

# **International Finance**

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# **Global Financial Environment**

## **International Finance**

International Finance/ International Monetary Economics/International Macroeconomics

Is the study of monetary and macroeconomic inter-relations between countries.

It helps you to understand and appreciate the financial and non-financial movements of goods and services in the market

It helps you to understand the importance of various institutions with respect to transactions

It helps to know acknowledge the changing trends with respect to money banking and finance

### **Definition**

The economic and monetary system that transcends national borders. The field of international finance concerns itself with studying global capital markets and might involve monitoring movements in foreign exchange rates, global investment flows and cross border trade practices.

International finance is the study of monetary interactions between two or more countries, focusing on areas such as foreign direct investment and currency exchange rates.

### **Reasons why we study International Finance**

- Liberalisation of Trade and Investment

(higher integration leading to higher transmission effect)

- Shrinkage of economic spaces

(Globalisation, Deregulation)

### **Scope of International Finance**

#### **International Financial Economics:**

It is concerned with causes and effects of financial flows among nations and applications of macroeconomic policy to the global economy.

#### **International Financial Management:**

It is concerned with working of economic units (MNCs) in International Business

#### **International Financial Markets:**

It is concerned with international financial markets/instruments/forex investments etc

### **Importance of International Finance**

- Emergence of New Economic Order- (PIGS/PIIGS/PIIGGS, China, BRICS, US & UK, Oil)
- Globalisation and MNCs
- Portfolio flows
- Trade and Foreign Direct Investment
- Globalization and Regulation - (Hot Money, Financial Regulators, Risk Management, Currency Wars)

### **Importance of International Finance for Business Firms**

- Investment Decisions (NPV, IPR)
- Financing Decisions
- Working Capital Management Decisions (Cash Management)
- Dividend Decisions
- Accounting Decisions (Harmonization)

### **Importance of International Finance**

#### **for Investors**

1. Portfolio Management
2. Exchange Rate
3. Speculators

#### **for Central Banks**

1. International Finance and Banks

#### **for Regulators**

1. An important tool for analysis
2. Determination of relative values of currencies
3. International investment decisions
4. Use of IFRS (International Financial Reporting Standards)
5. Saving mechanism
6. Helps in understanding the functioning of various entities in market
7. Maintains peace among the nations
8. Managing International Financial Disagreements

### **Challenges in International Finance**

- International Cash Management
- Tariff and Non-Tariff Trade Barriers
- Foreign Exchange Risk
- Cold War
- International Business Cycle
- Dumping
- International Terrorism
- Economics and Currency Crisis

- Political Risks
- International Taxation

## **Cost of Capital**

Cost of capital is the minimum rate of return that a business must earn before generating value. This consists of both the cost of debt and the cost of equity used for financing a business. A company's cost of capital depends, to a large extent, on the type of financing the company chooses to rely on – its capital structure. The company may rely either solely on equity or solely on debt, or use a combination of the two.

Cost of capital is the return (%) expected by investors who provide capital for a business. Once this cost is paid for, the remaining money is profit. Since it generates a specific number that determines profitability, it's used to determine the hurdle rate.

For investors, cost of capital represents the degree of perceived risk. An investor always wants to put money into a company that will exceed the cost of capital and thus generate returns that are proportionate with the risk.

## **Definitions**

Ezra Solomon defines “Cost of capital is the minimum required rate of earnings or cutoff rate of capital expenditure”.

According to Mittal and Agarwal “the cost of capital is the minimum rate of return which a company is expected to earn from a proposed project so as to make no reduction in the earning per share to equity shareholders and its market price”.

According to Khan and Jain, cost of capital means “the minimum rate of return that a firm must earn on its investment for the market value of the firm to remain unchanged”.

## **Why Is Cost of Capital Important to Companies?**

Companies use the cost of capital to analyze projects. This number determines if the company should invest more assets and when they might see a return on this investment.

Cost of capital is also termed as cut-off rate, the minimum rate of return, or hurdle rate

## **Why Is Cost of Capital Important to Investors?**

For investors, cost of capital is the opportunity cost of making a specific investment (as well as the rate of return that can be earned by putting money into an investment).

Investors will use the cost of capital to compare different investments with equal risk. Therefore, the cost of capital is the rate of return required to persuade the investor to make an investment.

## **How Cost of Capital Affects Taxes?**

When a company decides how they will finance a project (with either debt or equity), taking on debt can lower the company's taxable income and, therefore, tax liability. In this way, debt can be a beneficial form of financing for a company. Weighted Average Cost of Capital (WACC) takes this into account by including the tax bracket for a company.

A firm's total cost of capital is a weighted average of the cost of equity and the cost of debt, known as WACC.

### **A Common Mistake When Reviewing Cost of Capital**

Analysts commonly make the mistake of equating cost of capital with the interest rate on that money.

Remember: Cost of capital is not dependent upon how and where the capital was raised. Put another way, cost of capital is dependent on the use of funds, not the source of funds.

### **Significance/Importance of Cost of Capital**

Determination of Capital Structure

Dividend Decisions

Capital Budgeting Decisions

Decisions Regarding Leasing:

Evaluation of Financial Performance

Maximisation of the value of the firm

Management of Working Capital:

### **Cost of Capital and Capital Structure**

Cost of capital is an important factor in determining the company's capital structure.

Determining a company's optimal capital structure can be a tricky endeavor because both debt financing and equity financing carry respective advantages and disadvantages.

