led to the growth of international banking.

Legal and Regulatory framework: Flexible legal and regulatory framework encourages traders and investors to enter into the international markets. Quick approval to set up business, less complicated compliance requirements and stable political situations help many new players to enter into a number of nations to expand their activities Also, due to lesser tax rates or no taxes to be payable, certain tax havens play important roles as off shore banking centers which encourages many international banking units to open their branches in such off shore centers.

Cost of Capital: The operating efficiency of an enterprise depends upon the average cost of capital. Many companies enter into new emerging markets to take advantages of the lower cost of capital in such markets. Banks as a financial intermediary play an important role as source of funds. Banks through their professional skills take advantage of the arbitrage opportunity in different international markets and increase their profits.

Current account and Capital account transactions: Banks play crucial role in export and import trade. By providing different types of financial and non financial support, banks help enterprises, corporate customers and individuals doing business in different countries, by extending trade finance and investment opportunities. Banks also facilitate movement of funds (inward and outward remittances) through their network and correspondent banking arrangements.

Risks: Different risks paved ways for diversification, thereby global investors look for alternative destinations to invest their savings with twin objectives of safety of funds and better returns. In view of their presence in different time zones, international banks also face various risks

Benefits

Flexibility

International banking facility provides flexibility to multinational companies to deal in multiple currencies. The major currencies that multinational companies or individuals can deal with include the euro, dollar, pounds, sterling, and rupee. The companies having headquarters in other countries can manage their bank accounts and avail of financial services in other countries through international banking without any hassle.

Accessibility

International banking provides accessibility and ease of doing business to companies from different countries. An individual or MNC can use their money anywhere around the world. This gives them the freedom to transact and use their money to meet any requirement of funds in any part of the world.

International banking allows the business to make international bill payments. The currency conversion facility allows the companies to pay and receive money easily. Also, benefits like overdraft facilities, loans, deposits, etc. are available every time for overseas transactions.

Accounts Maintenance

A multinational company can maintain the records of global accounts in a fair manner with the help of international banking. All the transactions of the company are recorded in the books of banks across the globe. By compiling the data and figures, the accounts of the company can be maintained.

Globalization and growing economies around the world have led to the development of international banking facilities. The world is now a marketplace and each business wants to exploit it. Geographical boundaries are no more a concern. With access to technology, banking facilities have grown vastly. One prime example of it is international banking. In the years to come, such banks would see higher growth and higher profitability. Big business houses are expanding themselves at a rapid pace.

To maintain the growth, these businesses will need the financial services of international banking. Therefore, the demand for its facilities will increase.

Types of Services Offered

To arrange trade finance

An international bank arranges the finance for the traders who want o deal with the foreign country.

To arrange foreign exchange

The core services provided by the international bank are to arrange a foreign exchange for the import-export purpose.

To hedge the funds

The international bank hedge the funds by buying the securities at the lower price level and sell it when the price level rising.

Offer investment banking services

It also offers an investment banking services by signing underwriting of shares, financial decisions for investment.

A correspondent bank relationship-

Established when two banks maintain a correspondent bank account with one another. The correspondent banking system provides a means for a bank's MNC clients to conduct business worldwide through his local bank or its contacts.

A representative office- A small service facility staffed by parent bank personnel that is designed to assist MNC clients of the parent bank in its dealings with the bank's correspondents. It is a way for the parent bank to provide its MNC clients with a level of service greater than that provided through merely a correspondent relationship.

A foreign branch bank- Operates as a local bank, but legally it is a part of the parent bank. As such, a branch bank is subject to the banking regulations of its home country and the country in which it operates. The primary reason a parent bank would establish a foreign branch is that it can provide a much fuller range of services for its MNC customers through a branch office than it can through a representative office.

A subsidiary bank- is a locally incorporated bank that is either wholly-owned or owned in major part by a foreign subsidiary. 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.

Types of International banking

Correspondent banks

Correspondent banks involve the relationship between different banks which are in different countries. This type of bank is generally used by the multinational companies for their international banking. This type of banks is in small size and provides service to those clients who are out of their country.

2) Edge act banks

Edge act banks are based on the constitutional amendment of 1919. They will operate business internationally under the amendment.

3) Off-shore banking centre

It is a type of banking sector which allows foreign accounts. Offshore banking is free from the banking regulation of that particular country. It provides all types of products and services.

4) Subsidiaries

Subsidiaries are the banks which incorporate in one country which is either partially or completely owned by a parent bank in another country. The affiliates are somewhat different from the subsidiaries like it is not owned by a parent bank and it works independently.

5) Foreign branch bank

Foreign banks are the banks which are legally tied up with the parent bank but operate in a foreign nation. A foreign bank follows the rules and regulations of both the countries i.e. home country and a host country.

Examples of international banking

- City group
- HSBC Holdings
- Bank of America
- JP Morgan Chase
- Royal Bank of Scotland Group.

Reasons for International Banking

• **Low marginal costs**

– Managerial and marketing knowledge developed at home can be used abroad with low marginal costs.

• **Knowledge advantage**

– The foreign bank subsidiary can draw on the parent bank's knowledge of personal contacts and credit investigations for use in that foreign market.

• **Home nation information services**

– Local firms in a foreign market may be able to obtain more complete information on trade and financial markets in the multinational bank's home nation than is obtainable from foreign domestic banks.

• Prestige

Very large multinational banks have high perceived prestige, which can be attractive to new clients.

• **Regulatory advantage**

– Multinational banks are often not subject to the same regulations as domestic Banks Wholesale defensive strategy – Banks follow their multinational customers abroad to avoid losing their business at home and abroad.

• **Retail defensive strategy**

– Multinational banks also compete for retail services such as travellers checks and the tourist and foreign business market.

• **Transactions costs**

– Multinational banks may be able to circumvent government currency controls.

• **Growth**

– Foreign markets may offer opportunities for growth not found domestically.

• **Risk reduction**

– Greater stability of earnings with diversification

INTERNATIONAL FINANCIAL INSTITUTIONS

At the Bretton Woods Conference in 1944 it was decided to establish a new monetary order that would expand international trade, promote international capital flows and contribute to monetary stability. The IMF and the World Bank were borne out of this Conference of the end of World War II.

The World Bank was established to help the restoration of economies disrupted by War by facilitating the investment of capital for productive purposes and to promote the long-range balanced growth of international trade. On the other hand, the IMF is primarily a supervisory institution for coordinating the efforts of member countries to achieve greater cooperation in the formulation of economic policies. It helps to promote exchange stability and orderly exchange relations among its member countries. It is in this context that the present chapter reviews the purpose and working of some of the international financial institutions and the contributions made by them in promoting conomic and social progress in developing countries by helping raise standards of living and productivity to the point of which development becomes self- sustaining

International sources of finance

One major source of financing is international non-profit agencies. There are several regional development banks such as the Asian Development Bank, the African Development Bank and Fund and the Caribbean Development Bank.

The primary purpose of these agencies is to finance productive development projects or to promote economic development in a particular region. The Inter- American Development Bank, for example, has the principal purpose of accelerating the economic development of its Latin American member countries. In general, both public and private entities are eligible to borrow money from such agencies as long as private funds are not available at reasonable rates and terms.

Although the interest rate can vary from agency to agency, these loan rates are very attractive and very much in demand. Of all the international financial organisations, the most familiar is the World Bank, formally known as the International Bank for Reconstruction and Development (IBRD). The World Bank has two affiliates that are legally and financially distinct entities, the International Development Association (IDA) and the International Finance Corporation (IFC). Exhibit 1 provides a comparison among IBRD, IDA and IFC in terms of their objectives, member countries, lending terms, lending qualifications as well as other details. All three organisations have the same central goals: to promote economic and social progress in poor or developing countries by helping raise standards of living and productivityto the point at which development becomes self-sustaining.

Toward this common objective, the World Bank, IDA and IFC have three interrelated functions and these are to lend funds, to provide advice and to serve as a catalyst in order to stimulate investments by others. In the process, financial resources are channelled from developed countries to the developing world with the hope that developing countries, through this assistance, will progress to a level that will permit them, in turn, to contribute to the development process of other less fortunate countries. Japan is a prime example of a country that has come full circle. From being a borrower, Japan is now a major lender to these three organisations. South Korea is moving in a direction similar to that of Japan nearly a quarter of a century ago.

THE WORLD BANK The World Bank group is a multinational financial institution established at the end of World War II (1944) to help provide long-term capital for the reconstruction and development of member countries. The group is important to multinational corporations because it provides much of the planning and financing for economic development projects involving billions of dollars for which private businesses can act as contractors and suppliers of goods and engineering related services.

purpose for the setting up of the Bank are

- To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs and encouragement of the development or productive facilities and resources in less developed countries.

- To promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

- To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and condition of labour in their territories.

- To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, can be dealt with first.To conduct its operations with due regard to the effect of

International investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy.

The World Bank is the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The IBRD has two affiliates, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA). The Bank, the IFC and the MIGA are sometimes referred to as the "World Bank Group".

International Bank for Reconstruction and Development

The IBRD was set up in 1945 along with the IMF to aid in rebuilding the world economy. It was owned by the governments of 151 countries and its capital is subscribed by those governments;

Functions and objectives

It provides funds to borrowers by borrowing funds in the world capital markets, from the proceeds of loan repayments as well as retained earnings.

At its funding, the bank's major objective was to serve as an international financing facility to function in reconstruction and development.

With Marshall Plan providing the impetus for European reconstruction, the Bank was able to turn its efforts towards the developing countries.

Generally, the IBRD lends money to a government for the purpose of developing that country's economic infrastructure such as roads and power generating facilities.

Funds are directed towards developing countries at more advanced stages of economic and social growth. Also, funds are lent only to members of the IMF, usually when private capital is unavailable at reasonable terms. Loans generally have a grace period of five years and are repayable over a period of fifteen or fewer years.

The projects receiving IBRD assistance usually require importing heavy industrial equipment and this provides an export market many US goods.

Generally bank loans are made to cover only import needs in foreign convertible currencies and must be repaid in those currencies at long-term rates.

The government assisted in formulating and implementing an effective and comprehensive strategy for the development of new industrial free zones and the expansion of existing ones; reducing unemployment, increasing foreign-exchange earnings and strengthening backward linkages with the domestic economy; alleviating scarcity in term financing; and improving the capacity of institutions involved in financing, regulating and promoting free zones.

The World Bank lays special operational emphasis on environmental and women's issues. Given that the Bank's primary mission is to support the quality of life of people in developing member countries, it is easy to see why environmental and women's issues are receiving increasing attention.

On the environmental side, it is the Bank's concern that its development funds are used by the recipient countries in an environmentally responsible way. Internal concerns, as well as pressure by external groups, are responsible for significant research and projects relating to the environment.

The women's issues category, specifically known as Women In Development (WID) is part of a larger emphasis on human resources. The importance of improving human capital and improving the welfare of families is perceived as a key aspect of development.

The WID initiative was established in 1988 and it is oriented to increasing women's productivity and income. Bank lending for women's issues is most pronounced in education, population, health and nutrition and agriculture. 15.3.2 International Development Association

The IDA was formed in 1960 as a part of the World Bank Group to provide financial support to LDCs on a more liberal basis than could be offered by the IBRD. The IDA has 137 member countries, although all members of the IBRD are free to join the IDA. IDA's funds come from subscriptions from its developed members and from the earnings of the IBRD.

Credit terms usually are extended to 40 to 50 years with no interest. Repayment begins after a ten-year grace period and can be paid in the local currency, as long as it is convertible. Loans are made only to the poorest countries in the world, those with an annual per capita gross national product of $480 or less. More than 40 countries are eligible for IDA financing. An example of an IDA project is a $8.3 million loan to Tanzania approved in 1989 to implement the first stage in the longer-term process of rehabilitating the country's agricultural research system cofinancing is expected from several countries as well as other multilateral lending institutions.

Although the IDA's resources are separate from the IBRD, it has no separate staff. Loans are made for similar projects as those carried out by IBRD, but at easier and more favourable credit terms. As mentioned earlier, World Bank/IDA assistance historically has been for developing infrastructure.

The present emphasis seems to be on helping the masses of poor people in the developing countries become more productive and take an active part in the development process. Greater emphasis is being placed on improving urban living conditions and increasing productivity of small industries.

International Finance Corporation

The IFC was established in 1956. There are 133 countries that are members of the IFC and it is legally and financially separate from the IBRD, although IBRD provides some administrative and other services to the IFC.

The IFC's main responsibilities are (i) To provide risk capital in the form of equity and long-term loans for productive private enterprises in association with private investors and management; (ii) To encourage the development of local capital markets by carrying out standby and underwriting arrangements; and (iii) To stimulate the international flow of capital by providing financial and technical assistance to privately controlled finance companies. Loans are made to private firms in the developing member countries and are usually for a period of seven to twelve years.

The key feature of the IFC is that its loans are made to private enterprises and its investments are made in conjunction with private business. In addition to funds contributed by IFC, funds are also contributed to the same projects by local and foreign investors. IFC investments are for the establishment ne1x enterprises as well as for the expansion and modernization of existing ones.

They cover a wide range of projects such as steel, textile production, ining, manufacturing, machinery production, food processing, tourism and local development finance companies. Some projects are locally owned, whereas others are joint ventures between investors in developing and developed countries.

In a few cases, joint ventures are formed between investors of two or more developing countries. The IFC has also been instrumental in helping to develop emerging capital markets.

Multilateral investment guarantee agency (MIGA)

Reduce the risk of a sudden deleveraging: Macroprudential regulations address situations where institutions and market participants behave in a way that is rational for individual investors but triggers negative externalities associated with system-wide reactions leading to sharp deleveraging and market disruption.

The risk of sudden drops in leverage and liquidity squeezes should be addressed by imposing minimum buffers in times of financial expansion. Rule makers should also avoid mechanisms that create cliff effects, as is the case when the eligibility criteria for collateral are associated with discrete ratings or when other regulatory mechanisms are associated with binary thresholds.

What does the World Bank do?

The World Bank is the world’s largest source of development assistance, providing nearly $30 billion in loans, annually, to its client countries. The Bank uses its financial resources, its highly trained staff and its extensive knowledge base to individually help each developing country onto a path of stable, sustainable and equitable growth.

The main focus is on helping the poorest people and the poorest countries hut for all its clients, the Bank emphasizes the need for: investing in people, particularly through basic health and education; protecting the environment; supporting and encouraging private business development; strengthening the ability of the governments to deliver quality services efficiently and transparently; promoting reforms to create a stable macroeconomic environment conducive to investment and long-term planning; focusing on social development, inclusion, governance and institution building as key elements of poverty reduction.

The Bank is also helping countries to strengthen and sustain the fundamental conditions that help to attract and retain private investment. With Bank support- both lending and advice- governments are reforming their overall economies and strengthening banking systems. They are investing in human resources, infrastructure and environmental protection which enhance the attractiveness and productivity of private investment. Through World Bank guarantees, MICA's political risk insurance and in partnership with IFC's equity investments, investors are minimising their risks and finding the comfort to invest in developing countries and countries undergoing transition to market-based economies.

Where does the World Bank get its money?

The World Bank raises money for its development programmes by tapping the world's capital markets and in the case of the IDA, through contributions from wealthier member governments. IBRD,

which accounts for about three-fourths of the Bank's annual lending, raises almost all its money in financial markets. One of the world's most prudent and conservatively managed financial institutions, the IBRD sells AAA-rated bonds and other debt securities to pension funds, insurance companies, corporations, other banks and individuals around the globe. IBRD charges interest from its borrowers at rates, which reflect its cost of borrowing.

Loans must be repaid in 15 to 20 years; there is a three to five year grace period before repayment of principal begins. IDA helps to promote growth and reduce poverty in the same ways as does the IBRD but using interest free loans (which are known as IDA "credits"), technical assistance and policy advice.

IDA credits account for about one-fourth of all Bank lendings. Borrowers pay a fee of less than 1 per cent of the loan to cover administrative costs. Repayment is required in 35 to 40 years with a 10 years grace period. Nearly 40 countries contribute to IDA's funding, which is replenished every three years. IDA's funding is managed in the same prudent, conservative and cautious way as is the IBRD's. Like the IBRD, there has never been default on an IDA credit.

Who runs the World Bank?

The World Bank is owned by more than 180 member countries whose views and interests are represented by a board of governors and a Washington based board of directors. Member countries are shareholders who carry ultimate decision making power in the World Bank. Each member nation appoints a governor and an alternate governor to carry out these responsibilities.

The governors, who are usually officials such as ministers of finance or planning, meet at the Bank's annual meetings each fall. They decide on key Bank policy issues, admit or suspend country members, decide on changes in the authorised capital stock, determine the distribution of the IBRD's net income and endorse financial statements and budgets.

INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF) came into official existence on December 27, 1945, when 29 countries signed its Articles of Agreement (its Charter) agreed at a conference held in Bretton

Woods, New Hampshire, USA, from July 1-22, 1944. The IMF commenced financial operations on March 1, 1947. Its current membership is 182 countries. Its Total Quotas are SDR 212 billion (almost US$300 billion), following a 45 per cent quota increase effective from January 22,1999.

