Eurocurrency Market
A Eurocurrency is any freely convertible currency deposited in a bank outside its country of origin. These deposits can be placed in a foreign bank or in a foreign branch of a domestic US bank. Any convertible currency can exist in “Euro” e.g.

**Characteristics of the Eurocurrency Market:** The various characteristics of the Eurocurrency market are:

1. It is a large international money market relatively free from government regulation and interference, i.e., the market is essentially unregulated.
2. The deposits in the Eurocurrency market are primarily for short-term. This sometimes leads to problems about managing risk, since most Eurocurrency loans are for longer periods of times.
3. Transaction, in this market are generally very large with government, public sector organisations tending to borrow most of the funds. This makes the market a wholesale rather than a retail market.
4. The Eurocurrency market exists for savings and time deposits rather than demand deposits.
Significance

The Eurocurrency market plays a key role in the capital investment decisions of many firms since it is a funding source for corporate borrowing. The Eurocurrency market is totally a creation of the regulations placed by national governments on bankings.

Eurocurrency markets serve two valuable purposes: (1) Eurocurrency market is a major source of short-term bank loans to help meet the corporate’s working capital requirements including the financing of imports and exports; (2) Eurocurrency deposits are an efficient and convenient money market device for holding excess corporate liquidity.
EuroCurrency Interest Rates

The base interest rate paid on deposits among banks in the Eurocurrency market is called LIBOR, the London Interbank Offered Rate. (Outside London, which is the centre of the entire Euromarket, the base rate on deposits is generally slightly higher.) LIBOR is determined by the supply and demand for funds in the Euromarket for each currency, because participating banks could default (and, infrequently, do default) on their obligations and the rate paid for Eurodollar deposits in addition to the spread over LIBOR in the Euromarket. This also helps reduce the cost of using the Euromarket for borrowers. The total cost of borrowing in the Euromarket for a prime US corporation historically was marginally below the domestic US prime rate. Interest rates on other Eurocurrencies generally follow the same pattern, though when capital controls exist in a particular country (e.g., France), borrowing rates may be higher in the Euromarket (which is not restricted) than in the domestic market.
The most important characteristic of the Eurocurrency market is that loans are made on a floating rate basis. Interest rates on loans to governments and their agencies, corporations, and non-prime banks are set at a fixed margin above LIBOR for the given period and the currency chosen. At the end of each period, the interest for the next period is calculated at the same fixed margin over the new LIBOR.

**Eurocurrency CDs are issued in two forms:** These are Tap CDs and Tranche CDs. The former are issued in relatively large denominations (commonly from $250,000 to $5 million) and for maturities of less than one year, whenever banks need to “tap” the market for funds. Tranche CDs are issued in large aggregate amounts (typically $10 million to $50 million),
Part V: Managing Foreign Operations

C21 Eurocurrency Market

Growth of the Eurodollar Market

1. Large deficits in the US balance of payments, particularly during the 1960s, which resulted in the accumulation of substantial dollars held by foreign financial institutions and individuals.

2. The restrictive environment which prevailed in the United States during the 1963–1974 period to stem capital outflows. These restrictions, which took the form of both voluntary and mandatory controls, encouraged US and foreign multinational companies to borrow dollars abroad.

3. The massive balance of payments surpluses realised by OPEC countries due to sharp increases in oil prices in 1973-1974 and again in 1978. A good proportion of these “petrodollars” was deposited in financial institutions outside the United States.

4. The efficiency and lower cost base of the Eurodollar market. Being a wholesale funds market, operating free of restrictions at a substantially lower cost than its counterpart in the United States,
International Bonds Market

**Foreign Bonds:** These are the bonds floated in a particular domestic capital market (and in the domestic currency of that market) by non-resident entities. The bonds are generally named on the basis of the capital markets in which they are floated.

The procedure for floating foreign bonds is similar to that of Euro bonds. However, the complexities of individual market mechanisms and their respective characteristics need to be understood.

**The Euro Bond Market**

Euro bonds are unsecured debt securities issued and sold in markets outside the home country of the issuer (borrower) and denominated in a currency different from that of the home country of the issuer. Euro bonds are underwritten and sold in more than one market simultaneously usually through international syndicates and are purchased by an international investing public that extends far beyond the confines of the countries of issue.
Special Features and Innovations in the International Bond Market

The Euro bond market has flourished due to several unique features that set it apart from the domestic and foreign bond market. These features are:

1. The Eurobond market is an off shore operation not subject to national controls, which most countries have over domestic issues of securities denominated in local currency.