### **Cost of Capital and Capital Structure**

Debt is a cheaper source of financing, as compared to equity. Companies can benefit from their debt instruments by expensing the interest payments made on existing debt and thereby reducing the company's taxable income. These reductions in tax liability are known as tax shields.

Tax shields are crucial to companies because they help to preserve the company's cash flows and the total value of the company.

However, at some point, the cost of issuing additional debt will exceed the cost of issuing new equity.

### **WACC**

Weighted Average Cost of Capital (WACC) is the average rate of return a company expects to compensate all its different investors. The weights are the fraction of each financing source in the company's target capital structure.

A company is typically financed using a combination of debt (bonds) and equity (stocks). Because a company may receive more funding from one source than another, we calculate a

weighted average to find out how expensive it is for a company to raise the funds needed to buy buildings, equipment, and inventory.

### **Kinds of Capital Suppliers**

Whenever there is discussion with respect to WACC, the types of suppliers of capital to the firm:

1. Those who lead funds and expect a fixed return irrespective of the success or failure of the project
2. Those who are willing to merge their fortunes with the performance of the project, expecting high returns, if profit permits and sacrifice returns, if the project doesn't succeed.

### **WACC Formula**

Here is the basic formula to calculate for weighted average cost of capital (WACC):

$$\text{WACC} = ((E/V) * Re) + [(D/V) * Rd]*(1-T)]$$

E = Market value of the company's equity

D = Market value of the company's debt

V = Total Market Value of the company (E + D) • Re = Cost of Equity

Rd = Cost of Debt

T= Tax Rate

### **What Does WACC tell us?**

It's important for a company to know its weighted average cost of capital as a way to gauge the expense of funding future projects. The lower a company's WACC, the cheaper it is for a company to fund new projects.

A company looking to lower its WACC may decide to increase its use of cheaper financing sources. For instance, Corporation ABC may issue more bonds instead of stock because it can get the financing more cheaply. Because this would increase the proportion of debt to equity, and because the debt is cheaper than the equity, the company's weighted average cost of capital would decrease.

### **What is the difference between WACC and IRR?**

Internal Rate of Return (IRR) is used to evaluate the attractiveness of a project or investment. If the IRR of a new project exceeds a company's required rate of return, that project is desirable. If IRR falls below the required rate of return, the project should be rejected.

Used in tandem with the IRR formula, WACC is the "required rate of return" that a project or investment's IRR must exceed to add value to the company. This return rate may also be referred to as a "hurdle rate" or "cost of capital."

For example, if a company's WACC is 10%, a proposed project must have an IRR of 10% or higher to add value to the company. If a proposed project yields an IRR lower than 10%, the company's borrowed money (cost of capital) is costing more than what the proposed project

or investment is expected to yield and probably wouldn't yield a positive return to the company.

Here's another way to look at it. If you were to use your credit card with a 10% annual interest rate (think of it like the WACC) to buy a lemonade stand, you'd need the lemonade stand to return 10% or more every year (similar to the IRR) if you wanted to make any money. Otherwise, you'd be losing money every year and not adding value to your net worth!

### **What's the Difference Between NPV and WACC?**

While IRR makes it easier for managers to decide which project or investment would yield the highest percentage return on investment (ROI), Net Present Value (NPV) measures how much value a potential project or investment could add in absolute dollar amounts.

When considering the WACC, an analyst could apply the percentage WACC to the amount of money needing to be borrowed to complete a proposed project or investment. From there the analyst could compare the NPV against the cost of capital to decide if an investment is worth pursuing.

### **Cost of Equity**

Cost of Equity is the rate of return a company pays out to equity investors. A firm uses cost of equity to assess the relative attractiveness of investments, including both internal projects and external acquisition opportunities. Companies typically use a combination of equity and debt financing, with equity capital being more expensive.

How to calculate Cost of Equity

The cost of equity can be calculated by using

The CAPM (Capital Asset Pricing Model)

Dividend Capitalization Model (for companies that pay out dividends)

### **COE using CAPM Model**

CAPM takes into account the riskiness of an investment relative to the market. The model is less exact due to the estimates made in the calculation (because it uses historical information).

$$E(R_i) = R_f + \beta_i * [E(R_m) - R_f]$$

Where:

$E(R_i)$  = Expected return on asset i

$R_f$  = Risk-free rate of return

$\beta_i$  = Beta of asset i

$E(R_m)$  = Expected market return

### Risk-Free Rate of Return:

The return expected from a risk-free investment (if computing the expected return for a US company, the 10-year Treasury note could be used).

Beta: The measure of systematic risk (the volatility) of the asset relative to the market. Beta can be found online or calculated by using regression: dividing the covariance of the asset and market's returns by the variance of the market.

$\beta_i < 1$ : Asset i is less volatile (relative to the market)

$\beta_i = 1$ : Asset i's volatility is the same rate as the market  $\beta_i > 1$ : Asset i is more volatile (relative to the market)

Expected Market Return: This value is typically the average return of the market (which the underlying security is a part of) over a specified period of time (five to ten years is an appropriate range).

### COE using Dividend Capitalization Model

The Dividend Capitalization Model only applies to companies that pay dividends, and it also assumes that the dividends will grow at a constant rate. The model does not account for investment risk to the extent that CAPM does (since CAPM requires beta).

$$R_e = (D_1 / P_0) + g$$

Where:

$R_e$  = Cost of Equity

$D_1$  = Dividends/share next year ▪  $P_0$  = Current share price

$g$  = Dividend growth rate

#### Dividends/Share Next Year

- Companies usually announce dividends far in advance of the distribution. The information can be found in company filings (annual and quarterly reports or through press releases). If the information cannot be located, an assumption can be made (using historical information to dictate whether the next year's dividend will be similar).