Staff: approximately 2,700 from 110 countries. • Accounting Unit: Special Drawing Right (SDR). As of August 23, 1999, SDR I equalled US $1.370280. IMF is a cooperative institution that 182 countries have voluntarily joined because they see the advantage of consulting with one another on this forum to maintain a stable system of buying and selling their currencies so that payments in foreign currency can take place between countries smoothly and without delay.

Its policies and activities are guided by its Charter known as the Articles of Agreement. IMF lends money to members having trouble meeting financial obligations to other members, but only on the condition that they undertake economic reforms to eliminate these difficulties for their own good and that of the entire membership. Contrary to widespread perception, the IMF has no effective authority over the domestic economic policies of its members.

What authority the IMF does possess is confined to requiring the member to disclose information on its monetary and fiscal policies and to avoid, as far as possible, putting restrictions on exchange of domestic for foreign currency and on making payments to other members.

There are several major accomplishments to the credit of the International Monetary System. For example, it

• sustained a rapidly increasing volume of trade and investment;

• displayed flexibility in adapting to changes in international commerce;

• proved to be efficient (even when there were decreasing percentages of reserves to trade);

• proved to be hardy (it survived a number of pre-1971 crises, speculative and otherwise, and the down-and-up swings of several business cycles);

• allowed for a growing degree or international cooperation; • established a capacity to accommodate reforms and improvements.

To an extent, the fund served as an international central bank to help countries during periods of temporary balance of payments difficulties by protecting their rates of exchange. Because of that, countries did not need to resort to exchange controls and other barriers to restrict world trade.

Origins of IMF

The need for an organisation like the IMF became evident during the great depression that ravaged the world economy in the 1930s. A widespread lack of confidence in paper money led to a spurt in the demand for gold and severe devaluation in the national currencies. The relation between money and the value of goods became confused as did the relation between the value of one national currency and another. In the 1940s, Harry Dexter (US) and John Maynard Keynes (UK) put forward proposals for a system that would encourage the unrestricted conversion of one currency into another, establish a clear and unequivocal value for each currency and eliminate restrictions and practices such as competitive devaluations. The system required cooperation on a previously unattempted scale by all nations in establishing an. innovative monetary system and an international institution to monitor it.

After much negotiations in the difficult war time conditions, the international community accepted the system and an organization was formed to supervise it.

The IMF began operations in Washington DC in May 1946. It then had 39 members. The IMF's membership now is 182.

Members and administration

On joining the IMF, each member country contributes a certain sum of money called a 'quota subscription', as a sort of credit union deposit. Quotas serve various purposes.

• They form a pool of money that the IMF can draw from to lend to members in times of financial difficulty.

• They form the basis of determining the Special Drawing

Rights (SDR).

• They determine the voting power of the member.

Statutory purposes

The purposes of the International Monetary Fund are:

• To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.

• To facilitate the expansion and balanced growth of international trade and to contribute, thereby, to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

• To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

• To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

• To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive to national or international prosperity.

• In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

Financial assistance

The IMF lends money only to member countries with balance of payments problems. A member country with a payments problem can immediately withdraw from the IMF the 25 per cent of its quota. A member in greater difficulty may request for more money from the IMP and can borrow up to three times its quota provided the member country undertakes to initiate a series of reforms and uses the borrowed money effectively. The frequently used mechanisms by the

IMF to lend money are

1. Standby Arrangements

2. Extended Arrangements

3. Structural Adjustment Mechanism (With low interest

rates)

Regular IMF facilities

• Standby Arrangements (SBA) are designed to provide short-term balance of payments assistance for deficits of a temporary or cyclical nature, such arrangements are typically for 12 to 18 months. Drawings are phased on a quarterly basis, with their release made conditional on meeting performance criteria and the completion of periodic programme reviews. Repurchases are made to 5 years after each purchase.

• Extended Fund Facility (EFF) is designed to support medium-term programmes that generally run for three years. The EFF aims at overcoming balance of payments difficulties stemming from macroeconomic and structural problems. Performance criteria are applied, similar to those in standby arrangements and repurchases are made in 4½ to 10 years.

Concessional IMF facility

• Enhanced Structural Adjustment Facility (ESAF) was established in 1987 and enlarged and extended in 1994. Designed for low-income member countries with protracted balance of payments problems, ESAF drawings are loans and not purchases of other members' currencies. They are made in support of three year programmes and carry an annual interest rate of 0.5 per cent, with a 51h year grace period and a 10 year maturity. Quarterly benchmarks and semi-annual performance criteria apply; 80 low income countries are currently eligible to use the ESAF.

SDRs

As time passed, it became evident that the Fund's resources for providing short- term accommodation to countries in monetary difficulties were not sufficient. To resolve the situation, the Fund, after much debate and long deliberations, created new drawing rights in 1969.

Special Drawing Rights (SDRs), sometimes called paper gold, are special account entries on the IMF books designed to provide additional liquidity to support growing world commerce. Although SDRs are a form of money not convertible to gold, their gold value is guaranteed, which helps to ensure their acceptability. Initially, SDRs worth $9.5 billion were created.

Participant nations may use SDRs as a source of currency in a spot transaction, as a loan for clearing a financial obligation, as a security for a loan, as a Swap against currency, or in a forward exchange operation. A nation with a balance of payments need may use its SDRs to obtain usable currency from another nation designated by the fund. A participant also may use SDRs to make payments to the Fund, such as repurchases.

The Fund itself may transfer SDRs to a participant for various purposes including the transfer of SDRs instead of currency to a member using the Fund's resources. By providing a mechanism for international monetary cooperation, working towards reducing restrictions to trade and capital flows and helping members with their short-term balance of payments difficulties, the IMF makes a significant and unique contribution to human welfare and improved living standards throughout the world.

Services

Besides supervising the international monetary system and roviding financial support to member countries, the IMF assists its members by:

• Providing technical assistance in certain areas of its competence.

• Running an educational institute in Washington and offering training courses abroad.

• Issuing wide variety of publications containing valuable information and statistics that are useful not only to the member countries but also to banks, research institutes, university and the media.

ASIAN DEVELOPMENT BANK (ADB)

The Asian Development Bank is a multilateral developmental finance institution founded in 1966 by 31 member governments to promote social and economic progress of Asian and the Pacific region. The Bank gives special attention to the needs of smaller or less developed countries and gives priority to regional/non-regional national programmes. In early 1960, the United National Economic Commission for

Asia and Far East (UNECAFE) estimated that Asia and the Pacific region had an annual deficit of US $ one billion. The ADB was formed to fill this gap. The inaugural

Meeting was held in Tokyo and the newly named bank was installed in Manila (Philippines).

The first President was Mr. Wanatanade and during his initial years the bank conducted regional surveys to develop a fuller understanding of the social and economic conditions of the Developing Member Countries (DMC). In 1974, the Asian Development Fund was established to streamline the bank's means of financing.

During 1972-76, the Banks' commitment to the DMCs increased from $316 million to 776 million. n the late 70s, the bank recognised the need to develop additional strategy to reduce poverty in the region, so they evolved the concept of multi-project loans which was a cost-effective means for funding projects too small for the Bank's involvement.

In 1978, the Asian Development Fund was increased to 2.15 illion. 1986 was a significant year for the Bank because the Peoples Republic of China joined the Bank and India received her first loan of $100 million to the ICICI (Investment Credit and Investment corporation of India) for one lending to Private Sector enterprises. In 1993, annual lending commitments rose to $5 billion and the cumulative total by 1991 was
$37.6 billion for 1039 projects.

On the borrowing front, in 1991, the Bank offered Dragon Bonds which was a US $ 300 million offering in the capital markets orHong Kong, Singapore and Taipei. The present President is Mr. Tadao Chino, who was Japan's former Vice Minister of Finance for International Affairs, before he took over in January 1999.

Bank Profile

Over the past 41 years, the bank's membership has grown from 1 to 57, of which 41 are from within the region and 16 from outside the region. The Bank gives special attention to the needs of the smaller or less developed countries and priority to regional, sub-regional and national projects and programmes.

The Bank's principal functions are

- To extend loans and equity investments for the economic and social development of its Developing Member

Countries (DMCS); • To provide technical assistance for the preparation and execution of development projects and programmes and for advisory services;

• To promote and facilitate investment of public and private capital for development purposes; and

• To respond to requests for assistance in coordinating development policies and plans of its DMCs.

Shareholders The two largest shareholders of the Bank, as of31 December 997, were Japan and the United States, each accounting for 16 per cent of the total subscribed capital. Forty one regional members accounted for 63 per cent of total shareholding while 16 non-regional members contributed 37 per cent of the total.

Location

The Bank's headquarters are in Manila, Philippines. It has resident missions in Bangladesh, Cambodia, India, Indonesia, Nepal, Pakistan, Sri Lanka and Vietnam and has opened resident missions in Kazakhstan and Uzbekistan. These resident missions improve the Bank's coordination with the governments and donor agencies; assist with activities related to country programming and processing of new loans and technical assistance projects; and help ensure project quality.

International Financial Services Centre

- An IFSC caters to customers outside the jurisdiction of the domestic economy. Such centres deal with flows of finance, financial products and services across borders. London, New York and Singapore can be counted as global financial centres. Many emerging IFSCs around the world, such as Shanghai and Dubai, are aspiring to play a global role in the years to come.
- An expert panel headed by former World Bank economist Percy Mistry submitted a report on making Mumbai an international financial centre in 2007. However, the global financial crisis that unfolded in 2008 made countries including India cautious about rapidly opening up their financial sectors.

- Finance Minister Arun Jaitley, had announced in the Union Budget 2015 that India's first IFSC's would be set up in GIFT City in Gujarat.
- Gujarat International Finance Tec-City (GIFT City) would be the country's first IFSC, with which top bourses BSE and NSE signed MOUs for setting up International exchanges there. However, BSE already started India International exchange on January 9, 2017.

Services @ IFSC

- Fund-raising services for individuals, corporations and governments
- Asset management and global portfolio diversification undertaken by pension funds, insurance companies and mutual funds.
- Wealth management.
- Global tax management and cross-border tax liability optimization, which provides a business opportunity for financial intermediaries, accountants and law firms.
- Global and regional corporate treasury management operations that involve fund-raising, liquidity investment and management and asset-liability matching
- Risk management operations such as insurance and reinsurance.
- Merger and acquisition activities among trans-national corporations

IFSC in SEZ

- Definition of IFSC as per SEZ Act: As per Section 2 (q) of SEZ Act, 2005, "International Financial Services Centres" means an International Financial Services Centre which has been approved by the Central Government under sub-section (1) of Section 18 of SEZ Act, 2005.
- As per Sub section (1) of Section 18 of SEZ Act, 2005, The Central Government may approve the setting up of an International Financial Service Centre in a Special Economic Zone and may prescribe the requirements for setting up and operation of such centre. Provided that the Central Government shall approve only one International Financial Services Centre in a Special Economic Zone.
- As per Sub section (2) of Section 18 of SEZ Act, 2005, The Central Government may, subject to such guidelines as may be framed by the Reserve Bank, the

Securities and Exchange Board of India, the Insurance Regulatory and Development Authority and such other concerned authorities, as it deems fit, prescribe the requirements for setting up and the terms and conditions of the operation of Units in an International Financial Services Centre.

- Accordingly Securities board of India has recently issued guidelines dated 27.03.2015 named as SEBI (International Financial Services Centres) Guidelines, 2015
- SEBI (International Financial Service Centres) Guidelines, 2015 has been issued to facilitate and regulate financial services relating to securities market in an International Financial Services Centre set up under section 18 (1) of SEZ Act, 2005
- Such guidelines will facilitate setting up and operations of units in country's first IFSC at GIFT City, Gujarat.
- SEBI (International Financial Service Centres) Guidelines, 2015 shall come into force w.e.f April 01, 2015
- Replace as: RBI would permit the setting up of IFSC Banking units (IBUs) in International Financial Services Centres (IFSC) by banks in accordance with RBI regulations relating to Financial Institutions issued vide notification no. FEMA.339/2015 - RB dated March 02, 2015.
- IRDA of India would allow Life and Non-life Insurance services, health Insurance services and reinsurance services to set up a branch in IFSC.
- Such guidelines would be referred to as Insurance Regulatory and Development Authority of India (International Financial Services Centre) Guidelines, 2015.
- Insurance Regulatory and Development Authority of India (International Financial Services Centre) Guidelines, 2015 shall come into force w.e.f. April 06, 2015.

Fiscal Incentives available under SEZ Act 2005 for IFSC units

- Since India has many restrictions on the financial sector, such as partial capital account convertibility, high SLR (statutory liquidity ratio) requirements and foreign investment restrictions, an SEZ can serve as a testing ground for financial sector reforms before they are rolled out in the entire nation.

- Exemption as per SEZ Act, 2005: Apart from SEZ related incentives as per the SEZ Act, 2005 there is an exemption from the securities transaction tax leviable under section 98 of the Finance (No. 2) Act, 2004 in case the taxable securities transactions are entered into by a non-resident through the International Financial Services Centre;

Question

Part A

1.Mention the meaning of international banking

2. State the examples of international banking

3. MIGA – Expand the term

4. List out the types of international banking

PART B

1. Briefly describe the advantages for starting international banking

2. Examine the importance of IFSC 3.Describe

the types of international banking

4.Analyze the functions and objectives of IBRD

TEXT / REFERENCE BOOKS

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SCHOOL OF BUSINESS ADMINSTARTION

UNIT – II– INTERNATIONAL BANKING-SBAA3015

RISK MANGEMENT IN INTERNATIONAL BANKING

Risk Management in international Banking – Risk Management-Credit risk, Market risk, settlement risk, Liquidity risk, operational risk and legal risk-Need and importance of credit rating -Asst Liability Management (ALM)-Importance of ALM- off -Balance sheet-Off balance sheet items -off balance sheet risk -Asset liability and international banking operations

Risk management in international banking

The word "Risk" can be linked to the Latin word "Rescum" which means Risk at Sea. Risk can be defined as of losing something of value or something which is weighed against the potential to gain something of value. Values can be of any type i.e. health, financial, emotional well being etc. Risk can also be said as an interaction with uncertainty.

Risk perception is subjective in nature, people make their own judgment about the severity of a risk and it varies from person to person. Every human-being carries some risk and define those risks according to their own judgment. The concept of Risk Management has been derived in order to manage the risk or uncertain event.

Risk Management refers to the exercise or practice of forecasting the potential risks thus analyzing and evaluating those risks and taking some corrective measures to reduce or minimize those risks.

Today risk management is practiced by many organizations or entities in order to curb the risk which they can face it in near future. Whenever an organization makes any decision related to investments, they try to find out the number of financial risk attached with it.

Financial risks can be in the form of high inflation, recession, volatility in capital markets, bankruptcy etc. The quantum of such risks depends on the type of financial instruments in which an organization or an individual invests

So, in order to reduce or curb such exposure of risks to investments, fund managers and investors practice or exercise risk management. For example an individual may consider investing in fixed deposit less risky as compared to investing in share market.

As investment in equity market is riskier than fixed deposit, thus through the practice of risk management equity analyst or investor will diversify its portfolio in order to minimize the risk.

Definition --- Risk

Risk takes on many forms but is broadly categorized as a chance wherein an outcome or investment's actual return will differ from the expected outcome or return.

Risk includes the possibility of losing some or all of the original investment.

Different versions of risks are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment.

A fundamental idea in finance is the relationship between risk and return. As risk is directly proportional to return, the more risk a bank takes, it can expect to make more money

How important Risk Management is for Banks?

Till now we have seen how risk management works and how much it is important to curb or reduce the risk. As risk is inherent particularly in financial institutions and banking organizations and even in general, so this article will deals with how Risk Management is important for banking institutions.

Till date banking sectors have been working in regulated environment and were not much exposed to the risks but due to the increase of severe competition banks have been exposed to various types of risks such as financial risks and non-financial risks.

The function and process of Risk Management in Banks is complex, so the banks are trying to use the simplest and sophisticated models for analysing and evaluating the risks.

In a scientific manner, banks should have expertise and skills to deal with the risks which are involved in the process of integration. In order to compete effectively, large-scale banking organizations should develop internal risk management models.

At a more desired level, Head offices staff should be trained in risk modelling and analytic tools to conduct Risk Management in Banks.

Risk Management in Indian Banking Sector

- Practice of Risk Management in Banks is newer in Indian banks but due to the growing competition, increased volatility and fluctuations of markets the risk management model has gained importance.
- Due to the practice of risk management, it has resulted in the increased efficiency in governing Indian banks and has also increased the practice of corporate governance. The essential feature of risk management model is to minimize or reduce the risks of the products ad services which are offered by the banks therefore, in order to mitigate the internal & external risks there is a need of efficient risk management framework.
- Indian banks have to prepare risk management models or framework due to the increasing global competition by foreign banks, introduction of innovative financial products and instruments and increasing deregulations.