2. Euro bond issues are not subject to the costly and time-consuming registration procedure. Disclosure requirements are also less stringent than those which apply to domestic issues.

3. Euro bonds are issued in bearer form, which facilitates their negotiation in the secondary market. This feature also means that the country of the ultimate owner of the bond is not a matter of public record.

4. Euro bonds offer investors, exemption from tax-withholding provisions applicable to domestic and foreign bonds.
External Commercial Borrowings

1. The scarcity of domestic capital resources hinders a high rate of capital formation.

2. The rate of savings is low because the income levels are at a low level and whatever small savings are possible, they are very difficult to mobilise.

3. Scarcity of foreign exchange also plays an important role as most of the developing economies are characterized by an adverse balance of payment.

4. Generally the country’s exports are not sufficient to cover the large imports of machinery, components, spare parts, materials and related services.

5. Funding of infrastructure sector by the government alone cannot go on forever on borrowed money.
Risks Involved in ECBs

Raising an ECB abroad definitely offers the firm a cost advantage as compared to raising the money in India. It is for this reason that most of the Indian financial institutions find their prime blue-chip clients deserting them and moving on to tapping the ECB market.

Raising money abroad exposes the firm to a currency risk. Now the firm has to spend more rupees in buying the required amount of dollars to meet the interest/principal liability.

Simultaneously, the firm is also exposed to an interest rate risk. In India, most of the ECBs are pegged to the 6-month LIBOR (denoted as 6-month LIBOR plus a spread) and any variation (particularly an increase) in the LIBOR at the reset dates (dates on which the prevailing LIBOR is used to compute the liability) enhances the firm’s cost.
Managing Exposure Arising From ECBs

A company raising an ECB exposes itself to primarily two kinds of risks: exchange rate risk and interest rate risk. To safeguard its position, the company has to incur a cost so that it is protected from the effects of any adverse movement of the exchange rate or the interest rate. This arrangement may provide the necessary hedge to the firm against both the interest rate and the exchange rate movements but it necessitates two different contracts, more documentation and a greater default risk, since dealing with two parties and also default by either can incur huge damages to the company’s interests. Entering into a single such arrangement provides the company a perfect hedge against movements of both the exchange rate and the interest rates but such a contract may prove to be costlier than entering into two single contracts.
Euro Debt

External Commercial Borrowings (ECBs) are defined to include:

1. Commercial bank loans.
2. Buyer’s credit.
3. Supplier’s credit.
4. Credit from official export credit agencies.
5. Securitised instruments such as fixed rate notes and floating rate bonds.
6. Commercial borrowings from the private sector window of multilateral financial institutions such as IFC, ADB, AFIC, CDC, etc.
7. Various forms of Euro bonds and Syndicated loans.
Foreign Currency Convertible Bonds (FCCBs)

Convertibles are more beneficial for the issuer than a GDR because of the following characteristics:

i. They have a lower coupon than straight debt.

ii. They provide a broader investor base, i.e., both, those who invest in debt as well as in equity.

iii. They allow a higher premium to the issuer than a GDR.

iv. Dilution of equity is not immediate, but deferred.

Pure Euro Debt

i. Deep Discount Convertibles

ii. Bunny Bonds

iii. Bulldog Bonds

iv. Yankee Bonds

v. Samurai Bonds

vi. Dragon Bonds
Characteristics of Euro Debt

The pricing of ECB loans is like the U-curve. For small loans (up to $3 million) the interest rates are high. This is because of the high proportion of fixed costs towards clearing the loan proposal. As the size of the loan increases to $15 to $18 million, the interest rates decline. In case of big loans, they rise again due to the higher risk perception of the lender and larger syndication cost. So, in case of small loans, the interest is fixed at about 50–100 basis points above LIBOR, while for medium-size loans, they fall to 35–45 basis points above LIBOR, and rise again for large loans to more than 100 basis points above LIBOR.
Advantages of Euro Issues

- Advantages in Holding Global Depository Receipts
- Advantages to the Issuer
- Advantages of Euro Debt
- Advantages of Euro Convertibles
- Common Benefits to all Issuers of Euro Paper
Performance of Indian Euro Issues

From May 1992 onwards, Indian companies have been issuing Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds/Euro Currency Bonds (FCCBs/ECBs) on the Euro market on a large scale. Up to March 1996, Indian companies had raised US $5,180 million through 64 issues of GDRs and ECBs.

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