#### Current Share Price

- The share price of a company can be found by searching the ticker or company name on the exchange that the stock is being traded on, or by simply using a credible search engine.

#### Dividend Growth Rate

- The Dividend Growth Rate can be obtained by calculating the growth (each year) of the company's past dividends and then taking the average of the values.
- The growth rate for each year can be found by using the following equation:

- Dividend Growth =  $(D_t/D_{t-1}) - 1$
- Where:
- $D_t$  = Dividend payment of year t
- $D_{t-1}$  = Dividend payment of year t-1 (one year before year t)

### **Cost of Equity v/s Cost of Debt**

The cost of equity is often higher than the cost of debt. Equity investors are compensated more generously because equity is riskier than debt, given that:

Debtholders are paid before equity investors (absolute priority rule).

Debtholders are guaranteed payments, while equity investors are not.

Debt is often secured by specific assets of the firm, while equity is not.

In exchange for taking less risk, debtholders have a lower expected rate of return.

The cost of equity applies only to equity investments, whereas the Weighted Average Cost of Capital (WACC) accounts for both equity and debt investments.

Cost of equity can be used to determine the relative cost of an investment if the firm doesn't possess debt (i.e., the firm only raises money through issuing stock). The WACC is used instead for a firm with debt. The value will always be cheaper because it takes a weighted average of the equity and debt rates (and debt financing is cheaper).

### **Cost of Debt**

The cost of debt is the return that a company provides to its debtholders and creditors. These capital providers need to be compensated for any risk exposure that comes with lending to a company.

Since observable interest rates play a big role in quantifying the cost of debt, it is relatively more straightforward to calculate the cost of debt than the cost of equity.

Not only does the cost of debt reflect the default risk of a company; it also reflects the level of interest rates in the market. In addition, it is an integral part of calculating a company's Weighted Average Cost of Capital or WACC.

### **How to calculate Cost of Debt**

The Cost of Debt can be calculated using:

- Yield to Maturity
- Matrix Pricing

### **Cost of Debt through YTM (Yield to Maturity)**

If a company is public, it can have observable debt in the market. An example would be a straight bond that makes regular interest payments and pays back the principal at maturity.

This approach is widely used when the company being analyzed has a simple capital structure, where it does not have multiple tranches of debt, including subordinated debt or senior debt for example, with each having significantly different interest rates

### **Cost of Debt through Matrix Pricing**

The other approach is to look at the credit rating of the firm found from credit rating agencies such as S&P, Moody's, and Fitch. A yield spread over US treasuries can be determined based on that given rating. That yield spread can then be added to the risk-free rate to find the cost of debt of the company.

This approach is particularly useful for private companies that don't have a directly observable cost of debt in the market. Simply put, a company with no current market data will have to look at its current or implied credit rating and comparable debts to estimate its cost of debt. When comparing, the capital structure of the company should be in line with its peers.

When neither the YTM nor the debt-rating approach works, the analyst can estimate a rating for the company. This happens in situations where the company doesn't have a bond or credit rating, or where it has multiple ratings.

We would look at the leverage ratios of the company, in particular, its interest coverage ratio. A higher number for this ratio means a safer borrower. The yield spread can then be estimated from that rating.

### **Debt is Relatively Cheaper form of Finance**

Debt, such as a corporate bond, has fixed interest payments. In equity financing, however, there are claims on earnings. The larger the ownership stake of a shareholder in the business, the greater he or she participates in the potential upside of those earnings.

Another reason is the tax benefit of interest expense. The income tax paid by a business will be lower because the interest component of debt will be deducted from taxable income, whereas the dividends received by equity holders are not tax-deductible. The marginal tax rate is used when calculating the after-tax rate.

The true cost of debt is expressed by the formula

= After-Tax Cost of Debt

= Cost of Debt x (1 – Tax Rate)

### **Numerical**

(For understanding purposes only)

#### **Question No. 1**

Suppose the company uses equity, preference, and debt in the following proportions: 50, 10 and 40. If the component costs of equity, preference, and debt are 16%, 12% and 8 % respectively. The Weighted Average Cost of Capital (WACC) will be:

Solution:

Cost of Equity = 16

Cost of Debt = 12

Cost of Preference = 8 ▪Proportion of Equity = 50% ▪Proportion of Debt = 12% ▪Proportion of Preference = 40%

WACC

$$=(\text{Cost of Equity}) (\text{Proportion of Equity}) + (\text{Cost of Debt}) (\text{Proportion of Debt}) + (\text{Cost of Preference}) (\text{Proportion of Preference})$$

$$=(16)(0.50) + (12) (0.10) + (8)(0.40) = 12.4\%$$

## Question No. 2

If Bharat Nigam Limited had cost of specific sources of capital are equity = 16% , preference = 14% , and debt = 12%. The market proportions of equity, preference and debt are in the following proportions: 0.60, 0.05 and 0.35. If the tax rate is 30 percent The Weighted Average Cost of Capital (WACC) will be:

Solution:

Cost of Equity = 16

Cost of Debt = 12

Cost of Preference = 14 ▪Proportion of Equity = 0.60 ▪Proportion of Debt = 0.35 ▪Proportion of Preference = 0.05 ▪Tax Rate = 30%  $= (1 - 0.30)$

$$\text{WACC} = (\text{Cost of Equity}) (\text{Proportion of Equity}) + (\text{Cost of Debt}) (\text{Proportion of Debt}) (1 - \text{Tax Rate}) + (\text{Cost of Preference}) (\text{Proportion of Preference})$$

$$=(16)(0.60) + (12) (0.35) (1 - 0.30) + (14)(0.05) = 13.24\%$$

## Company Cost of Capital and Project Cost of Capital

The Company Cost of Capital is the rate of return expected by the existing capital providers. It reflects the business risk of existing assets and the capital structure currently deployed.