Banking sector of India has made a great advancements in terms of technology, quality etc. and have started to diversify and expand its horizons at a rapid rate. However, due to the increasing globalization and liberalization and also increasing advancements leads these banks to encounter some risks. Since in banks risks plays a major role in the earnings therefore higher the risk, higher will be the returns. Hence it is essential to maintain equality between risk and return

Country Risk Management System

Country risk management systems should be commensurate with the type, volume, and complexity of the institution's international activities, and examiners should consider these factors when assessing country risk management systems and practices. Effective oversight by the board of directors,

Adequate risk management policies and procedures,

Accurate systems for reporting country exposures,

Effective processes for analyzing country risk, Forward-looking country risk rating systems,

Country exposure limits, • Regular monitoring of country conditions,

Periodic stress testing of foreign exposures, and

Adequate internal controls and audit function.

The March 2002 Statement indicates that to effectively control risk associated with international activities, institutions must have a risk management system that focuses on the concept of country risk.

A program that is limited to an assessment of transfer risk, and especially one that solely relies on transfer risk designations assigned by the ICERC, ignores other important facets of country risk and would not be appropriate. Transfer risk and the ICERC program are discussed in subsequent subsections.

Policies and Procedures

Management is responsible for developing and implementing sound, well-defined policies and procedures for managing country risk. Management should also ensure that country risk management policies and practices are clearly communicated to applicable offices and staff. At a minimum, policies and procedures should:

Articulate a strategy for conducting international activities;

Specify appropriate products, services, and affiliates (e.g., banks, branches, affiliates, joint ventures, etc.);

Identify allowed and disallowed activities;

Describe major risks in applicable countries or regions;

Establish risk tolerance limits;

Develop standards and criteria for analyzing and rating country risk;

Delineate clear lines of responsibility and accountability for country risk management decisions; Require periodic reporting of country risk exposures and policy exceptions to senior management and the board; and Ensure compliance with regulatory guidance and reporting requirements.

RISK MANAGEMENT IN INTERNATIONAL BANKING

- While risks are integral part of our lives, and are applicable to domestic trade and investment arena also, as far as international banking activities are concerned, these banks are exposed to additional risks on account of various factors.

  Important factors are:

- Cross Border Risk: The cross border risks arise on account of trade and investment activities between two or more countries. This is one of the major risks the international banks face. This type of risk is also called as country risk
- Currency Risk: When an international trade and/or financial transaction take place, it would result in a currency deal. In view of the additional deal (involvement of foreign currency) a new risk arises called currency risk. Two or more than two currencies (in case of cross rates) are involved, and due to the market fluctuations the exchange rate (price) of the currencies results in a risk called "foreign exchange rate risk" as well

Credit Risk:

In today's complicated international financial markets, the credit risk arises on account of nonperformance of obligations by counterparty in respect of On balance sheet items as well as off-balance sheet contracts such as forward contracts, interest rate swaps and currency swaps and counterparty risk in the interbank market. These have necessitated prescribing maximum exposure limits for individual counterparties for fund and non-fund exposures

Mitigation of Credit Risk:

To manage various risks, banks have formulated Risk Management policies duly approved by their board. Some of the risk mitigation practices are mentioned below: Banks have setup experienced credit management team to ensure better credit appraisal

To restrict exposures, credit limits are setup both for at individual and group wise levels

Investments are subject to bank's Investment Policy guidelines. Bank's investment policy is formulated as per the Regulator's directives

– In view of the uncertainties associated with the non-performance in case of off balance sheet items like letters of credit, guarantees, derivative products like forward exchange contracts, futures, interest rate swaps, options, etc., a full credit appraisal needs to be carried out before limits for non-funded credit lines are granted to the clients – Adequate financial and/or physical assets should be obtained as collateral security.

On an ongoing basis valuation of such collateral security should be carried out based on the market prices (this procedure is called as market to market practice) to assess the present value – Exposure limits should be put in place covering counterparty, industry, country, and business group, currency for on and off balance sheet items.

Operational Risks: Operational risks can arise due to – Non-compliance with laid- down procedures and authorizations for dealing, settlement and custody; – Fraudulent practices involving deals and settlements;

– Legal risks due to inadequate definitions and coverage of covenants and responsibilities of the bank and counterparty in contracts and agreements.

– Information Technology, which drives the markets, should be given importance in managing the risks, especially the operational risks.

Operational Risk Basel Committee for Banking Supervision has defined operational risk as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’.

Thus, operational loss has mainly three exposure classes namely people, processes and systems. Managing operational risk has become important for banks due to the following reasons – 1. Higher level of automation in rendering banking and financial services 2. Increase in global financial inter-linkages Scope of operational risk is very wide because of the above mentioned reasons. Two of the most common operational risks are discussed below

(a) **Transaction Risk:** Transaction risk is the risk arising from fraud, both internal and external, failed business processes and the inability to maintain business continuity and manage information.

(b) **Compliance Risk**: Compliance risk is the risk of legal or regulatory sanction, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank’s reputation is closely linked to its adherence to principles of integrity and fair dealing

Liquidity risk

Liquidity risk management in banks is defined as **the risk of being unable either to meet their obligations to depositors or to fund increases in assets as** they fall due without incurring unacceptable costs or losses.

The liquidity risk of banks arises from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk.

The liquidity risk in banks manifest in different dimensions

Funding Risk – need to replace net outflows due to unanticipated withdrawal/nonrenewal of deposits (wholesale and retail);

ii) **Time Risk** - need to compensate for non-receipt of expected inflows of funds, i.e. performing assets turning into non-performing assets;

III) **Call Risk** - due to crystallisation of contingent liabilities and unable to undertake profitable business opportunities when desirable.

Market risk

This risk results from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities, and currencies. It is also referred to as Price Risk

Price risk occurs when assets are sold before their stated maturities. In the financial market, bond prices and yields are inversely related. The price risk is closely associated with the trading book, which is created for making profit out of short-term movements in interest rates.

The term Market risk applies to (i) that part of IRR which affects the price of interest rate instruments, (ii) Pricing risk for all other assets/ portfolio that are held in the trading book of the bank and (iii) Foreign Currency Risk.

Forex Risk: Forex risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an

open position either spot or forward, or a combination of the two, in an individual foreign currency.

Market Liquidity Risk:

Market liquidity risk arises when a bank is unable to conclude a large transaction in a particular instrument near the current market price.

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Settlement risk

is the risk that arises when payments are not exchanged simultaneously. The simplest case is when a bank makes a payment to a counterparty but will not be recompensed until some time later; the risk is that the counterparty may default before making the counter payment.

Legal risk

The management of Legal and Regulatory Risk aims to ensure that the Group's exposure to potential legal liabilities during the course of business such as rule implementation or product liability are well mitigated to avoid disruption to its business and operations.

Need and importance of credit rating

Credit rating plays a significant role in all credit as well as investment decisions. Credit signifies status of ability to pay or reputation about solvency and capacity to pay.

Rating is nothing but estimated worth or value in terms of symbolic grade given to a person's or organisation's ability to pay back the loans raised, with the help of financial position of the individual or organisation.

By combining credit and rating, these two words, one can find out the meaning of credit rating, which is concerned with an act of assigning symbolic grade or values by estimating financial position and thus disclosing solvency which indicates ability or capacity of the issuer about the repayment of loans raised.

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Concept of credit rating

Credit rating may be defined as an expression, through use of symbols, of opinion about the quality of credit of the issuer of debt securities with reference to a particular instrument.

As per the SEBI regulations, credit rating is nothing but anopinion regarding securities expressed in the form of standard symbol or in any other standardised form assigned by a credit rating agency.

The symbol given by rating agency for credit rating indicates a credit character of that particular security and thus it only facilitates to take a view on credit risk pertaining to that security. However, it does not directly recommend whether to purchase, sale or hold that security. Thus, rating is a measure of credit risk only and hence it does not communicate anything about the degree of market risk.

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Companies, financial institutions, public sector enterprises, local bodies and others raise funds from the domestic as well as international money or capital market by issuing debt instruments which are rated by the rating agencies. Investors also like to make their investment decisions based on credit rating of instruments.

AAA – Highest Safety, Lowest Credit Risk

AA – Highest Safety, Very Low Credit Risk

A – High Safety, Low Credit Risk

BBB – Moderate Safety, Moderate Credit Risk

BB – Moderate Risk, Moderate Risk of Default

B – High Risk, High Risk of Default

C – Very High Risk, Very High Risk of Default

D – Default / Expected to be in Default soon

BENEFITS OF CREDIT RATING

The rating of debt instruments offer benefits to the interested parties such as investors, issuers and intermediary agencies like brokers etc. These benefits are described below :

Benefits to Investors

Safeguards against Bankruptcy: Credit rating of an instrument given by the credit rating agency gives an idea to the investors about the degree of financial strength of the issuer company which enables him to decide about investment. Highly rated instrument of a company gives an assurance to the investors of safety of their investment and the interest (or return) on their investments with least risk of bankruptcy.

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Recognition of Risk: Credit rating provides investors with rating symbols which carry information in easily recognisable manner for the benefit of investors to perceive risk involved in investment.

It becomes easier for the investors by looking at the symbol to understand the worth of the issuer company because the instrument is rated by scientifically and professionally analysing the financial position of the company.

In view of this, there is no need for the investors to incur cost for collecting credit information and to carry out analysis. The investors without any knowledge of financial analysis can easily use rating symbols for investment decisions

Credibility of Issuer: Rating symbol assigned to a debt instrument gives an idea about the credibility of the issuer company. The rating agency is quite independent of the issuer company and has no business connections or otherwise any relationship with it or its Board of Directors, etc. Due to absence of business links between the rating agency and the issuer company the confidence of investors is enhanced in such rating symbol.

Rating Facilitates Quick Investment Decisions: Investor can take quick decisions about the investment to be made in various instruments with the help of credit rating assigned to various instruments. In view of this, there is no need for investors to undertake fundamental analysis of a company based on financial strength of the company, quality of management, as well as other parameters.

No Need to Depend on Investment Advisors or Professionals: For making investment decisions, investors with no knowledge of investment may have to seek advice of financial intermediaries such as, the stock brokers, the portfolio managers, or financial consultants while investing funds in debt instruments.

However, investors need not depend upon the advice of Credit Rating these financial intermediaries as the rating symbol assigned to a particular instrument suggests the credit worthiness of the instrument and indicates the degree of risk involved in it. Thus, investors can make direct investment decisions.

Choice of Investment: Several alternative credit rated instruments are available at a particular point of time for deploying investible funds. The investors can make choice of various instruments depending upon their own risk profile and diversification plan.

Benefits of Rating Surveillance: Investors get the benefit of credit rating agency's on-going surveillance of the rated instruments of different companies. The Credit Rating Agency downgrades the rating of any instrument if subsequently the company's financial performance is not so good or financial position has suffered because of happening of internal or external events which necessitates consequent dissemination of information on its position to the investors

Benefits of Credit Rating to Issuer Company A company which has obtained credit rating from rating agency for its issue of debt security enjoys various advantages.

Few of these advantages are given below :

Lower Cost of Borrowing: A company, whose debt instrument or public deposits programme, is highly rated, will be in a position to reduce the cost of borrowing by quoting lesser interest rate on fixed deposits or debentures or bonds as the investors will prefer low rate of interest because of lower credit risk.

Wider Audience for Borrowing: A company having very good rating for its debt instrument can approach various categories of investors for resource mobilisation using the press media. Investors in different strata of the society could be attracted by higher rated instruments as the investors understand the degree of certainty about timely payment of interest and principal on a debt instrument with better rating.

Rating as Marketing Tool: Companies with rated instruments improve their own image and can use credit rating as a marketing tool to create better image in dealing with its customers, lenders and other creditors. Even consumers feel confident in using products manufactured by the companies carrying higher rating for their credit instruments.

Self Discipline by Companies: Rating encourages the companies to come out with more disclosures about their accounting system, financial reporting and management pattern, etc.

The company gets opportunity and motivation to improve upon its existing practices to match to the competitive standard and maintain the standard of rating attained by it or make improvement upon the rating.

Reduction of Cost in Public Issues: A company with higher rated instrument is able to attract the investors and raise the funds with least efforts. Thus, the company whose debt instrument is highly rated can minimise cost of public issues by controlling expenses on media coverage, conferences and other marketing expenditures.

Motivation for Growth: Rating provides motivation to the company for growth as the promoters of the company feel confident in their own efforts and are encouraged to undertake expansion of their existing operations or new projects. With better image created through higher credit rating the company can mobilize funds from the public and institutional lenders like banks and financial institutions.

Benefits to Financial Intermediaries Highly credit rated instruments put the brokers at an advantage to make less efforts in studying the company's credit position to convince their clients to select a particular investment proposal.

Rated instruments speak themselves about the financial soundness of the company and the strength of the instrument rated by the credit rating agency.

This enables brokers and other financial intermediaries to save their time, cost, energy and manpower in convincing their clients about investments in any particular instruments. They utilize their resources in expanding their clientele and intensifying their business activities.

Other Benefits The other benefits of credit rating in general are given below

i**) Identification of Strength and Weakness of the Issuer Company:**

A company having obtained the rating for its security understands its own strength and weakness in all spheres of corporate environment and can take corrective steps to improve upon its position and also remain guided by the surveillance efforts of the Credit Rating Agency.

Particularly, companies with low credit rating make efforts to improve upon their performance. Thus, credit rating creates a tendency amongst rated corporate units to remain healthy and maintain higher standard for corporate governance which will help them to improve their standing both in domestic as well as in international market.

The Rating process starts with a rating request from the issuer company followed by the signing of the rating agreement with the credit rating company which employs a multi-layered decision making process while giving a credit rating symbol.

Credit rating agency sends its team of analysts to the issuer company who interacts with the company's management.

Meeting with Management Team Rating agency's team will have an open dialogue with the management of issuer company. Only through this process interest of investors can be best served.

The topics discussed during the meeting with management team are wide-ranging and include the issuer's competitive position, business strategies, short term and long term financial policies, current and past financial performance and future business outlook. Along with these parameters, equal importance need to be placed on the issuer's business risk profile

Rating Committee and Assignment of the Rating The reports prepared by a team of analysts is then submitted to a Rating Committee. The committee approach for assigning rating symbol ensures the rating's objectivity as the decision results from the collective analysis of a group comprising of highly experienced professionals. Based on the knowledge and expertise of the members of the rating committee, credit rating is decided and assigned accordingly. The rating is a composite assessment of all these factors with the key issues getting greater attention from the Rating Committee.

Confidentiality A substantial portion of the information set forth in various documents of the issuer company is highly sensitive and is provided to the credit rating agency only for the purpose of arriving at the ratings. The analysts and rating committee are required to maintain such information in strict confidence and not to use the same for any other purpose

Advice to Issuer When the rating committee has arrived at the rating decision, it is first communicated to the issuer and subsequently, the rationale for the rating is forwarded. In the event that the issuer disagrees with the rating it has the opportunity to appeal against the decision. Issuers appealing against a rating decision should provide new or additional information, which is material to the appeal and specifically addresses the concerns expressed in the rating rationale. The client of the credit rating agency has a right to reject the credit rating and the whole exercise is kept confidential.

Information to SEBI

A credit rating agency has to inform SEBI about new rating instruments or symbols introduced by it. Surveillance and Annual Review After a credit rating has been assigned, credit rating agency has to monitor the issuer's on-going performance and the economic environment in which it operates.

Surveillance enables analysts to stay abreast of current developments, identify potential problem areas of Issuer Company and be apprised of any changes in the issuer's business plan and operations.

The credit analyst maintains periodic contact with the issuer company and ensures that financial and other information is regularly shared with a credit rating agency.

It is normal practice to put all credit ratings under continuous surveillance even if there is no obvious reason to change the rating.

Regulation of credit rating agencies in India

The credit rating agencies are regulated by SEBI. The relevant regulations of SEBI can be examined under the following heads :

1) Registration of Credit Rating Agencies

2) Promoter of Credit Rating Agency and Eligibility Criteria

1) Registration of Credit Rating Agencies It is mandatory for credit rating agencies to have registration with SEBI and to obtain certificate of registration form SEBI. The certificate of registration shall be issued by SEBI subject to following conditions.

a) Credit rating agency would comply with the provisions of the SEBI Act, regulations and guidelines of SEBI, and instructions issued by SEBI from time to time on credit rating.

b) Where any information or particulars furnished to SEBI by a credit rating agency is found to be false or misleading or any particular material has undergone change subsequent to its furnishing at the time of application, it would immediately inform SEBI in writing. The certificate of registration is valid for three years after which the same will have to be renewed by SEBI

Promoter of a Credit Rating Agency

A credit rating agency can be promoted by any of the following organisation or combination thereof.

a) Public financial institution as defined in section 4-A of the Companies Act of 1956,

b) Scheduled bank,

c) Foreign bank operating in India with the RBI approval,

d) Foreign credit rating agency having at least five years' experience in rating securities,

e) Any company incorporated under the Companies Act or body corporate having continuous minimum networth of Rs. 100 crore as per its audited annual accounts for the previous five years prior to filing of the application with SEBI for registration

Eligibility Criteria

The credit rating agency l is set up and registered as a company.

has mentioned in its memorandum of Association credit rating activity as one of its main objects. Has a minimum net worth of Rs. 5 crore. is promoted by those who have professional competence, sound financial position, and who have acquired reputation of fairness and integrity in business transaction to the satisfaction of SEBI. has adequate staff having professional competence and experience to the satisfaction of SEBI

RESTRICTION OF RATING OF SECURITIES

Securities issued by a promoter or promoters of a credit rating agency :

A credit rating agency is prohibited from rating securities issued by its promoter(s) who hold not less than 10 per cent of its shares. If the promoter of a credit rating agency is a lending institution its chairman or director/s or employees cannot hold a similar position in the credit rating agency or its rating committee.