The Project Cost of Capital is the rate of return expected by the capital providers for a new project or investment the company proposes to undertake . It will depend on the business risk and the debt capacity of the new project.

## Capital Budgeting

Capital budgeting is a company's formal process used for evaluating potential expenditures or investments that are significant in amount. It involves the decision to invest the current funds for addition, disposition, modification or replacement of fixed assets. The large expenditures include the purchase of fixed assets like land and building, new equipments, rebuilding or replacing existing equipments, research and development, etc. The large amounts spent for these types of projects are known as capital expenditures. Capital

Budgeting is a tool for maximizing a company's future profits since most companies are able to manage only a limited number of large projects at any one time.

Capital budgeting usually involves calculation of each project's future accounting profit by period, the cash flow by period, the present value of cash flows after considering time value of money, the number of years it takes for a project's cash flow to pay back the initial cash investment, an assessment of risk, and various other factors.

Capital is the total investment of the company and budgeting is the art of building budgets.

### **Features Of Capital Budgeting**

- 1) It involves high risk
- 2) Large profits are estimated
- 3) Long time period between the initial investments and estimated returns

### **Capital Budgeting Process**

**1. Project identification and generation:** The first step towards capital budgeting is to generate a proposal for investments. There could be various reasons for taking up investments in a business. It could be addition of a new product line or expanding the existing one. It could be a proposal to either increase the production or reduce the costs of outputs.

**2. Project Screening and Evaluation:** This step mainly involves selecting all correct criteria's to judge the desirability of a proposal. This has to match the objective of the firm to maximize its market value. The tool of time value of money comes handy in this step. Also the estimation of the benefits and the costs needs to be done. The total cash inflow and outflow along with the uncertainties and risks associated with the proposal has to be analyzed thoroughly and appropriate provisioning has to be done for the same.

**3. Project Selection:** There is no such defined method for the selection of a proposal for investments as different businesses have different requirements. That is why, the approval of an investment proposal is done based on the selection criteria and screening process which is defined for every firm keeping in mind the objectives of the investment being undertaken. Once the proposal has been finalized, the different alternatives for raising or acquiring funds have to be explored by the finance team. This is called preparing the capital budget. The average cost of funds has to be reduced. A detailed procedure for periodical reports and tracking the project for the lifetime needs to be streamlined in the initial phase itself. The final approvals are based on profitability, Economic constituents, viability and market conditions.

**4. Implementation:** Money is spent and thus proposal is implemented. The different responsibilities like implementing the proposals, completion of the project within the requisite time period and reduction of cost are allotted. The management then takes up the task of monitoring and containing the implementation of the proposals.

**5. Performance review:** The final stage of capital budgeting involves comparison of actual results with the standard ones. The unfavorable results are identified and removing the various difficulties of the projects helps for future selection and execution of the proposals.

## **Factors Affecting Capital Budgeting:**

**1. Availability of Funds:** The nature and type of funds available with the entity determines whether they will be undertaking a given project or not. Here the credit worthiness of the firm, approach of financial and non-financial institutions towards the entity determines the nature of funds.

**2. Working Capital:** The size and nature of working capital is also instrumental in determining capital budgeting. The volatility and stability of business, the nature of business are detrimental factors about the size of working capital.

**3. Structure of Capital:** Whether a firm decides to raise its own capital, or borrow its capital or prefer more debts and equity are the questions which are to be addressed when we are discussing about the structure of capital. Because on the any given factor specified above the capital budgeting would be eventually determined.

**4. Capital Return:** The rate of return on capital influences the nature of capital budgeting. If the period of return or the rate of return influencing the capital return is either large or small the capital budgeting will be either extended or shortened.

**5. Management decisions:** Capital budgeting is the process used for evaluating potential expenditures or investments that are significant in amount. Therefore an efficient and effective management will determine an effective project. Any mistake or error in decision making could cost the company its market value, investments etc.

**6. Accounting methods:** The methods of taxation, depreciation, treatment of assets etc determine the nature of accounting methods

**7. Government policy:** The commercial and economic policies of government could either deter or make the investment. So taxation policy FDI/FII norms and others determine the investment.

**8. Lending terms of financial institutions:** Financial Institutions could make it difficult for provision of finances of the entity as well as the terms and conditions associated credit. The entities find it difficult to manage and arrange finances accordingly.

**9. Economic value of the project:** The business valuation of the investment affects the company. Therefore the type of project selected and nature of investment and the returns from the project determine the valuation of project which is important for the company.

## **Capital Budgeting Decisions:**

The crux of capital budgeting is profit maximization. There are two ways to it; either increase the revenues or reduce the costs. The increase in revenues can be achieved by expansion of operations by adding a new product line. Reducing costs means representing obsolete return on assets.

**1. Accept / Reject decision** – If a proposal is accepted, the firm invests in it and if rejected the firm does not invest. Generally, proposals that yield a rate of return greater than a certain required rate of return or cost of capital are accepted and the others are rejected. All independent projects are accepted. Independent projects are projects that do not compete with one another in such a way that acceptance gives a fair possibility of acceptance of another.

**2. Mutually exclusive project decision** – Mutually exclusive projects compete with other projects in such a way that the acceptance of one will exclude the acceptance of the other projects. Only one may be chosen. Mutually exclusive investment decisions gain importance when more than one proposal is acceptable under the accept / reject decision. The acceptance of the best alternative eliminates the other alternatives.

**3. Capital rationing decision** – In a situation where the firm has unlimited funds, capital budgeting becomes a very simple process. In that, independent investment proposals yielding a return greater than some predetermined level are accepted. But actual business has a different picture. They have fixed capital budget with large number of investment proposals competing for it. Capital rationing refers to the situation where the firm has more acceptable investments requiring a greater amount of finance than that is available with the firm. Ranking of the investment project is employed on the basis of some predetermined criterion such as the rate of return. The project with highest return is ranked first and the acceptable projects are ranked thereafter.

### **Merger and Acquisition**

The terms mergers and acquisitions may often be confused and look similar. However, the two have different meanings. Mergers may be of various types and so can acquisitions be. There are few terms like “spin out”, “demerger” and “spin off”, which are used to denote the process by which a company separates into two different companies. The nascent company is usually a listed company on the stock exchange. The term “Mergers And Acquisitions” is an expression of a strategy pertaining to the corporate sector. It envisages management of processes related to selling, buying and combining one or more companies for obtaining a common cause. It also comprises corporate finances. Common cause consists of aiding, financing or assisting a company to grow fast so that there is no necessity of establishing a separate entity. Mergers and acquisitions can be denoted by M&A.

Although they are often uttered in the same breath and used as though they were synonymous, the terms merger and acquisition mean slightly different things.

A merger occurs when two separate entities (usually of comparable size) combine forces to create a new, joint organization in which – theoretically – both are equal partners. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

An acquisition refers to the purchase of one entity by another (usually, a smaller firm by a larger one). A new company does not emerge from an acquisition; rather, the acquired company, or target firm, is often consumed and ceases to exist, and its assets become part of the acquiring company. Acquisitions – sometimes called takeovers – generally carry a more negative connotation than mergers, especially if the target firm shows resistance to being bought. For this reason, many acquiring companies refer to an acquisition as a merger even when technically it is not.

Legally speaking, a merger requires two companies to consolidate into a new entity with a new ownership and management structure (ostensibly with members of each firm). An acquisition takes place when one company takes over all of the operational management decisions of another. The more common interpretive distinction rests on whether the transaction is friendly (merger) or hostile (acquisition).

In practice, friendly mergers of equals do not take place very frequently. It's uncommon that two companies would benefit from combining forces and two different CEOs agree to give up some authority to realize those benefits. When this does happen, the stocks of both companies are surrendered and new stocks are issued under the name of the new business identity.

Since mergers are so uncommon and takeovers are viewed in a derogatory light, the two terms have become increasingly conflated and used in conjunction with one another. Contemporary corporate restructurings are usually referred to as merger and acquisition (M&A) transactions rather than simply a merger or acquisition. The practical differences between the two terms are slowly being eroded by the new definition of M&A deals. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders. The public relations backlash for hostile takeovers can be damaging to the acquiring company. The victims of hostile acquisitions are often forced to announce a merger to preserve the reputation of the acquiring entity.

### **Types of Merger**

A merger is a combination of two firms where one is absorbed by the other completely. In this case, the company which is small compared to the other loses its identity and becomes a part of that other big company. Although, the later continues with its identity.

Merger is not like consolidation, it abolishes the merged company and the surviving company take over all the privileges, rights and liabilities of the merged company. It is a method by which the companies unify the asset ownerships, previously which was controlled by separate bodies, legally.

Mergers are of different types based on the relationships between the organizations involved. These are discussed below:

**a. Horizontal Merger:** It involves the joining of two companies which are not competing with each other directly. That is, those companies are willing to sell the same kind of product to those customers who belong to a common market.

**b. Vertical Merger:** Vertical merger involves the merging of a supplier and a company or a customer and a company. For example, a tyre company may merge with a rubber production company.

**c. Product-extension Merger:** It involves combining two companies who sell different products in a common market. Those products may be related somewhat.

**d. Market-extension Merger:** Market-extension Merger involves the merging of two firms who sell the same kind of product but in different markets.

**e. Conglomeration Merger:** In a concentration merger, the participating companies don't have any related markets or products. In fact, they do not possess any common business tie up.

### **International Mergers and Acquisitions:**

The opening up of the European countries to International mergers and acquisitions and the economic reforms in developing countries provided major boost to international mergers and acquisitions since the 1990s.

Foreign investment gets major impetus from international mergers and acquisitions. While there are various advantages of international mergers and acquisitions, certain impediments in the form of regulatory restrictions also exist.

The adoption of economic reforms in many countries in the last two decades of the 20<sup>th</sup> century opened up opportunities of international mergers and acquisitions. With different countries opening up their economies to foreign investors, international mergers and acquisitions has received. The European economy also opened up to foreign mergers and acquisitions in the 1990s, which resulted in M&A (merger and acquisition) activities of large volumes taking place across Europe.

While USA has always been the pioneer in merger and acquisition activities, UK too has registered high levels of mergers and acquisitions. With the European countries gaining momentum in mergers and acquisitions, international mergers and acquisitions also received a major boost.