Securities Issued by Certain Entities

The securities of an entity cannot be rated by a credit rating agency if it is (a) borrower of its promoter or (b) a subsidiary of its promoter or (c) an associate (a person holding at least 10 per cent of the share capital) of its promoter when there are common chairman/directors or employees to credit rating agency and these entities as well as on the rating committee of rating agency

PROFILE OF CREDIT RATING AGENCIES IN INDIA

At present in India there are four credit rating agencies which rate debt instruments as well as corporate.

1) **Credit Rating Information Services of India (CRISIL Ltd.).** This is the first rating agency in India. It was set-up in 1987 jointly by the erstwhile ICICI Ltd. and UTI. Other shareholders include: Asian Development Bank (ADB), LIC, State Bank of India, and HDFC, etc. The CRISIL Ltd. is the world's fourth largest rating agency. The activities of CRISIL Ltd. are as under :

1. To provide credit rating service in respect of

– Ratings of corporate debt issuances

– Ratings of banks, non-banking finance companies

– Ratings of borrowing programmes of governments and government bodies – Ratings of structured finance instruments

– Ratings of micro-finance institutions

To provide analytical tools for management of risk such as market risk, credit and operational risk and valuation services

To undertake research on economy, industry and company performance and publish such reports

To provide corporate as well as market advisory services to corporate and non- corporate clients.

The CRISIL Ltd. has rated over 4700 debt instruments issued by 2200 companies.

2) Investment Information and Credit Rating Agency of India Ltd. (ICRA Ltd.) This company was promoted by the IFCI Ltd. to meet the requirements of the companies based in the north India. Along with IFCI, State Bank of India, Unit Trust of India, PNB and LIC were other promoters of the company. The objective of the ICRA Ltd. are as follows To rate rupee denominated debt instruments issued inter alia, by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and local bodies, etc

To take-up assignments for credit assessment of companies/undertakings intending to use the same for obtaining specific line of assistance from commercial banks, financial institutions, non-bank financial services companies.

It provides services of general assessment. At the request of banks or any other potential users, it prepares, as per their requirements, general assessment reports. It does not assign any specific symbols in respect of such general assessments. It provides a report on various aspects of the functioning of companies such as operations, quality of management etc.

To undertake research-based study reports to address the unique needs and requirements of an individual client.

The assignments include (1) due diligence studies, (2) equity assessment/valuation, (3) industry analysis, and (4) market study etc.

To offer advisory services to banks, finance companies, manufacturing companies, government, regulatory authorities and local bodies in the following areas: a) strategic consulting b) risk management c) inputs for policy formulation

CARE Ltd.

Credit Analysis and Research (CARE) Ltd. is a credit rating and information services company. This company was promoted by the Industrial Development Bank of India (IDBI) jointly with investment institutions, banks and finance companies. It commenced its credit rating operations in October 1993. The functions of CARE Ltd. are as under : to undertake credit rating of all types of debt instruments, both short term and long term. to make available information on any company, industry or sector required by a business enterprise. to undertake equity research study of listed or to be listed companies on the major stock exchanges.

Duff and Phelps Credit Rating (India) Private (DCR) Ltd. This credit rating company was set-up in 1996. It was promoted by JM Financial and Alliance Group jointly with international rating agency Duff and Phelps. The activities of the company are as under : l to undertake credit rating of debt instruments including rating of commercial papers. l to evaluate company performance and give rating to them. l to provide country rating

ICRA formerly Investment Information and Credit Rating Agency Ltd

• Is an Indian independent and professional investment information and credit rating agency.

• Established in 1991 with Headquarters in Gurgaon

• Moody's Investment Company India Private Limited is the largest shareholder with 31.66% shareholding. • Services rendered by ICRA are: a. Rating services b. Information services c. Advisory services

ASSET LIABILITY MANAGEMENT

As indicated in the previous chapter on risk management, risks can have an impact on either the accounting earnings which are periodically reported and or Value of equity which is relatively a new dimension.

The Asset Liability Management (ALM) function involves planning, directing, and controlling the flow, level, mix and rates on the bank assets and liabilities. The ALM responsibilities are fully aligned to the overall objectives at the bank level. There was no need for an elaborate ALM function till the interest rates were guided by the regulator and the business of banking was purely volume driven. Deregulation of interest rates, interest rate volatility and increasing competition in the financial market place has made the ALM function a significantly important function in today's environment.

Categorisation of Bank Balance Sheet

At this juncture, it is important to understand how the assets & liabilities in the balance sheet of a bank are classified into Banking Book and Trading Book. The following are the points distinguishing one from the other:

Held-till-maturity vs. Short-term holding period

The intention of the bank in case of banking books is to hold the assets and liabilities till maturity whereas in case of trading book the holding period is extremely short and may vary between a few hours (or minutes in some cases) to a maximum of 90 days (as per the RBI's stipulation of holding period)

Accrual Income vs. Price Change Asset Liability Management The assets & liabilities in the banking book accrue income and expenses respectively over time. The target variable in case of the banking book is the net accrual income. In case of the trading book, price appreciation (or depreciation) due to fluctuation in market price is the main target variable as the holding period is very short

Historical cost vs. Mark-to-market Value The assets & liabilities in the banking book are valued at historical cost. Change in the values of assets and liabilities are not recognized in the P&L account. The norm in case of trading book is periodic valuation (mark-to-market) and reflection of the market value of the assets and liabilities in the balance sheet. Any appreciation or depreciation with reference to the value prior to valuation would pass through the P&L account as profit or loss.

Scope of ALM

ALM is a part of overall risk management of a bank which addresses the following risks:

Liquidity Risk: Risk arising out of unexpected fluctuation in cash flows from the assets and liabilities – both in banking and trading books.

I**nterest Rate Risk:** Risk arising out of fluctuations in the interest rates on assets and liabilities in the banking book.

M**arket Risk:** Risk of price fluctuations due to market factors causing changes in the value of the trading portfolio.

NATURE OF ALM RISKS AND ITS ORGANISATION

The nature of risks addressed by ALM is the ones which need to be and are centralized at the bank treasury level for efficient management. In other words, interest rate and liquidity risks may be created by branches of a bank in the process of their intermediation between depositors and borrowers, but these risks need to be pooled at the highest level and managed.

This is because these risks arising at a branch is not relevant as they need to be offset by exactly opposite positions in some other branch of the same bank. Hence, what is significant to be managed is the net position arising at the bank treasury level rather than individual positions arising at a number of branches. In other words, branch heads do not have anything to with the management of interest rate and liquidity risks at their own level.

Their job at present is restricted to providing accurate and timely data for the assessment of the risks which are centralized. By its very nature, as the trading portfolio is managed at the treasury level, no further centralization is warranted. Like in many countries, the RBI has

entrusted the job of ALM in each bank to the AssetLiability Committee (ALCO) to be set up in each bank.
ALCO, consisting of senior executives of a bank, is the apex decision making unit responsible for managing all the three risks that come under the purview of ALM in an integrated manner.

As per RBI requirements, the ALCO is required to meet periodically to assess the bank's position in terms of the risks and provide strategic guidance to achieve the overall targets and objectives set. With the above introduction, the concentration of the following section is on the three risks that the ALCO is supposed to address.

BALANCE SHEET STRUCTURE: IMPLICATIONS FOR ALM

Balance Sheet Structure: Assets l Advances - A significant portion linked to Prime Lending Rate (PLR) in the form of CC/OD, Demand loan & term loans - PLR linked loans
– Absence of reset dates (future dates on which the rates would be reset is unknown)Pattern of repayment based on behavioural studies - Unavailed portion of CC/OD
–Uncertainty of utilisation - Borrower Option to prepay in case of Fixed Rate Term loans Investments - Major portion Fixed Rate - Medium to long duration portfolio - Illiquidity of a significant portion of the portfolio – no or very low flexibility for reshuffling (altering the structure)

Balance Sheet Structure: Liabilities l Deposits – Savings and Current - Non- maturity – No date of maturity - High volatility of balances in case of current account
- Customer Option to freely introduce or withdraw money at any time - Administered interest rates unrelated to market interest rates l Term Deposits: Cumulative, Non-Cumulative and Recurring -Overwhelming majority in Fixed Rates - Customer Option (put option valuable when interest rates go above the contractual fixed rate)
- The reinvestment risk in case of cumulative deposits - Uncertain instalment payments in case of recurring deposits

Floating Rate (a recent development) Borrowings - Fixed or Floating Rate - Various tenor - Usually no options, hence no uncertainty about the term It can be understood from the above structure that a significant portion of liabilities in the form of term deposits have a fixed-rate meaning that the rates would remain unchanged till the maturity or till the deposit remains with the bank. 'Borrowings' which is a smaller portfolio in the liabilities are at market related rates.

Off Balance sheet

Off Balance sheet refers to those activities of assets or debt or financing liabilities of the company that belongs to the company's balance sheet but do not appear/present in the balance sheet i.e. the activities that are not recorded in the balance sheet but company has the rights and obligations for those activities and has the impact on its financial health that taken into consideration by many investors during review of balance sheet as a whole.

on Balance Sheet vs Off Balance Sheet

On Balance sheet items are those that form part of balance sheet of company and at the same time presented in the balance sheet whereas off balance sheet items are not recorded or presented in the balance sheet of company but forms part of balance sheet.

On balance sheet items are very easy to analyze as they appear clearly on the face of balance sheet whereas off balance sheet items are very difficult to analyze by the investors and proves to be matter of concern.

Example of on balance sheet items is Cash, Banks balance, fixed assets, etc. And example of off balance sheets items are operating leases, sold off investments, etc.

How does it Work?

Off balance sheet are much useful for those companies that are highly leveraged. If the company is already having high debt-to-equity ratio, it will be a problem for a company to increase its debt. Also, it will be much expensive for the company to borrow more finances because of high interest rates charged by lender.

The measures of in debt ness of the company such as debt to equity (D/E) and other leveraged ratios do not get affected due to off balance sheet activities. This helps the company in its borrowing. The liquidity position of the company is also not affected due to off balance sheet activities.

Example of Off Balance Sheet

Some of the examples are provided and discussed as below-

One of the most common examples of off balance sheet is operating leases, which are not recorded in lessee's balance sheet. The asset continues to appear in lessor's books of accounts. One more example is that when assets are secured and are sold off, the selling of the assets as investment does not appear in the books of accounts.

Any disposal of inventory does not appear in the balance sheet but forms part of notes to accounts. All the above are the example of off balance sheet. Various joint ventures, Research and development activities also form part of examples of off balance sheet activities

off Balance Sheet Items

Similar to above, off balance sheet items are those items which forms part of asset and liabilities of the company but do not presented in the company's balance sheet. Likewise, the presentation of off balance sheet activities, these items also shown in notes to accounts and are sometimes difficult to identify.

Depending upon the business of the company, there can be large portion of off balance sheet items in many books of accounts of the company. These items can be formally shown as "assets under management" as a presentation. The working of off-balance sheet items is similar to those of off-balance sheet activities.

Different off balance sheet items include

Operating Leases: It is an off-balance sheet item in which rentals expenses are shown in lessee's books of account and asset is shown in lessor's books of account.

Cash in transit also forms part of notes to accounts but does not recorded in the balance sheet so, it is off balance sheet item

Accounts Receivable:

It may also be the off balance sheet item and default risk under this category is highest. Almost all of the company have the said asset category.Other items are inventory write off and its disposal etc.

Off Balance Sheet Disclosures

According to Securities and exchange Commission and generally accepted accounting principles (GAAP), every public company is required to disclose all its off balance sheet activities in the notes of its financial statements, the transactions, obligations (including contingent obligations), arrangements or any other relationships , with unconsolidated entities that have or may have in future any material effect on company's financial conditions, revenues ,Changes in financial conditions, expenses, results of operations, liquidity , capital expenditures or capital resources.

The Securities and Exchange Commission (SEC) has recently proposed the rules to implement the above disclosure as per sec 401(a) of Sarbanes-Oxley Act 2002 in each quarterly and annual financial report of the company filed with SEC.

Questions

PART A

1. Define risk

2. What are the policies and procedure for risk management

3. Mention the mitigation of credit risk

4. List out the symbols in credit rating

5. Give the concept of credit rating

PART B

1. Describe the factors influencing risk management in international banking

2. Explain in detail about process of credit rating

3. Analyze the credit rating activities CRISIL

4. Outline the risk management in Indian banking sector

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SCHOOL OF MANAGEMENT STUDIES

UNIT – III- INTERNATIONAL BANKING - SBAA3015

International banking operations

Off Shore financial centre- Rationale – characteristics of Offshore financial centre - Types of offshore centre – international banking facilities – Special economic zone(SEZ) -Regulatory concerns. Correspondence banking – Clearing house functions – payments and collection – credit services -foreign exchange services- other facilities Foreign bank branches operations factors behind overseas branch expansion – objectives of abroad branches- constraints faced by overseas operations

Meaning of Offshore Financial Centres:

Offshore financial centres play a critical role in the international financial system. They provide finance, insurance, broking, holding-company and head-office services, and exist because the economic benefits outweigh their costs.

In a global economy, there will be bona fide business reasons for setting up a business in any country, including a low tax one. These dealings can be genuine and profits allocated to them commensurate with the economic value they add.

Role may include a wide range of business objectives.

i. They allow businesses to reduce costs and increase revenues through centralised group services within a multinational enterprise.

ii. They assist in the efficient and effective movement of capital and resources and provide opportunities for global investment.

iii. They provide facilities to manage financial affairs confidentially and ensure legal protection from unjustified claims through trusts.

iv. They permit the use of intermediary entities to overcome cumbersome regulations at home (and host) country.

v. They provide flexibility in legal systems ("legal arbitrage") to develop quick legislative solutions to meet specific market needs.

vi. They provide tax-neutral services and assist in international tax planning. Etc.

The fast changing global environment demands that multinational enterprises remain flexible to take advantage of the business opportunities, wherever they arise, at an acceptable cost.

Due to various, domestic constraints, many onshore jurisdictions are unable to keep pace with these new demands, and have indirectly encouraged (he growth of relatively smaller offshore centres that provide new and innovative business services quickly or/and at lower costs. Their flexible tax systems, fewer regulations, greater confidentiality and opportunities for cost savings make them attractive to global businesses.

Tax mitigation is frequently not the key factor in the use of offshore financial centres. Many jurisdictions are used as “regulation havens” to avoid, besides confiscatory tax regimes, onerous controls (e.g. exchange controls) and legal claims (e.g. asset protection trusts). Moreover, several offshore centres provide “secrecy havens”.

However, the impact of taxes still plays an important role. Cross-border transactions usually lead to higher tax costs since they involve more than one tax jurisdiction. The use of offshore centres helps reduce this tax liability.

Many financial centres offer zero tax or special tax regimes as “tax havens “Both traditional and non-traditional offshore financial centres may act as **tax havens.**

They may be broadly divided into three main categories for tax purposes:

(i) Traditional offshore centres with nil or very low tax on corporate or business income and few or no treaties (“base havens”).

(ii) Traditional offshore centres with reasonable domestic tax rates but with special tax regimes that allow the use of their treaty network for offshore activities, (“treaty havens”).

(iii) Non-traditional offshore (e.g. onshore) centres with special incentives or benefits that may be exploited for a particular international transaction or activity to gain a tax or non-tax advantage for offshore activities, often with the help of tax treaties ("special concession havens").

The role of offshore financial centres is often found either as a base haven, or as a treaty haven. An effective international structure may need a "conduit" company for tax minimization in a treaty country and a **"base"** company for capital accumulation in a low or nil tax offshore centre.

The conduit company focuses on the treaty advantages that are obtained from the source country, whereas the base company minimizes the taxes in an intermediary country of residence. Base and treaty havens may also be located in high- tax countries that provide special legislation for offshore activities.

CHARACTERISTICS OF OFF SHORE CENTRE

Nature of the Entity

An offshore banking company is generally set up in offshore jurisdictions or a financial centre which allows a multi-national company to register in their jurisdiction and obtain a banking licence, by which banking operations such as managing cash, raising capital for the group, providing finance to individual subsidiaries and managing financial risk can be undertaken.

An offshore banking licence allows the holder to operate a bank in one country that provides services to depositors who are residents in other countries

The licence is issued by the country in which the bank is operated, which is not necessarily the country in which the holder is a citizen or resident. Usually these countries have low or even zero tax rates, meaning depositors can lower their tax bills by banking there, rather than in their own country. Such jurisdictions are used for banking activities largely because of privacy and asset protection. A high return on investment is also a factor that comes into play while choosing a jurisdiction.

However, owing to allegations claiming the use of bank secrecy laws for tax avoidance and money laundering, banking regulations have been tightened in several OFCs.

Jurisdictions of preference for an offshore banking company Switzerland and Cayman Islands are the top jurisdictions for offshore banking in the world owing to secrecy, convenience and return on investments. Seychelles, Isle of Man, Luxembourg, Andorra and Lichtenstein are also increasingly used for offshore banking.