There are various benefits that accrue to firms that undertake international mergers and acquisitions. Cross border mergers and acquisitions are effective in boosting Foreign Direct Investment (FDI). For international investors, it is easier to invest through a merger or an acquisition. International mergers and acquisitions provide access to infrastructure and customer base in a country which is quite difficult to build from the scratch. Moreover an existing brand name in a country provides strong business edge. Access to local markets of different countries is possible through international mergers and acquisitions.

With the developing countries adopting liberal economic policies, the incentives of firms in the developed nations to indulge in mergers and acquisitions in these countries are huge. International mergers and acquisitions provide a way to tap the markets of these countries. On the other hand, for these developing countries international mergers and acquisitions provide them access to improved technologies and more productive operative mechanisms.

However there are certain impediments to international mergers and acquisitions. Regulations of different countries play an important role. In some countries certain sectors are prohibited from international mergers and acquisitions, while for some other sectors certain conditions need to be fulfilled. In China, for instance, laws regarding international mergers and acquisitions are quite stringent.

### **Methods of Financing International Mergers and Acquisitions**

Usually, the following methods are implemented for funding international mergers and acquisitions:

**a. Financing (or taking loans):** Financing is the process of providing funds for business activities, making purchases or investing. Financial institutions such as banks are in the business of providing capital to businesses, consumers and investors to help them achieve their goals. The use of financing is vital in any economic system, as it allows companies to purchase products out of their immediate reach. Companies find it difficult to find finances upon than find appropriate finances which meet the requirement of the M&A.

**b. Cash:** The cash available with the company could also be used to fund the M&A.

**c. Factoring:** Factoring is a financial service in which the business entity sells its bill receivables to a third party at a discount in order to raise funds. It differs from invoice discounting. The concept of invoice discounting involves, getting the invoice discounted at a certain rate to get the funds, whereas the concept of factoring is broader. Factoring involves the selling of all the accounts receivable to an outside agency. Such agency is called a factor. A company looking forward for factoring as an option to

**d. Hybrid Financing:** Hybrid Financing is the financial instrument that par takes some characteristics of debt and some characteristics of equity. Simply, it is the financial security that possesses the characteristics of both the debt and equity.

### **Significant International Mergers and Acquisitions**

The merger of British Petroleum (BP) with Amoco (erstwhile Standard Oil of Indiana)

The acquisition of Mannesmann AG by Vodafone Airtouch PLC

The merger of Exxon with Mobil (The name of the company formed as a result of the merger is ExxonMobil)

The acquisition of AirTouch Communications by the Vodafone Group

The acquisition of Compaq by Hewlett-Packard

The acquisition of Shell Transport & Trading Company by Royal Dutch Petroleum Company

The merger of Bank One Corporation with JPMorgan Chase & Company

### **Factors Affecting International Mergers and Acquisitions**

The following elements influence the international mergers and acquisitions from many aspects:

**a. Corporate governance:** The set of rules and regulations, practices and procedures followed in different companies are different. These differences in the corporate set-up could either make or break the companies.

**b. Company acts:** The legal bindings for a company are instrumental in determining the nature of its working. With international M&As, it's difficult for the company, to directly change their working, or their mechanisms because the company law/bills/acts determine the functioning and one cannot bypass laws for even commercial purposes.

**c. The capacity of average workers:** When companies change their identities, the workers are the ones who face the music of the activities. They are the cornerstone of the process but every worker and every workplace is different. Therefore it's important to understand the capacities of the workers before determining the new nature of work at the new workplace.

**d. Expectation of the consumers:** Sometimes the M&A, raises the nature and expectations of the company that the consumers also expect better from the company. When these

consumer expectations are not met, the consumers find it difficult to accept and acknowledge the products and services of the company.

**e. Political features of a country:** If a particular country rules out policies which make it difficult for the given merger and acquisition then this process a difficult task accomplish. A democratic and market-based government supports such endeavours while socialist economy doesn't support such endeavours.

**f. Tradition and culture of a country:** The morals and traditions of a country will determine the acceptance of the given business practice. Sometimes people object the idea of a particular merger and acquisition solely on the grounds of a foreign company being associated with the same.

# **International Money and Equity Markets**

## **Definition**

A financial market is a broad term describing any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets are typically defined by having transparent pricing, basic regulations on trading, costs and fees, and market forces determining the prices of securities that trade.

Financial market is an apparatus that allows people to buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other items of value at low transaction costs and at prices that reflect the efficient-market supposition.

## **Financial Markets**

### **Based on Maturity Structure**

Money Market

Capital Market

### **Based on Trading Structure**

Primary Market

Secondary Market

## **Capital Market**

The **Capital Market** aids raising of capital on a long-term basis, **generally over 1 year**. It consists of a primary and a secondary market and can be divided into two main subgroups – Bond market and Stock market.

The **Bond market** provides financing by accumulating debt through bond issuance and bond trading

The **Stock market** provides financing by sharing the ownership of a company through stocks issuing and trading

## **Money Market**

The **Money Market** enables economic units to manage their liquidity positions through lending and borrowing short-term loans, **generally under 1 year**. It facilitates the interaction between individuals and institutions with temporary surpluses of funds and their counterparts who are experiencing a temporary shortage of funds. Money Market is classified into Call Money Market and Interbank Market.

**Call Money Market** is a market to borrow funds for one day or upto one week.

**Interbank Market** is a market to borrow funds from overnight to upto one year.

## **Primary Market**

A Primary Market, or the so-called “New Issue Market”, is where securities such as shares and bonds are being created and traded for the first time without using any intermediary such as an exchange in the process.

When a private company decides to become a publicly-traded entity, it issues and sells its stocks at a so-called Initial Public Offering (IPOs).

IPOs are a strictly regulated process which is facilitated by investment banks or finance syndicates of securities dealers that set a starting price range and then oversee its sale directly to the investors.

## **Secondary Market**

A Secondary Market, or the so-called “Aftermarket” is the place where investors purchase previously issued securities such as stocks, bonds, futures and options from other investors, rather from issuing companies themselves. The secondary market is where the bulk of exchange trading occurs and it is what people are talking about when they refer to the “stock market”. It includes the NYSE, Nasdaq and all other major exchanges.

## **Different Types of Financial Markets**

Capital Markets

Money Markets

Foreign Exchange Markets

Commodity Markets

Derivatives Markets

Insurance Markets

Equity Markets

Debt Markets

Offshore Markets

**Capital Market**

A capital market is basically a system in which people, companies, and governments with an excess of funds transfer those funds to people, companies, and governments that have a shortage of funds.

Capital markets carry out the desirable economic function of directing capital to productive uses.

### **Origin and Growth of International Capital Markets**

**1960s-** Rise in demand of Dollar-denominated Bonds by Europeans and others.

**Until 1970s-** Only corporate entities raised equity and debt finances in domestic markets.

**Since 1970s-** Expanding trade volumes and patterns promoted financial markets.

**1980s-** The start of globalisation process and widening of markets and development of stock exchanges across the world.

**1990s-** Liberalisation of economies and globalisation aided in growth of the capital markets.

### **Classification of International Capital Markets**

**International Equity Markets:** Companies whose stocks are traded outside their country of origin.

**International Bond Markets:** These consist of entities that sell bonds outside the home country. The bond can be of several types – Foreign Bonds, Euro Bond and Global Bond.

**Euro Currency Markets:** It is a short term financing option for Euro currency. Euro Bonds, Euro Credit, Euro Notes, Euro Bonds.

**Offshore Centers:** They are territories that have a few financial regulations and are essentially, tax havens. They are of two types – Operational centres (where extensive financial activities occur) and Booking Center (favourable tax/secretcy laws)

### **Participants in International Capital Markets**

Stock Exchange

Retail Investors

Institutional Investors

Intermediaries

Regulators

Brokers

Custodians

Depositories

Rating Agencies

### **Obstacles to International Investment**

Information Barriers

Capital Control Risks  
Currency Conversion  
Foreign Exchange Risks  
Restrictions on Foreign Investment and Control  
Taxation  
Inefficient Trade Barriers  
Regulatory Risks  
Political Risks  
Unfamiliar Market Practices

### **Need for Foreign Capital**

Capital Investment requirements  
Technology transfers  
Exploitation of natural resources  
Development of entrepreneurship  
Development of economic infrastructure  
Financing Balance of Payments deficit

### **Foreign Direct Investment (FDI)**

Foreign Direct Investment (FDI) means investing in a country other than your home country. It involves, foreign direct capital inflows from one country to another. Wherein, foreign countries have an ownership interest or a say in the business. FDI is generally seen as an accelerator for economic growth and it can be undertaken by institutions, corporations and individuals.

For example, if the UK invests either in TATA's or by setting up a subsidiary of a UK based company in India.

Foreign Direct Investment (FDI) is when a company takes controlling ownership in a business entity in another country. With FDI, foreign companies are directly involved with day-to-day operations in the other country. This means they aren't just bringing money with them, but also knowledge, skills and technology.

Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets, including establishing ownership or controlling interest in a foreign company.

### **Foreign Investment Investors (FIIs)**

Foreign Institutional Investors (FIIs) are large companies that invest in countries other than where their headquarters are located. The term FII is most commonly used in India, where it

refers to outside entities investing in the nation's financial markets. However, this term is also used officially in China.

Examples of FIIs are pension funds, mutual funds, investment trusts, insurance or reinsurance companies, trustees, banks, endowment funds.

FIIs can include hedge funds, insurance companies, pension funds, investment banks and mutual funds. FII is an important source of capital in developing economies. Yet, countries like India have placed limits on the total value of assets an FII can purchase and the number of equity shares it can buy, particularly in a single company. This helps limit the influence of FII on individual companies and the nation's financial markets.

However, FII as a category does not exist now. It was decided to create a new investor class called "Foreign Portfolio Investor" (FPI) by merging the existing three investor classes viz. FIIs, Sub Accounts and Qualified Foreign Investors.

### **Qualified Foreign Investor (QFIs)**

The Qualified Foreign Investor (QFI) is sub-category of Foreign Portfolio Investor and refers to any foreign individuals, groups or associations, or resident, however, restricted to those from a country that is a member of Financial Action Task Force (FATF) or a country that is a member of a group which is a member of FATF and a country that is a signatory to International Organization of Securities Commission's (IOSCO) Multilateral Memorandum of Understanding (MMOU).

QFI scheme was introduced by Government of India in consultation with RBI and SEBI in the year 2011, through a Union Budget announcement.

The objective of enabling QFIs was to deepen and infuse more foreign funds in the Indian capital market and to reduce market volatility as individuals are considered to be long term investors, as compared to institutional investors.

QFIs are distinct from FIIs and Non-Resident Indians. They are allowed to directly invest into mutual funds and stocks of Indian companies. It was felt that foreign investors had been kept at bay owing to concerns relating to money laundering and due diligence by government and regulators.