Benefits of offshore banking company

Secrecy and confidentiality: Offshore banking jurisdictions provide for very tightly bound bank secrecy laws which keep all information regarding customers and account details completely private.

Tax benefits: Storing of funds in a jurisdiction with significant tax benefits can be useful for factors such as low or nil withholding rates on interest payments, etc. Interest is generally paid by offshore banks without tax being deducted. This is an advantage to individuals who do not pay tax on worldwide income, or who do not pay tax until the tax return is agreed, or who feel that they can illegally evade tax by hiding the interest income.

Other benefits: Offshore banks can sometimes provide access to politically and economically stable jurisdictions. This will bean advantage for residents in areas where there is risk of political turmoil, who fear their assets may be frozen, seized or disappear. However it is often argued that developed countries with regulated banking systems offer the same advantages in terms of stability.

Offshore Financial Centers and Tax Havens – An Overview

Easy access to deposits: Lower level of regulation allows easier access to the money stored by the company.(iv) Higher returns: Some offshore banks may operate with a lower cost base and can provide higher interest rates than the legal rate in the home country due to lower overheads and a lack of government intervention.

Types of Offshore Financial Centers:

a. Base Havens:

Base havens are offshore financial centres with nil or very low corporate taxes, no withholding taxes, and no or, at best, a few tax treaties. Often, they charge a “fee in lieu of taxes” or a flat rate tax, irrespective of the actual turnover or profits.

There are generally no exchange controls or currency restrictions, and a high level of banking and commercial secrecy is provided. The lack of tax treaties reduces the possibilities of exchange of information under the treaty provisions. Their primary use is to collect and accumulate income in a tax-free or low-tax environment.

Base companies are useful for the administration of income generating assets, and for group financial management. They may also engage in service-type activities, such as copyright owning, group management and regional co-ordination services, overseas commercial or professional activities, re-invoicing, insurance or shipping services, etc.

Base havens may also serve as a central or bulk purchasing company, or as a trading company. They may not be suitable for certain activities due to lack of skilled labour force, unsuitable communication facilities or inadequate business infrastructure. Many of the smaller centres also suffer from potential political and economic uncertainties, and weak regulatory systems.

The role of a base company as a holding or finance company is usually limited since it lacks a treaty network. For example, a group finance company needs treaty provisions to reduce the interest withholding tax in the source country. Low or nil tax base havens with no tax treaties may still be useful in situations when the income from the subsidiaries is tax-exempt in the host country.

A company in the base haven is often structured as an intermediary entity that is either a subsidiary or as a parallel company with the same shareholders as the home or host country. It may also be owned by an offshore discretionary trust with the shareholders as beneficiaries. Such tax planning requires a certain amount of caution.

For example:

It must avoid "unplanned" tax residence under the domestic tax laws in either the home or host country due to the location of its management.

The lack of treaties may expose even a minimal economic activity to host country taxation under an "effectively connected" or "business connection" rule, or other local source rules. Such short-term activity may be subject to tax, since the tax treaty protection of the "permanent establishment rule" will not be available.

b. Treaty Havens:

Treaty havens are offshore financial centres that permit nonresidents to use their tax treaties for resident intermediary entities, e.g. treaty shopping. The tax treaties with source countries provide for reduced or nil withholding tax on inbound income.

Normally, they exempt qualifying entities from corporate income taxes and capital gains, and then generally levy a nil or reduced withholding tax on outbound payments. As a result, they are useful as a tax-efficient location for intermediary or conduit companies that allow flow-through income in international tax planning through treaty shopping.

The intermediary structure using treaty havens can be either a direct conduit or a stepping-stone conduit. The direct conduit takes advantage of the treaty concessions granted to the intermediary entity by the host and home jurisdictions.

The stepping-stone conduit relies either on (i) a tax reduction through a counterbalancing expense, or (ii) the use of a related company in a base haven to extract the profits from the intermediary country through tax-deductible expenses. The erosion of the tax base leads to a reduced tax liability imposed at the regular corporate rate. The use of an intermediary entity can provide several tax benefits.

For example:

It helps to minimize the total tax through the use of third-country treaties. For example, the treaty with an intermediary jurisdiction may provide more favourable treaty benefits, or grant them if there is no treaty between the host and home States.

c. Special Concession Havens:

Many high-tax **"onshore"** countries act as tax havens and provide special tax regimes with exemptions or reliefs to attract businesses with certain types of international business activities. They also allow the use of their treaty network for treaty shopping. As mentioned

For example:

Several countries have special provisions for holding, finance or licensing companies, usually with the benefits of their tax treaties. They also give preferential treatment for financial services, such as insurance, offshore banking, mutual funds management and leasing activities to non residents.

A special economic zone

A special economic zone (SEZ) is an area in which the business and trade laws are different from the rest of the country. SEZs are located within a country's national borders.

- ✓ Their aims include increased trade balance, employment, increased investment, job creation and effective administration.
- ✓ To encourage businesses to set up in the zone, financial policies are introduced.
- ✓ These policies typically encompass investing, taxation, trading, quotas, customs and labour regulations.
- ✓ Additionally, companies may be offered tax holidays, where upon establishing themselves in a zone, they are granted a period of lower taxation.
- ✓ The benefits a company gains by being in a special economic zone may mean that it can produce and trade goods at a lower price, aimed at being globally competitive.

History of SEZ

Indian Special Economic Zone was structured with the establishment of the first Export Processing Zone (EPZ) at Kandla in the year 1965. Special Economic Zone came in to existence because the economic reforms incorporated in the early 1990s did not resulted in the overall growth of the Indian economy.

The economic reforms incorporated during the 1990s did not produce the desired results. The Indian manufacturing sector witnessed a sudden dip in the overall growth of the industry, during the second-half of 1990s.

The History of SEZs in India suggests that red tape, lengthy administrative procedures, rigid labor laws and poor physical infrastructural facilities were the main cause of deterioration of Foreign Direct Investments (FDI) inflow in to India. Further, the Indian markets were not mature enough to facilitate easy entry of Foreign Institutional Investors (FIIs) in to the Indian economic system.

Furthermore, the legal framework of Indian economy was not strong enough to prevent misuse of Indian markets by the foreign investors.

Thus, the lack of investor friendly environment in India prevented growth of Indian industry, in spite of implementation of liberal economic policy by the central government.

This resulted in the formation of a much larger and more efficient form of their predecessors with world-class infrastructural facility. The Special Economic Zone (SEZ) Policy was announced in April 2000. This resulted in the formation of a much larger and more efficient form of their predecessors with world-class infrastructural facility. The SEZ Act, 2005 and SEZ Rules became effective on and from 10th February 2006.

Need for SEZ

The prime objective was to enhance foreign investment and provide an internationally competitive and hassle free environment for exports.The idea was to promote exports from the country and realizing the need that level playing field must be made available to the domestic enterprises and manufacturers to be competitive globally.

SEZ are set up in order to attract foreign investors to invest in India, SEZ are brought with world class facilities , water , electricity , roads , transport , storage etc.. this foreign investment will help in economic development of our country.

SEZs play a key role in rapid economic development of a country. In the early 1990s, it helped China and there were hopes (perhaps never very high ones, admittedly) that the establishment in India of similar export-processing zones could offer similar benefits -- provided, however, that the zones offered attractive enough concessions.

Advantages of SEZ

- ✓ 15-year corporate tax holiday on export profit – 100% for initial 5 years, 50% for the next 5 years and up to 50% for the balance 5 years equivalent to profits ploughed back for investment.
- ✓ No license required for import made under SEZ units.
- ✓ Exemption from customs duty on import of capital goods, raw materials, consumables, spares, etc.
- ✓ Exemption from payment of Central Sales Tax on the sale or purchase of goods, provided that, the goods are meant for undertaking authorized operations.
- ✓ Since SEZ units are considered as ‘public utility services’, no strikes would be allowed in such companies without giving the employer 6 weeks prior notice in addition to the other conditions mentioned in the Industrial Disputes Act, 1947.
- ✓ Has host of Public and Private Bank chains to offer financial assistance for business

houses

- ✓ In –house Customs clearance facilities.
- ✓ Abundant supply of technically skilled as well as semi-skilled manpower.
- ✓ Well connected with network of public transport, local railways and cabs.
- ✓ Simplification of procedures and self-certification in the labor acts.
- ✓ Full authority to provide services such as water, electricity, security, restaurants, recreational, facilities within the zone on purely commercial basis.
- ✓ Pollution free environment with proper drainage and sewage system

Disadvantages of SEZ

Loss of revenue to government

Generally government gets huge tax from industries. But, as government is providing tax holidays for industries, it loses most of the revenue from it. This reason government has to lay more burdens on common man. If it is not laid government may not fulfil its stint properly. Even government fails to give subsidies, it falls on poor and middle class. Hence, there is criticism on government that it is helping the rich.

Land grabbing

Lands are grabbed from poor and middle class people on the pretext of development. Generally, the land is considered to be an asset to these people and they invest on it working their entire life. But, government with its simple G.O., it evacuates people. This is the reason in so many states there are widespread movements by people.

Regional disparity

The places which are near to SEZs get good facilities and good infrastructure is available. This produces disparity among places. There may be tensions prevail like new states movements.

Loss of agricultural land

As land grabbing is going on, there are instances that fertile agriculture lands are being taken in order to provide way for industries. This is not only keeping agriculture at stake but also food crisis may arise in near future.

Compensatory problems

Government provides compensation. But it is not equal to the loss rendered. People have to sacrifice their lands for private persons which they have earned with years of their hard work. In land related issues, agriculture land loss due to SEZs is more problematic as farmer loses his livelihood and his asset. He has to search for another livelihood which is not easier. He has to work as a labour in another farm or has to leave his village.

Deindustrialization

SEZs attract many industrialists in other places in India and they show interest as there is tax exemption. This process enables deindustrialization in already existed places and migration starts. This is not a good omen. There should be development equally

Manufactures one or more good in a particular sector like gems and jewellery, electronic hardware or software = 10 or more hectares •Manufactures one or more services=100 or more hectares

Types of SEZ

Sector specific SEZ : Manufactures one or more good in a particular sector like gems and jewellery, electronic hardware or software = 10 or more hectares Manufactures one or more services=100 or more hectares

Multi- Product SEZ Manufacture multiple goods or rendering multiple services in one sector or across multiple sectors. And land used is 1000 or more hectares

SEZ in a port or airport; or for free trade and warehousing:SEZ in an existing port or airport for manufacture of goods falling in two or more sectors including trading and warehousing Land used is 40 or more hectares.

Special Economic zone in India

SEEPZ- Andheri (East), Mumbai

Khopata- Multi-product, Mumbai

Navi Mumbai- Multi-product, Mumbai

Salt Lake Electronic City, West Bengal

CLEARING HOUSE

A clearing house is a mediator between two firms (which may or may not know each other) that are engaged in a financial transaction (wherein one party is a buyer & another party is seller in the said transaction), taking the exact opposite positions for each firm and ensures that there is no risk of default in the transaction

The above diagram shows the simplified process of how the transaction actually flows between two parties. The buyer receives the actual goods from the deemed seller (i.e., the clearing house), and the seller receives the consideration for the goods sold to the deemed buyer (i.e., the clearing house).

It makes the transaction secured. The question that arises here is, “will the clearing do the same for free of cost?” The answer is obviously, “No.” The mediator charges a nominal amount from each of the parties to the contract, say 0.001% of the trade involved. Isn’t the margin too low? Obviously, yes. But the mediator earns due to huge volumes of trade around the globe.

The clearing house is involved in regular transactions of trading goods (i.e., manual physical delivery or customized contracts) and also in a futures contract or derivatives contracts or option contracts (i.e., automated exchange driven contracts).

Functions

- The first and foremost thing a clearing house does is that it ensures a smooth flow of the transaction.
- It guarantees the occurrence of the transaction in the manner planned by the said parties.
- This guarantee is given by checking the repaying capacity & credibility of the parties involved. Now, this applies irrespective of whether the parties are natural or artificial persons.
- It ensures that the system is available during the trading hours. This makes sure that the market is liquid.
- A clearing house also provides standardized norms regarding the quality, quantity, price, minimum ticks, maximum movement of price within a day & maturity for the contract.

Importance

The basic risk each trader faces is non-honouring of the contract & default risk on the side of the buyer.

Clearing house eliminates such risks & thereby providing an assurance to the financial transaction.

It is made responsible for settlement between the parties, time limit within which the transaction should get completed, monitoring over the adequacy of margins placed on the accounts of each trader.

Clearing house ensures that the variable margin is called for in case of the maintenance margin is breached by a trader.

Benefits

Ease of transaction. It is a secure way of dealing in a financial transaction at a negligible cost. Reduction in human-oriented errors. Faster processing of transactions. There is no need to search eligible counterparty to the transaction.

Disadvantages

- The system of clearing house has itself emerged due to flaws in the earlier physical settlement system.
- Basically, the clearing house is made to advantage the public at large. It can never default due to stringent regulations imposed by the government. We can better call it the limitations rather than the disadvantages.
- Limited settlement hours since the exchange is not available 24 x 7.
- A specific quantum of orders is required. So, you cannot trade in odd lots as per your convenience. Lower internet connection may delay placing your orders. There is a very minute risk of default on the part of the sub-brokers to the clearing house.

Example of Clearing House

Say, the stock is trading at $ 850. You will see a number of contracts as follows:

Clearing House -Example

Explanation

Here, Mr. C can buy from Mr. R only 5000 stocks at $ 849. The price will move down. Then, you can see Mr. B can buy from Mr. Q at the price of $ 848 to the extent of 10,000 stocks. Mr. Q will be left with 10,000 stocks at $ 848.

Now, Mr. Q can increase his price at $ 849 & sell to Mr. C stock to the extent 5000.The price will not move until one of the parties to the transaction modifies its prices.So, you can see all these happen in seconds on the stock market. The stock exchange here is the mediator facilitating the trade.

Stock Market Clearing houses

Stock exchanges require a clearinghouse to make sure that the stock trader's required funds are available in their account to complete the trade. By taking on this middleman role, the clearinghouse can smoothly facilitate the transfer of stocks and money between the two parties. The clearinghouse can give the investor who is selling the stocks peace of mind that they will be paid for their sale.

Foreign bank branch

Meaning

A foreign bank branch is a type of foreign bank that is obligated to follow the regulations of both the home and host countries. Because the foreign bank branch has loan limits based on the total bank capital, they can provide more loans than subsidiary banks. That is because the foreign bank branch, while possibly small in one market, is technically part of a larger bank. Hence, it enjoys the capital base of the larger entity.

Objectives and functions

A foreign bank branch is a type of foreign bank that is obligated to follow the regulations of both the home and host countries.

Banks often open a foreign branch to provide more services to their multinational corporate clients.

Foreign bank branches tend to be more effective in countries with high taxes and nations where it is easy for international firms to enter the market.

Foreign bank branches may face special difficulties during an economic or political crisis.

Understanding Foreign Bank Branches

Banks often open a foreign branch to provide more services to their multinational countries . However, operating a foreign bank branch may be considerably more complicated because of the dual banking regulations that the foreign branch needs to follow.

For example, suppose that Bank of America opens a foreign bank branch in Canada. The branch would be legally obligated to follow both Canadian and American banking regulations in many cases. In actual practice, foreign bank branches are sometimes exempted from specific rules in one country or the other.

With globalization and capital markets maturing, the administrative burden of multiple regulatory standards might be offset by other operational economies of scale. These may include global branding, marketing, and product offerings best served by a single entity with numerous local branches.

Foreign Bank Branches vs. Subsidiaries of Foreign Banks

A foreign bank branch should not be confused with a subsidiary. A subsidiary is technically a separate legal entity, even though it is owned by a parent corporation. Naturally, taxation and regulation drive the decision to operate as a foreign bank branch or a subsidiary.

Disadvantages of Foreign Bank Branches

- Foreign bank branches may face special difficulties during an economic or political crisis. Since they operate in that foreign country during a crisis, they will be negatively impacted by events there. At the very least, foreign bank branches stand to lose money. At worst, they might have to deal with a run on the bank branch with little support from the foreign government.
- A government in crisis is more likely to use its limited resources to support domestic banks. Foreign banks might be left to bail out their own branches.
- This situation is different from a subsidiary bank, which is technically a domestic company in the foreign country. Subsidiary banks are also sometimes joint ventures with domestic banks, further increasing the chances that the local government will support them.

Question bank

PART A

1.State the meaning of off shore banking financial Centre.

2.Mention the two benefits of off shore Centre

3.What do mean by tax havens?

4.Explain the need for special economic zone

5.List out the two functions of clearing house

PART B

1. Describe the activities of clearing houses in India

2.Elaborate the advantages and disadvantages of SEZ

3.Outline the role and characteristics of off shore Centre.

4.Explain the types of off shore banking Centre

5. Discuss the objectives and functions of foreign bank branch

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SCHOOL OF MANAGEMENT STUDIES

UNIT–IV-INTERNATIONALBANKING-SBAA3015

INTERNATIONAL PAYMENT ARRANGEMENTS

International payment arrangement – Society for worldwide financial telecommunication (SWIFT)-SWIFIT messaging payments methods in international trade- Cash in advance - letter of credit – Documentary collection open account or credit – counter trade or Barter

INTRODUCTION

To succeed in today's global marketplace and win sales against foreign competitors, exporters must offer their customers attractive sales terms supported by the appropriate payment methods. Because getting paid in full and on time is the ultimate goal for each export sale, an appropriate payment method must be chosen carefully to minimize the payment risk while also accommodating the needs of the buyer.

Society for World-wide Interbank Financial Telecommunication (SWIFT)

Society for World-wide Interbank Financial Telecommunications Society for World-wide Interbank Financial Telecommunication (SWIFT) a specialised non-profit co-operative owned by banks, is the most important private message courier.

SWIFT transmits messages in standardised formats and many interbank funds transfer systems (like CHIPS), have been designed to reformat SWIFT messages electronically for execution through the clearing house. Over the years SWIFT has become an integral part of many interbank payment systems. Banks in India are also connected to the SWIFT network.

SWIFT consists of national data concentration centres, which are connected by leased telephone lines to operating centres in Belgium, the Netherlands and the United States. Computer terminals at the participating banks are linked to the national orientation centres, with SWIFT, a message can be sent from one bank to another as speedily as with a telex but error free, more securely and at lower cost.

SWIFT has largely replaced interbank transfers made by cheque or draft because of the advantage of speed, at the same time providing for immediate verification and authenticity. The system has over a thousand members in several dozen countries, giving essentially global coverage. In essence, SWIFT provides member banks (that would alternatively operate through correspondent banks), the same payment service as that available to a few multinational banks that have an extensive network of wholly owned affiliates. Earlier firms, the relay mechanism outlined in our example used to be handled by cheque, but now a days a computer- based facility merely request a few entries into the system.

Each bank has a code number. all the relevant information about the payment is entered into a computer terminal and the authenticity of the payment is checked. At the end of the day, the CHIPS Clearing House funds get netted out and the real money is paid.

In addition to providing a tabulation for all the member banks of CHIPS at the end of the day, the system also permits members to look at those payment that are "on line" (i.e., in storage, awaiting approval), so that better information on available funds can be used for the member bank's credit decisions.

If a credit officer knows that a certain account will be credited later in the day, he may be willing to grant credit.

Although its **operating procedures** are highly technical, CHIPS operations have important economic implications:

1) The role of the US dollar as a world vehicle currency is influenced by the relative operating efficiency and safety of its payment mechanism.

2) Its handling of failures to settle accounts, which have the potential to initiate a chain reaction leading to a worldwide liquidity crisis, makes such occurrences isolated events.

3) The specific roles of individual banks in the dollar clearing system have important implications for world-wide correspondent banking relationships and, therefore, market share and profits

Cash in advance

Cash in advance is a payment term used in some trade agreements. It requires that a buyer pay the seller in cash before a shipment is received and oftentimes before a shipment is even made. Cash in advance is a provision that can be required in any transaction in which there is a delay between the sales agreement and the sales delivery.

- Cash-in-advance payment terms require a buyer to make payment prior to receipt of purchased goods.
- Cash-in-advance terms can be associated with any sales transaction in which goods or services are not provided immediately.
- Cash in advance is the best payment option for sellers but is not always used because of industry standards or competition.
- Companies can choose from a variety of payment terms and will typically choose payment terms that appropriately manage their own risks while remaining comparable to competitors.

Understanding Cash in Advance

Cash in advance payment methods are used to eliminate credit risk, or the risk of non-payment, for the seller. In general, the structure of cash in advance transaction fully benefits the seller and poses risks for the buyer. Cash in advance payments are not necessarily uncommon trade terms, but the risks for a buyer increase if the seller or network they are dealing with is not highly credible.

Cash in advance terms can be associated with any sales transaction in which goods or services are not provided immediately onsite, such as in brick and mortar sales, but rather delayed through a shipping process. Two areas where cash in advance terms can be common include online marketplaces and international trade.

In a transaction with cash in advance terms, the seller requires the buyer to make the entire payment upfront in order to initiate the process of shipping the expected goods. This protects the seller from lost money for goods shipped without payment and also alleviates any need for collections recourse.

In some cases, cash in advance arrangements may allow the buyer to pay immediately before ownership is transferred, through cash on delivery. However, most often pre- payment is fully made through wire services or online payment portals using a credit card, debit card, or bank account. The risks of cash in advance payments typically do not make it the preferred option for most buyers.

Cash-in-Advance Markets

Online marketplaces and international business trade two areas where cash in advance payments can be the most common. Most consumers and businesses are comfortable with making e-commerce purchases through well-established businesses like Walmart, Target, and Home Depot.

Buyers will typically make online cash in advance payments without much research or perceived risk. However, risks can increase as online businesses become less transparent. Amazon and ebay move somewhat higher up on the risk spectrum.

Contingent Guarantees

As such, both offer contingent guarantees backing sales from their sellers. Amazon guarantees a refund if the goods never arrive. On the eBay platform, eBay also has a money back guarantee for most items. In all cases of seller delinquency, eBay is involved in evaluating each case for monetary refunds if items are not received.

International business trade can involve a variety of businesses ranging from small companies to large conglomerates. Businesses that do not want to deal with the risks of inventory write-offs will require cash in advance payment terms.

Generally, a business's decision to institute cash in advance payments will depend on its risks. Larger businesses may have greater latitude to offer better payment terms for buyers because their accounts receivable and collections processes are more advanced. Smaller companies may not have the advantages of full-service accounts receivable and collections support. At small companies, write-offs for uncollected payments may also lead to unmanageable losses.

Letters of Credit

'Letters of Credit' also known as 'Documentary Credits' is the most commonly accepted instrument of settling international trade payments. A Letter of Credit is an arrangement whereby Bank acting at the request of a customer (Importer / Buyer), undertakes to pay for the goods / services, to a third party (Exporter / Beneficiary) by a given date, on documents being presented incompliance with the conditions laid down.

PARTIES TO A LETTER OF CREDIT (LC)

A letter of credit transaction normally involves the following parties:

APPLICANT / OPENER – the buyer of the goods / services (Importer) on whose behalf the credit is issued

ISSUING BANK –

the Bank which issues the credit and undertakes to make the payment on behalf of the applicant as per terms of the L/C.

BENEFICIARY –

the seller of the goods / services (exporter) in whose favour the credit is issued and who obtains payment on presentation of documents complying with the terms and conditions of the LC.

ADVISING BANK –

Banks which advises the LC, certifying its authenticity to beneficiary and is generally a bank operating in the country of the beneficiary.

CONFIRMING BANK

A bank which adds its guarantee to the LC opened by another Bank and thereby undertakes responsibility for payment/acceptance/negotiation/incurring deferred payment under the credit in addition to that of the Issuing Bank. It is normally a bank

operating in the country of the beneficiary and hence it's guarantee adds to the acceptability of the LC for the beneficiary. This is being done at the request / authorization of the Issuing Bank.

NOMINATED BANK: A Bank in exporter's country which is specifically authorized by the Issuing Bank to receive, negotiate, etc., the documents and pays the amount to the exporter under the LC.

REIMBURSING BANK: Bank authorised to honour the reimbursement claim made by the paying, accepting or negotiating bank. It is normally the bank with which Issuing Bank has Nostro Account from which the payment is made to the nominated bank.

TRANSFERRING BANK: In a transferable LC, the 1st Beneficiary may request the nominated bank to transfer the LC in favour of one or more second beneficiaries. Such a bank is called Transferring Bank. In the case of a freely negotiable credit, the bank specifically authorised in the LC as Transferring Bank, can transfer the LC.

International trade presents a spectrum of risk, which causes uncertainty over the timing of payments between the exporter (seller) and importer (foreign buyer).

For exporters, any sale is a gift until payment is received. Therefore, exporters want to receive payment as soon as possible, preferably as soon as an order is placed or before the goods are sent to the importer. For importers, any payment is a donation until the goods are received.

Therefore, importers want to receive the goods as soon as possible but to delay payment as long as possible, preferably until after the goods are resold to generate enough income to pay the exporter.

There is no limit to the number and variety of documents which letters of credit may stipulate. The following is a list of documents most commonly seen in a letter of credit transaction. Each document is described in briefwith a check-list for preparing the document.

Procedure or step to involving letter of credit transactions

Step 1. The Sales Contract

The sales contract is the formal agreement between the buyer and seller specifying the terms of sale that both parties have agreed upon. The contract should include a description of the goods; the amount; the unit price; the terms of delivery; the time allowed for shipment and presentation of documents; the currency; and the method of payment.

Step 2. Application & Agreement

The bank's letter of the credit application and agreement forms, when executed, constitute a payment and reimbursement contract between the issuing bank and its customer. It is also the customer's instruction to the issuing bank.

The letter of credit must be issued exactly under the customer's instructions; therefore, the application must be completed fully and accurately, to avoid the inconvenience of having to have the letter of credit amended. The agreement constitutes an undertaking by the customer to reimburse the issuing bank for drawings paid following the terms of the letter of credit, and normally takes the form of an authorization to debit the customer's account.

Step 3. Issuance of the Letter of Credit

The issuing bank prepares the letter of credit as specified in the application and forwards it by transmission or airmail to the advising bank, (a branch or correspondent of the issuing bank).

The issuing bank instructs the advising bank as to whether or not to add its confirmation, as per their customer's instructions.

Step 4. Advising

The advising bank forwards the letter of credit to the beneficiary (seller) stating that no commitment is conveyed on its part.

step 5. Shipment of Goods

Upon receiving the letter of credit, the beneficiary should examine it carefully and be satisfied that all the terms and conditions can be complied with.

If this is not possible, the beneficiary should request the applicant to arrange an amendment to the letter of credit. Once completely satisfied, the beneficiary will then be in a position to assemble and ship the goods.

Step 6. Presentation of Documents by Beneficiary

The beneficiary prepares an invoice in the number of copies required, with the description of goods shown exactly as stipulated in the letter of credit.

The beneficiary obtains the bill of lading and/or other transport documents from the carrier and prepares and/or obtains all other documents required by the letter of credit.

These are attached to the draft, drawn on the bank indicated and at the term stipulated in the letter of credit, and are presented to the advising/ confirming/ negotiating bank.

Step 7. Sending Documents to the Issuing Bank

The advising/confirming/negotiating bank checks the documents presented by the seller against the letter of credit. If the documents meet the requirements of the letter of credit, that bank will send them to the issuing bank, claiming reimbursement and paying the seller.

Step 8. Delivering Documents to the Applicant

The issuing bank will also check the documents for compliance and then deliver them to the applicant either against payment or as an undertaking to pay on the maturity of the drawing under the letter of credit.

Documents Usually Required Under a Letter of Credit

There is no limit to the number and variety of documents that letters of credit may stipulate.

Documents for collection of payment in letter of credit

As already stated, the beneficiary should, on first being advised of the letter of credit, examine it carefully and be satisfied that all the documentary requirements can be complied with.

Unless the documentary requirements can be strictly complied with, the beneficiary may not receive payment from the issuing bank. If there are any requirements that cannot be complied with, the beneficiary should immediately request the applicant to arrange for an appropriate amendment to the letter of credit.

Draft

A draft is a bill of exchange and a legally enforceable instrument which may be regarded as the formal evidence of debt under a letter of credit. Drafts drawn at sight are payable by the drawee on presentation. Term (usance) drafts, after acceptance by the drawee, are payable on their indicated due date.

Checklist

- Drafts must show the name of the issuing bank and the number and date of the letter of credit under which they are drawn.
- Drafts must be drawn and signed by the beneficiary of the letter of credit.
- The terms of the draft must be expressed in accordance with the tenor shown in the letter of credit., at sight or at a stated number of days after bill of lading/shipment date.
- The amount in words and figures must agree and be within the available balance of the letter of credit and in the same currency as the letter of credit.
- The amount must agree with the total amount of the invoices unless the letter of credit stipulates that drafts are to be drawn for a given percentage of the invoice amount.

Commercial Invoice

The commercial invoice is an itemized account issued by the beneficiary and addressed to the applicant, and must be supplied in the number of copies specified in the letter of credit.

Checklist

- The invoice description of the goods must be identical to that stipulated in the letter of credit.
- Unit prices and shipping terms, ie., CIF, FOB, etc., must be as stipulated in the letter of credit. Extensions and totals should be checked for arithmetical correctness. For definitions of CIF, FOB etc.,

Consular or Customs Invoice

A consular or customs invoice is prepared by the beneficiary on forms either supplied by the buyer or local

consulate offices.

A consular or customs invoice is prepared by the beneficiary on forms either supplied by the buyer or local consulate offices.

Checklist

- Consular invoices must be visaed (officially stamped) and signed by a consular officer of the importing

country and be supplied in the official form and number of copies as stipulated in the letter of credit.

- All headings of the forms must be completed.
- The value of goods required must agree with that shown on the commercial invoice.

Bill of Lading

A bill of lading is a receipt issued by a carrier for goods to be transported to a named destination, which details

the terms and conditions of transit. In the case of goods shipped by sea, it is the document of title which controls the physical custody of the goods. There are two different types of bill of lading:

- A STRAIGHT BILL OF LADING is one that names a specific consignee to whom goods are to be delivered. It is a non-negotiable document.
- An ORDER BILL OF LADING is one that is written “to order” or to order of a named party making the instrument negotiable by endorsement. Letters of credit usually call for an order bill of lading blank endorsed, meaning the holder of the bill of lading has title to the goods.

Air Waybill

An air waybill is a receipt issued by an air carrier indicating receipt of goods to be transported by air and showing goods consigned to a named party. Being a non- negotiable receipt, it is not a document of title.

Checklist

- Only the goods invoiced and specified in the letter of credit may be covered by the air waybill.

• If the letter of credit stipulates that freight is to be prepaid; or if the invoice is priced CIF or CFR; or if freight is otherwise included in the invoice: the air waybill must indicate that freight has been paid. • The airport of departure and airport of destination must be as stipulated in the letter of credit.

• The number of packages and gross weight shown on the air waybill must be consistent with the other documents.

• An air waybill issued by a forwarder is not acceptable.

Insurance Policy or Certificate

Under the terms of a CIF contract, the beneficiary is obliged to arrange insurance and furnish the buyer with the appropriate insurance policy or certificate. The extent of coverage and risks should be agreed upon between the buyer and seller in their initial negotiations and be set out in the sales contract.

Since the topic of marine insurance is extremely specialized and with conditions varying from country to country, the services of a competent marine insurance broker are useful and well-advised.

The foregoing are the most common documents usually called for in an export letter of credit. The following may also be asked for to satisfy government requirements or for the convenience of the buyer.

Certificate of Origin

As the name suggests, a certificate of origin certifies as to the country of origin of the goods described and should comply with any stipulations in the letter of credit as to originating country and by whom the certificate is to be issued. The certificate should be consistent with and identified with the other shipping documents by shipping marks and numbers, and must be signed.

Inspection Certificate

When a letter of credit calls for an inspection certificate it will usually specify by whom the certificate is to be issued; otherwise, the same general comments as in the case of the certificate of origin apply. As a preventative measure against fraud or as a means of protecting the buyer against the possibility of receiving substandard or unwanted goods, survey or inspection certificates issued by a reputable third party may be deemed prudent.

Such certificates indicate that the goods have been examined and found to be as ordered.

Packing List

A packing list is usually requested by the buyer to assist in identifying the contents of each package or container. It must show the shipping marks and number of each package. It is not usually required to be signed.

Shipment of Goods

Upon receiving the letter of credit, the beneficiary should examine it carefully and be satisfied that all the terms and conditions can be complied with. If this is not possible, the beneficiary should request the applicant to arrange an amendment to the letter of credit. Once completely satisfied, the beneficiary will then be in a position to assemble and ship the goods.

Presentation of Documents by Beneficiary

The beneficiary prepares an invoice in the number of copies required, with the description of goods shown exactly as stipulated in the letter of credit. The beneficiary obtains the bill of lading and/or other transport documents from the carrier and prepares and/or obtains all other documents required by the letter of credit. These are attached to the draft, drawn on the bank indicated and at the term stipulated in the letter of credit, and are presented to the advising/confirming/negotiating bank.

Sending Documents to the Issuing Bank

The advising/confirming/negotiating bank checks the documents presented by the seller against the letter of credit. If the documents meet the requirements of the letter of credit, that bank will send them to the issuing bank, claiming reimbursement and paying the seller.

Delivering Documents to the Applicant

The issuing bank will also check the documents for compliance and then deliver them to the applicant either against payment or as an undertaking to pay on maturity of the drawing under the letter of credit

PAYMENT PROCEDURE

Payment

On presentation of the documents called for under the letter of credit, provided they are in compliance with its terms, the advising/negotiating bank, in the case of an unconfirmed letter of credit, may pay/negotiate the draft. In the case of a confirmed letter of credit, the confirming bank is obliged to honour the drawing without recourse to the beneficiary.

Reimbursement

The advising/confirming/negotiating bank will claim reimbursement from the issuing bank.

Settlement On receipt of conforming documents, the issuing bank will also be responsible for checking documents and will charge the applicant’s account under the terms of the letter of credit application and agreement forms, effecting reimbursement to the negotiating bank.

Types of letter of credit

Irrevocable LC. This LC cannot be cancelled or modified without consent of the beneficiary (Seller). This LC reflects absolute liability of the Bank (issuer) to the other party.

Revocable LC. This LC type can be cancelled or modified by the Bank (issuer) at the customer's instructions without prior agreement of the beneficiary (Seller). The Bank will not have any liabilities to the beneficiary after revocation of the LC.

Stand-by LC. This LC is closer to the bank guarantee and gives more flexible collaboration opportunity to Seller and Buyer. The Bank will honour the LC when the Buyer fails to fulfill payment liabilities to Seller.

Confirmed LC. In addition to the Bank guarantee of the LC issuer, this LC type is confirmed by the Seller's bank or any other bank. Irrespective to the payment by the Bank issuing the LC (issuer), the Bank confirming the LC is liable for performance of obligations.

Unconfirmed LC. Only the Bank issuing the LC will be liable for payment of this LC.

Transferable LC. This LC enables the Seller to assign part of the letter of credit to other party(ies). This LC is especially beneficial in those cases when the Seller is not a sole manufacturer of the goods and purchases some parts from other parties, as it eliminates the necessity of opening several LC's for other parties.

Back-to-Back LC. This LC type considers issuing the second LC on the basis of the first letter of credit. LC is opened in favour of intermediary as per the Buyer's instructions and on the basis of this LC and instructions of the intermediary a new LC is opened in favor of Seller of the goods.

Payment at Sight LC. According to this LC, payment is made to the seller immediately (maximum within 7 days) after the required documents have been submitted.

Deferred Payment LC. According to this LC the payment to the seller is not made when the documents are submitted, but instead at a later period defined in the letter of credit. In most cases the payment in favor of Seller under this LC is made upon receipt of goods by the Buyer.

Red Clause LC. The seller can request an advance for an agreed amount of the LC before shipment of goods and submittal of required documents. This red clause is so termed because it is usually printed in red on the document to draw attention to "advance payment" term of the credit.

countertrade

countertrade, one of the oldest forms of trade, is a government mandate to pay for goods and services with something other than cash. It is a practice, which requires a seller as a condition of sale, to commit contractually to reciprocate and undertake certain business initiatives that compensate and benefit the buyer.

In short, a goods-for-goods deal is countertrade. Unlike monetary trade, suppliers are required to take customers products for their use or for resale.

In most cases, there are multiple deals that are separate yet related, and a contract links these separable transactions. Countertrade may involve several products, and such products may move at different points in time while involving several countries. Monetary payments may or may not be part of the deal.

There are three primary reasons for countertrade:

(1) countertrade provides a trade financing alternative to those countries that have international debt and liquidity problems,

(2) countertrade relationships may provide LDCs and MNCs with access to new markets, and

(3) countertrade fits well conceptually with the resurgence of bilateral trade

agreements between governments. The advantages of countertrade cluster around three subjects: market access, foreign exchange, and pricing.

Countertrade offers several advantages. It moves inventory for both a buyer and a seller. The seller gains other benefits, too. Other than the tax advantage, the seller is able to sell the product at full price and can convert the inventory to an account receivable. The cash-tight buyer that lacks hard currency is able to use any cash received for other operating purposes.

Types of Countertrade

There are several types of countertrade, including barter, counter purchase, compensation trade, switch trading, offsets and clearing agreements.

Barter-

Barter, possibly the simplest of the many types of counter trade, is a onetime direct and simultaneous exchange of products of equal value (i.e., one product for another).

By removing money as a medium of exchange barter makes it possible for cash-tight countries to buy and sell. Although price must be considered in any counter trade, price is only implicit at best in the case of barter.

For example, Chinese coal was exchanged for the construction of a seaport by the Dutch, and Polish coal was exchanged for concerts given by a Swedish band in Poland. In these cases. the agreement dealt with how many tons of coal was to be given by China and Poland rather than the actual monetary value of the construction project or concerts. It is estimated that about half of the U.S. corporations engage in some form of barter primarily within the local markets of the United States.

Counter purchase (Parallel Barter) –

Counter purchase occurs when there are two contracts or a set of parallel cash sales agreements, each paid in cash.

Unlike barter which is a single transaction with an exchange price only implied. A counter purchase involves two separate transactions-each with its own cash value. A supplier sells a facility or product at a set price and orders unrelated or non-resultant products to offset the cost to the initial buyer.

Thus, the buyer pays with hard currency, whereas the supplier agrees to buy certain products within a specified period.

Therefore money does not need to change hands. In effect, the practice allows the original buyer to earn back the currency. GE won a contract worth $300'million to build aircraft engines for Sweden's JAS fighters for cash only after agreeing to buy Swedish industrial products over a period of time in the same amount through a counter purchase deal.

Brazil exports vehicles, steel, and farm products to oil-producing countries from which it buys oil in return.

Compensation Trade (Buyback) –

A compensation trade requires a company to provide machinery, factories, or technology and to buy products made from this machinery over an agreed-on period.

Unlike counter purchase, which involves two unrelated products, the two contracts in a compensation trade are highly related. Under a separate agreement to the sale of plant or equipment, a supplier agrees to buy part of the plant's output for a number of years.

For example, a Japanese company sold sewing machines to China and received payment in the form of 300,000 pairs of pajamas. Russia welcomes buyback.

Switch Trading –

Switch trading involves a triangular rather than bilateral trade agreement. When goods, all or part, from the buying country are not easily usable or saleable; it may be necessary to bring in a third party to dispose of the merchandise. The third party pays hard currency for the unwanted merchandise at a considerable discount.

A hypothetical example could involve Italy having a credit of $4 million for Austria's hams, which Italy cannot use, A third-party company may decide to sell Italy some desired merchandise worth $3 million for a claim on the Austrian hams. The price differential or margin is accepted as being necessary to cover the costs of doing business this way. The company can 'then sell the acquired hams to Switzerland for Swiss francs, which are freely convertible to dollars.

Offset –

In an offset, a foreign supplier is required to manufacture/assemble the product locally and/or purchase local components as an exchange for the right to sell its products locally. In effect, the supplier has to manufacture at a location that may not be optimal from an economic standpoint. Offsets are often found in purchases of aircraft and military equipment.

One study found that more than half of the companies counter trading with the Middle East were in the defense industry and that the most common type of counter trade was offset. These companies felt that counter trade was a required element in order to enter these markets.

Clearing Agreement –

A clearing agreement is clearing account barter with no currency transaction required. With a line of credit being established in the central banks of the two countries, the trade in this case is continuous, and the exchange of products between two governments is designed to achieve an agreed-on value or volume of trade tabulated or calculated in nonconvertible “clearing account units.

For example, the former Soviet Union’s rationing of hard currency limited imports and payment of copiers.

Rank Xerox decided to circumvent the problem by making copiers in India for sale to the Soviets under the country’s “clearing” agreement with India.

The contract set forth goods, ratio of exchange, and time length for completion. Any imbalances after the end of the year were settled by credit into the next year, acceptance of unwanted goods, payment of penalty, or hard currency payment.

Although nonconvertible in theory, clearing units in practice can be sold at a discount to trading specialists who use them to buy saleable products.

Question Bank

Part A

1. Expand the word-SWIFT
2. What do you mean by cash in advance?
3. Who are the parties involved in letter of credit
4. List out the steps to involving letter of credit transaction
5. Give the primary reason for doing counter trading

PARTB

1,Summarize the required documents for collection of payments in letter of credit.

2.Elaborate the steps in letter of credit transactions with diagram.

3.Describe about cash in advance in payment in trade.

4.Explain the types of letters of credit.

5. Outline the operating procedure in SWIFIT

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SCHOOL OF MANAGEMENT STUDIES

UNIT-V-INTERNATIONAL BANKING-SBAA3015

INTERANATIONAL BANKING – RECENT TRENDS

Basel III Compliance by banking industry across the globe – shadow banking – performing assets – cross border terrorism

BASEL III is a set of international banking regulations developed by the Bank for International Settlements to promote stability in the international financial system. The Basel III regulations are designed to reduce damage to the economy by banks that take on excess risk.

- Basel III is a set of international banking regulations developed by the Bank for International Settlements to promote stability in the international financial system.
- The effect of Basel III on stock markets is uncertain although it is likely that increased banking regulation will be positive for bond market investors.
- The ultimate impact of Basel III will depend upon how it is implemented in the future, but the ideal situation is an overall safer international financial system.

Basel III

In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008.

A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding.

It was also felt that the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk.

The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity.

Capital: The capital adequacy ratio is to be maintained at 12.9%.

The minimum Tier 1 capital ratio and the minimum Tier 2 capital ratio have to be maintained at 10.5% and 2% of risk-weighted assets respectively.

In addition, banks have to maintain a capital conservation buffer of 2.5%. Counter-cyclical buffer is also to be maintained at 0-2.5%.

Leverage: The leverage rate has to be at least 3 %.

The leverage rate is the ratio of a bank's tier-1 capital to average total consolidated assets.Funding and Liquidity: Basel-III created two liquidity ratios: LCR(liquidity coverage ratio) and NSFR (Net Stable Funds Rate)

The liquidity coverage ratio (LCR) will require banks to hold a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short term stress scenario as specified by supervisors.This is to prevent situations like "Bank Run".

The goal is to ensure that banks have enough liquidity for a 30-days stress scenario if it were to happen.The Net Stable Funds Rate (NSFR) requires banks to maintain a stable funding profile in relation to their off-balance-sheet assets and activities. NSFR requires banks to fund their activities with stable sources of finance (reliable over the one-year horizon).The minimum NSFR requirement is 100%. Therefore, LCR measures short-term (30 days) resilience, and NSFR measures medium-term (1 year) resilience.

How Basel III Works

Basel III and Banks

Banks must hold more capital against their assets, thereby decreasing the size of their balance sheets and their ability to leverage themselves. While regulations were under discussion before the financial crisis, the events magnified the need for change.3

Basel III regulations contain several important changes for banks' capital structures. First, the minimum amount of equity, as a percentage of assets, increased from 2% to 4.5%.4 There is also an additional 2.5% buffer required, bringing the total equity requirement to 7%. This buffer can be used during times of financial stress, but banks doing so will face constraints on their ability to pay dividends and otherwise deploy capital. Banks had until 2019 to implement these changes, giving them plenty of time to prevent a sudden lending freeze as banks scramble to improve their balance sheets.

It is possible that banks will be less profitable in the future due in part to these regulations. The 7% equity requirement is a minimum, and it is likely that many banks will strive to maintain a somewhat higher figure to give themselves a cushion. If financial institutions are perceived as safer, the cost of capital for banks would actually decrease. More stable banks can issue debt at a lower cost. At the same time, the stock market might assign a higher P/E multiple to banks that have a less risky capital structure.

Basel III and Investors

As with any regulations, the ultimate impact of Basel III will depend upon how it is implemented in the future. Furthermore, the movements of international financial markets are dependent upon a wide variety of factors, with financial regulation being a large component. However, it is possible to predict some of the possible impacts of Basel III for investors.

It is likely that increased bank regulation is positive for bond market investors. That is because higher capital requirements will make bonds issued by banks safer investments. At the same time, greater financial system stability will provide a safer backdrop for bond investors even if the economy grows at a slightly slower pace as a result. The impact on currency markets is less clear, but increased international financial stability will allow participants in these markets to focus on other factors while focusing less on the relative stability of each country's banking system.

Basel III and Stock Markets

Finally, the effect of Basel III on stock markets is uncertain. If investors value enhanced financial stability above slightly higher growth fueled by credit, stock prices are likely to benefit from Basel III (all else being equal). Furthermore, greater macroeconomic stability will allow investors to focus more on individual company or industry research while worrying less about the economic backdrop or the possibility of broad-based financial collapse.

Basel III: Financial Outcomes

Basel III was not expected to be a panacea. However, in combination with other measures, the regulations have produced a more stable financial system. In turn, greater financial stability has spurred steady economic growth.

While banking regulations may help reduce the possibility of future financial crises, the may also restrain future economic growth. This is because bank lending and the provision of credit are among the primary drivers of economic activity in the modern economy. Therefore, any regulations designed to restrain the provision of credit are likely to hinder economic growth, at least to some degree.

Nevertheless, many regulators, financial market participants, and ordinary individuals are willing to accept slightly slower economic growth if it means greater stability and a decreased likelihood of a repeat of the events of 2008 and 2009.

Why need BASEL norms?

It is not for nothing that banks are considered important for an economy, especially if it is a developing country like India. Go back to 2008, the crisis in the US banking sector wreaked havoc throughout the world. The US is still trying to limp back to economic growth. A banking collapse is one of the worst crises a country can face. The BASEL norms have three aims: Make the banking sector strong enough to withstand economic and financial stress; reduce risk in the system, and improve transparency in banks.

BASEL III rules

After the 2008 financial crisis, there was a need to update the BASEL norms to reduce the risk in the banking system further. Until BASEL III, the norms had only considered some of the risks related to credit, the market, and operations. To meet these risks, banks were asked to maintain a certain minimum level of capital and not lend all the money they receive from deposits. This acts as a buffer during hard times.

The BASEL III norms also consider liquidity risks.

Leverage risk

Banks can also pile on debt like other companies. This increases the risk in the system. The Basel III norms limit the amount of debt a bank can owe even further.

This is called the Leverage Ratio. This is especially applicable for banks that trade in high-risk assets like derivatives.

Liquidity

Capital is money that is invested in assets like equity or government bonds. This money, therefore, is not readily available for day-to-day activities. Moreover, during a crisis, the value of investments can fall suddenly like the 2008 financial crisis. This means, the capital a bank holds can fall during times of need. This is why the BASEL III norms ask banks to hold liquid money. This is measured by the Liquidity Coverage Ratio (LCR), a ratio of the liquid money to total assets. This should equal the banks' net outflows during a 30-day stress period.

Implementation in India

The Reserve Bank of India (RBI) introduced the norms in India in 2003. It now aims to get all commercial banks BASEL III-compliant by March 2019. So far, India's banks are compliant with the capital needs. On average, India's banks have around 8% capital adequacy. This is lower than the capital needs of 10.5% (after taking into account the additional 2.5% buffer). In fact, the BASEL committee credited the RBI for its efforts.

Challenges for Indian banks

Complying with BASEL III norms is not an easy task for India's banks, which have to increase capital, liquidity and also reduce leverage. This could affect profit margins for Indian banks. Plus, when banks keep aside more money as capital or liquidity, it reduces their capacity to lend money. Loans are the biggest source of profits from banks. Plus, India banks have to meet both LCR as well as the RBI's Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) norms. This means more money would have to be set aside, further stressing balance sheets.

Shadow banking

shadow banking system is the group of financial intermediaries facilitating the creation of credit across the global financial system but whose members are not subject to regulatory oversight. The shadow banking system also refers to unregulated activities by regulated institutions. Examples of intermediaries not subject to regulation include hedge funds, unlisted derivatives, and other unlisted instruments, while examples of unregulated activities by regulated institutions include credit default swaps.

Key points

The shadow banking system consists of lenders, brokers, and other credit intermediaries who fall outside the realm of traditional regulated banking.

It is generally unregulated and not subject to the same kinds of risk, liquidity, and capital restrictions as traditional banks are.

The shadow banking system played a major role in the expansion of housing credit in the run up to the 2008 financial crisis, but has grown in size and largely escaped government oversight even since then.

Understanding Shadow Banking Systems

The shadow banking system has escaped regulation primarily because unlike traditional banks and credit unions, these institutions do not accept traditional deposits. Shadow banking institutions arose as innovators in financial markets who were able to finance lending for real estate and other purposes but who did not face the normal regulatory oversight and rules regarding capital reserves and liquidity that are required of traditional lenders in order to help prevent bank failures, runs on banks, and financial crises.

As a result, many of the institutions and instruments have been able to pursue higher market, credit, and liquidity risks in their lending and do not have capital requirements commensurate with those risks. Many shadow banking institutions were heavily involved in lending related to the boom in subprime mortgage lending and loan securitization in the early 2000's. Subsequent to the subprime meltdown in 2008, the activities of the shadow banking system came under increasing scrutiny due to their role in the over-extension of credit and systemic risk in the financial system and the resulting financial crisis.

The Breadth of the Shadow Banking System

Shadow banking is a blanket term to describe financial activities that take place among non-bank financial institutions outside the scope of federal regulators. These include investment banks, mortgage lenders, and money market funds, insurance companies, hedge funds, private equity funds and payday lenders, all of which are a significant and growing source of credit in the economy.

Despite the higher level of scrutiny of shadow banking institutions in the wake of the financial crisis, the sector has grown significantly. In May 2017, the Switzerland- based Financial Stability Board released a report detailing the extent of global non- bank financing. Among the findings, the board found that non-bank financial assets had risen to $92 trillion in 2015 from $89 trillion in 2014. A more narrow measure in the report, used to indicate shadow banking activity that may give rise to financial stability risks, grew to $34 trillion in 2015, up 3.2% from the prior year and excluding data from China.

Most of the activity centers around the creation of collateralized loans and repurchase agreements used for short-term lending between non-bank institutions and broker-dealers. Non-bank lenders, such as Quicken Loans, account for an increasing share of mortgages in the United States. One of the fastest-growing segments of the shadow banking industry is peer-to-peer (P2P) lending, with popular lenders such as LendingClub.com and Prosper.com. P2P lenders initiated more than $1.7 billion in loans in 2015.

Who Is Watching the Shadow Banks?

The shadow banking industry plays a critical role in meeting rising credit demand in the United States. Although it's been argued that shadow banking's disintermediation can increase economic efficiency, its operation outside of traditional banking regulations raises concerns over the systemic risk it may pose to the financial system. The reforms enacted through the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act focused primarily on the banking industry, leaving the shadow banking sector largely intact. While the Act imposed greater liability on financial companies selling exotic financial products, most of the non-banking activities are still unregulated.

The Federal Reserve Board has proposed that non-banks, such as broker- dealers, operate under similar margin requirements as banks. Meanwhile, outside of the United States, China began issuing directives in 2017 directly targeting risky financial practices such as excessive borrowing and speculation in equities.

Examples of entities that engage in shadow banking are**: Bond funds**

Money market funds

Finance companies Special

purpose entities.

How does shadow banking work?

In traditional lending, the volume of lending by a bank is linked to the volume of deposits the bank receives and what it can borrow on the markets. Shadow banking works on the same principle. So, for example, an investment fund takes in money from investors, issuing shares in the fund in return. In order to earn a return on the investment for its investors the fund uses this money to buy securities (for example, a bond issued by a country or company).

Just as the bank acts as the "middleman" between savers and borrowers to earn a specified interest rate, the investment fund acts as the channel linking investors and countries/companies to earn an investment return. By raising funds from investors and then lending this money to countries/companies, shadow banking entities act like banks.

What are the advantages/disadvantages of shadow banking?

An advantage to shadow banking is that it reduces the dependency on traditional banks as a source of credit. This is a positive benefit for the economy because it acts as an additional source of lending, and provides diversification in the financial system.

On the other hand, there is the risk that shadow banking can contribute to too much lending in the economy. This has the potential to lead to a harmful downturn.

Advantages

Enhanced support to the real economy –

Shadow banking creates additional sources of funding for households and non-financial companies, enhancing the ability of the financial system to intermediate savings and provide support to real investments. For example, securitizations allow banks to embrace an "originate to distribute "model, whereby loans are issued and sold to third-party investors, leaving room for further credit extensions.

By providing additional funding channels, SB enables non-financial companies to benefit from multiple sources of financial support and avoid overreliance on a single entity. It should be noted, however, that such an increase in the financial system's intermediation potential may lead toa disconnect between funding opportunities and real growth, which in turn may trigger looser lending standards and asset price bubbles.

When loan origination becomes profitable per se, as risks are passed on to third-party investors, it may swell beyond the levels that are justified by a sound economic expansion, as was the case with

the race towards sub-prime borrowers in the run-up to the GFC.

Additional asset types and risk/return combinations for investors - Shadow banking may provide investors with alternatives to traditional investments (stock, fixed income securities, bank deposits) that provide new risk/return combinations, for instance, through pooling and trenching.

Another example are money market funds investing in commercial paper, which can be seen as a new investment opportunity that could produce(marginally) higher returns while retaining a high degree of liquidity. Securitizations allowed market participants to invest in asset classes, like revolving consumer loans, that were previously available only to financial

Institutions, providing the potential for better portfolio diversification. While these developments may have led to excesses due to poorly understood risks, it is undoubtedly true that they showed the SB system's high potential for enhancing the spectrum of investment opportunities available to entities in financial surplus.

Efficient channeling of resources - Specialization and expertise may help facilitate efficient credit intermediation. Economies of scale may lead to lower costs in gathering information on the ultimate borrowers 'credit risk, and in disclosing it to final investors. SB, just like traditional banking, may facilitate the transformation of illiquid loans into short-term liabilities by deploying superior skills in the screening and monitoring of borrowers. In fact, securitisation creates marketable securities using bank-originated loans, where debtors were selected and assessed by a traditional lender using soft information to resolve informational asymmetries; in turn, servicers use bank-like techniques to monitor payments and pursue the early recovery of slow loans.

What oversight is there of shadow banking?

There is significant regulation of most of the shadow banking system in the EU. Within Ireland, resident money market funds, investment funds and finance companies are regulated.

Irish-resident special purpose entities are not regulated by the Central Bank as a sector, as is the case in other jurisdictions. However, the Central Bank imposes more extensive reporting requirements on special purpose entities than other jurisdictions which facilitates the monitoring of shadow banking activity.

Risks of shadow banks

Notwithstanding the complementary role played by shadow banks to the banking system, their activities, on the flip side, create risks which can assume a systemic dimension, due to their complexity, cross jurisdictional nature, as well as their interconnectedness with the banking system.

The risks emanating from shadow banking could be primarily of four types viz., (i) liquidity risk, (ii) leverage risk, (iii) regulatory arbitrage and (iv) contagion risk.

Liquidity risk –

This is one of the most common risks faced by shadow banks, as these entities undertake maturity transformation i.e., funding long term assets with short term liabilities. The risk of ALM mismatch leading to liquidity problems is quite high. In India, we had a situation during the height of
global crisis in 2008 when some NBFCs ran into severe liquidity problems as they were using short term liabilities such as CPs (commercial paper) and NCDs (Non- Convertible Debentures) to fund their long term lending or investment. I will be discussing this issue in detail a little later.

Leverage risk –

As shadow banks do not usually have prudential limits on borrowings, they can become highly leveraged. High leverage exacerbates the stress in the financial system and the real economy during the downturn adversely affecting financial stability.

Regulatory arbitrage – Credit intermediation is, traditionally, a banking activity. Regulations applied to banks in this regard can be circumvented by transferring components of the credit intermediation function to shadow banks which are subject to less stringent regulation. Transfer of risks outside the purview of banking supervision played an important role in the build-up to the global financial crisis.

Contagion risk - Shadow banking entities have close interlinkages with the banking sector both from the asset as well as the liabilities side, and also with other segments of the financial system, which can lead to contagion risk in times of loss of confidence and uncertainty.

Global approach to regulation of shadow banking

The developments during the global crisis reflected the gravitas of the risks have highlighted above. The light touch regulation enabled the shadow banking system to have high leverage. The liquidity risks faced by the shadow banking system quickly got transferred to the banking system due to its interconnectedness and interlinkages with the regular banking system, largely through committed liquidity facilities and reputational concerns. The contagion that followed, prompted the policy makers to review the regulation of the shadow banking sector to ensure and preserve financial stability.

As such, at the November 2010 Seoul Summit, the G20 Leaders highlighted the fact that, after formulation of the new capital standards for banks i.e., Basel III, "strengthening regulation and supervision of shadow banking" was one of the remaining issues of financial sector regulation that warranted attention.

• clarify what is meant by the 'shadow banking system';

• set out potential approaches for monitoring the shadow banking system;

• explore possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.

FSB can be divided into 5 broad categories

• management of client cash pools with features that make them susceptible to runs (e.g. credit investment funds with stable NAV features, leveraged credit hedge funds);

• loan provision that is dependent on short-term funding (e.g. finance companies with short-term funding structure or that accept deposits);

• intermediation of market activities that is dependent on short-term funding or on secured funding of client assets (e.g. securities brokers whose funding is heavily dependent on wholesale funding);

• facilitation of credit creation (e.g. credit insurers, financial guarantee insurers); and

• securitisation and funding of financial entities (e.g. securitisation vehicles). **The FSB advised that monitoring and responses be guided by a two-stage approach.**

• Firstly, authorities should cast the net wide, looking at all non-bank credit intermediation to ensure that data gathering and surveillance cover all the activities within which shadow banking-related risks might arise.

• Authorities should then narrow the focus, concentrating on the subset of non-bank credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create important risks. the FSB, working with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), has, therefore, examined and developed recommendations in five areas where financial stability risks from shadow banking have arisen. Work streams were created for analyzing the issues

in greater detail and developing effective policy recommendations in these areas, viz,:

• to mitigate the spill-over effect between the regular banking system and the shadow banking system –(BCBS);

• to reduce the susceptibility of money market funds (MMFs) to "runs" –(IOSCO);

• to assess and mitigate systemic risks posed by other shadow banking entities – (FSB sub group) ;

• to assess and align the incentives associated with securitization – (IOSCO and BCBS); and

• To dampen risks and pro-cyclical incentives associated with secured financing contracts such as repos, and securities lending that may exacerbate funding strains in times of "runs" – (FSB sub group).The policy recommendations have been guided by the following five general

Principles for regulatory measures:

• Focus: Regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates;

• Proportionality: Regulatory measures should be proportionate to the risks shadow banking poses to the financial system;

• Forward-looking and adaptable: Regulatory measures should be forward looking land adaptable to emerging risks;

• Effectiveness: Regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross-border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions

• Assessment and review: Regulators should regularly assess the effectiveness of their regulatory measures after implementation and make adjustments to improve them as necessary in the light of experience.

Size of the Shadow Banking Sector

The FSB committed to conducting

Annual monitoring exercises to assess global trends and risks in the shadow banking system through its Standing Committee on Assessment of Vulnerabilities (SCAV) and its technical working group, the Analytical Group on Vulnerabilities (AGV), using quantitative and qualitative information.

The FSB's second annual monitoring exercise,

which was recently concluded, covered 25 jurisdictions and the euro area as a whole, thereby bringing the coverage of the monitoring exercise to 86 per cent of global GDP and 90 per cent of global financial system assets.

The primary focus of the exercise was on a "macro-mapping" based on national Flow of Funds and Sector Balance Sheet data, that looks at all non-bank financial intermediation to ensure that data gathering and surveillance cover the areas where shadow banking-related risks to the financial system might potentially arise.

The main findings from the 2012 exercise are as follows:

According to the "macro-mapping" measure, the global shadow banking system, as conservatively proxies by "Other Financial Intermediaries" grew rapidly before the crisis, rising from USD 26 trillion in 2002 to USD 62 trillion in 2007. The size of the total system declined slightly in 2008 but increased subsequently to reach USD 67 trillion in 2011 (equivalent to 111 per cent of the aggregated GDP of all jurisdictions). The global estimate for the size of the shadow banking system has increased by some USD 5 to 6 trillion since last year.

- The shadow banking system's share of total financial intermediation (which includes banks, insurance and pension funds, public financial institutions and central banks) has decreased since the onset of the crisis and has remained at around 25 per cent in 2009-2011, after having peaked at 27 per cent in 2007. In broad terms, the aggregate size of the shadow banking system is around half the size of banking system assets.
- There is also a considerable diversity in the relative size, composition and growth of the non bank financial intermediaries across jurisdictions. For example, the size of the shadow banking system in US and a number of other jurisdictions continues to be large relative to the regular banking system. The US has the largest shadow banking system, with assets of USD 23 trillion in 2011, followed by the euro area (USD 22 trillion) and the UK (USD 9 trillion).
- There is also considerable divergence among jurisdictions in terms of: (i) the share of non-bank financial intermediaries (NBFIs) in the overall financial system; (ii) relative size of the shadow banking system to GDP; (iii) the activities undertaken by the NBFIs; and (iv) recent growth trends.
- Even during the period immediately following the global financial crisis (2008- 11), the shadow banking system continued to grow, although at a slower pace, in seventeen jurisdictions (half of them being emerging market and developing economies undergoing financial deepening) and contracted in the remaining eight jurisdictions.
- Among the jurisdictions where data is available, interconnectedness risk tends to be higher for shadow banking entities than for banks. Shadow banking entities seem to be more dependent on bank funding and are more heavily invested in bank assets, than vice versa.

Shadow Banking in India

In India, the shadow banks have been brought under progressively tighter regulations and many of the activities which contributed to the global crisis are either not allowed, or, if allowed, are allowed in a regulated environment with appropriate limits.

On the contrary, in India, Money Market Funds, investment funds and ETFs form part of Mutual Funds and are regulated by the Securities and Exchange Board of India (SEBI) under its Mutual Fund Regulations.

Hedge Funds are not significant players in India. Moreover, comprehensive guidelines (Alternative Investment Fund Guidelines) have been put in place by SEBI to regulate all funds established in India, which are private pooled investment vehicles raising funds from Indian or foreign investors.

NBFC sector in India- Evolution of regulation

on-Banking Financial Companies (NBFCs) in India are defined as companies carrying out a range of financial activities such as making loans and advances; investing in shares /bonds/debentures/and other securities; asset financing including leasing, and hire-purchase finance.

The recent additions to this sector have been (i) Infrastructure Finance Companies (IFC), (ii) Infrastructure Debt Funds (IDF), (iii) Micro Finance Institutions (NBFC- MFI) and (iv) Factors. In India, NBFCs quintessentially epitomize the shadow banking system as they perform bank like credit intermediation outside the purview of banking regulation. Apart from this, where the entire OFI assets account for approximately 24 percent of bank assets as on March 31, 2012, assets of the NBFC sector alone account for 12 percent, denoting the significance of NBFCs in the Indian shadow banking system.

Transferring of risk off balance sheet by banks by using SIVs/ conduits is not a model adopted in India. Apart from this, complex and synthetic derivative products which were at the core of the global crisis are also not presently permitted in India **WHY CARE ABOUT SHADOW BANKING?**

The rise of shadow banking has largely been the outcome of banks exiting the regulated sector in response to changes in the financial system, innovation and tighter regulatory constraints. Still, it involves several other potential advantages, including: • enhanced support to the real economy, as additional sources of funding are provided to households and non-financial companies;

- complexity allows shadow banks to exploit informational asymmetries in a way that can generate negative externalities. E.g. securitisation arrangers may retain high-quality loans while securitising risky assets;
- shadow banks may pile up exposures to extreme risks, sometimes encouraged by over-optimistic investors who tend to neglect worst-case scenarios;

the informal support provided to shadow banks by traditional institutions (due to reputational

- concerns or formal commitments to provide additional liquidity in case of need) is often

mispriced. This distorts competition and makes the financial system more vulnerable to shock waves that spread across different institutional types

- these risks of contagion are reinforced by the high reliance by shadow banks on volatile

sources of funding and the deep interconnections they have with the regulated banking system;

shadow banks are highly leveraged, and their use of debt increases in market booms, as they increase the value of the financial collateral that can be used for secured borrowing.

- This growing credit and leverage often leads to asset bubbles and ultimately to financial crises.

Five key recommendations on shadow banking regulations

On the basis of economic theory and empirical data surveyed in this study, five “horizontal “recommendations emerge - spanning across multiple issues - on how regulation on shadow banking should be built.

Make it safe, then make it work - The debate on macroprudential regulation has often highlighted a dichotomy between vitality and stability, speed and safety. This is a misleading perspective: vitality and stability are actually two faces of the same coin.

For shadow banking to deliver economic development via new sources of credit and better risk-sharing practices, policy makers must first ensure that it adopts business models that are not plagued by inconsistencies, conflicts of interest and moral hazard, and therefore remain viable over the long term.

Reduce the risk of a sudden deleveraging:

Macroprudential regulations address situations where institutions and market participants behave in a way that is rational for individual investors but triggers negative externalities associated with system-wide reactions leading to sharp deleveraging and market disruption. The risk of sudden drops in leverage and liquidity squeezes should be addressed by imposing minimum buffers in times of financial expansion. Rule makers should also avoid mechanisms that create cliff effects, as is the case when the eligibility criteria for collateral are associated with discrete ratings or when other regulatory mechanisms are associated with binary thresholds.

Draw clear lines as shadow banking thrives in ambiguity:

Shadow banking is built on the expectation that the liabilities issued by a non- bank entity - or chain of entities - remain liquid under most market scenarios. Ambiguity is key to this configuration: external support by the official banking system and the central bank is not paid for, but investors assume that it will be there when needed. Accordingly, to discipline SB, it is essential that regulation be unequivocal and that grey areas are minimised.

Regulate banks to address shadow banking:

In financial services there is a limit to the desirability of “letting one thousand flowers bloom", that is, of letting market forces and novel technologies find an equilibrium through competition between new players and the incumbents. Shadow banking is not,in itself, destabilizing, nor is it an intrinsically more efficient form of financial intermediation: it should co-exist with banking within a diversified ecosystem, not supersede it because of lower regulatory costs.

Consider bold decisions to bring down complexity:

Regulation tends to provide incentives for financial institutions to evolve towards desirable models without imposing straight restrictions. This has led to complex rules dominated by a "whack-a-mole" syndrome, were new, detailed provisions are introduced each time new market practices needed to be addressed. Simple "don'ts" that apply across all forms of financial intermediation should not be left out of the policy debate.

Question Bank

Part A

1. Write about the banking norms BASEL III.

2. What are called BASEL III rule.

3. State the meaning of shadow banking.

4. How does shadow banking work.

5. Mention any two advantages of shadow banking

PARTB

1. Explain the types risk emanating from shadow banking.

2. Summarize the points to global approach to regulate shadow bank. 3. Elaborate the principles and approach to guide shadow banking.

4. Explain the key recommendations on shadow banking.

5. Analyze about implementation of BASEL in banks in India.

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