### **Foreign Portfolio Investment (FPIs)**

Foreign Portfolio Investment (FPI) means investing in the financial assets of a foreign country, such as stocks or bonds available on an exchange. This kind of investment is considered less favourable than direct investment because portfolio investment can be sold off quickly and these are at times seen as short term attempts to make money, rather than a long-term investment in the economy.

A few examples of FPI are investments made in the shares of a foreign country or investment by purchasing the bonds floated by a foreign government.

Unlike FDI, FPI doesn't offer control over the business entity in which the investment is made

### **Advantages of Foreign Direct Investment**

Economic Development Stimulation

Easy International Trade

Employment and Economic Boost

Development of Human Capital Resources

Tax Incentives

Resource Transfer

Reduced Disparity between Revenues and Costs

Increased Productivity

Increment in Income

Economic Growth and Development

### **Disadvantages of Foreign Direct Investment**

Hindrance to Domestic Investment

Risk from Political Changes

Negative Influence on Exchange Rates

Higher Costs

Economic Non-Viability

Expropriation

Negative Impact on the Country's Investment

Modern-Day Economic Colonialism

### **Advantages of Foreign Investment Investor**

Enhanced flows of equity capital

Managing uncertainty and controlling risks

Improving capital markets

Equity market development aids economic development

Improved corporate governance

### **Disadvantages of Foreign Investment Investor**

Problems of Inflation

Problems for small investor

Adverse impact on Exports

Hot Money

## Basis of Distinction

Basis of Distinction	Foreign Direct Investment (FDI)	Foreign Investment Investor (FII)
Meaning	When a company situated in one country makes an investment in a company situated abroad, it is known as FDI.	FII is when foreign companies make investments in the stock market of a country.
Entry and Exit	Difficult	Easy
What it brings?	Long term capital	Long/Short term capital
Transfer of	Funds, resources, technology, strategies, know-how etc.	Funds only
Economic Growth	Yes	No
Consequences	Increase in country's Gross Domestic Product (GDP)	Increase in capital of the country
Target Specific Company	No such target	investment flows into the financial market
Control over a company	Yes, targets a particular company	No
Desirable	More preferred due to direct control over capital	Less Preferred
Effect on production and employment	Directly increases production and employment and increases productivity	No direct change in production and employment

## Components of International Equity Markets

Cross listing and Global Registered Shares

Yankhee Stock Offerings

Depository Receipts (GDR, ADR, IDR)

Bonds

## Factors affecting International Equity Returns

Macroeconomic factors

Exchange rates

Industrial structures

## Depository Receipts (DRs)

A Depository Receipt (DR) is a financial instrument representing certain securities (eg. shares, bonds etc.) issued by a company/entity in a foreign jurisdiction. Securities of a firm are deposited with a domestic custodian in the firm's domestic jurisdiction, and a

corresponding “depository receipt” is issued abroad, which can be purchased by foreign investors.

DR is a negotiable security (which means an instrument transferrable by mere delivery or by endorsement and delivery) that can be traded on the stock exchange, if so desired.

DRs constitute an important mechanism through which issuers can raise funds outside their home jurisdiction.

DRs are issued for tapping foreign investors who otherwise may not be able to participate directly in the domestic market. It is perceived as the beginning point of connecting with the foreign investors (i.e. a stage before the actual listing the shares /securities in a foreign stock exchange) or a way of introducing the company to a foreign investor.

For investors, depository receipt is a way of diversifying the risk, by getting exposure to a foreign market, but without the exchange rate risk as they are foreign currency denominated. Further, they feel more safe to invest from their home location.

Depository Receipts are negotiable financial instruments issued by banks in the foreign market for raising capital. Companies issue depository receipt in the foreign market by depositing their shares with one of custodian banks. After receiving shares from an issuing company ; custodian bank issues depository receipt in the country from where company desires to raise money and to get itself listed for trading.

Depository receipts are denominated in the currency of the country where they are traded and are governed by the rules and regulations of the same country’s capital market.

#### **According to Foreign Exchange Management Regulation ( 2014 ) –**

Depository Receipt ‘ means a foreign currency denominated instrument, whether listed on an international exchange or not, issued by a foreign depository in a permissible jurisdiction on the back of eligible securities issued or transferred to that foreign depository and deposited with a domestic custodian and includes ‘ global depository receipt ‘ as defined in section 2(44) of the Companies Act, 2013.

#### **Features of Depository Receipts (DRs)**

Funds from overseas market

Safety

Exchangeable

No Voting Rights

Liquidity

Corporate Benefits

Usage of Funds

#### **Advantages of DRs to Issuing Company**

Company Visibility

Availability of Funds

Liquidity

Greater Control

Fair Price

### **Advantages of DRs to Investors**

Easy to Buy and Sell

Safe

Liquidity

Diversification

Reasonable Price

Interchangeability

Other Benefits

### **Types of Depository Receipts (DRs)**

Depending on the location in which these receipts are issued:

- 1. Sponsored:** Where the Indian issuer enters into a formal agreement with the foreign depository for creation or issue of DRs. A sponsored DR issue can be further classified as:
  - i. **Capital Raising:** The issuer issues new securities which are deposited with a domestic custodian. The foreign depository then creates DRs abroad for sale to foreign investors. This constitutes a capital raising exercise, as the proceeds of the sale of DRs go to the Indian issuer.
  - ii. **Non-Capital Raising:** In a non-capital raising issue, no fresh underlying securities are issued. Rather, the issuer gets holders of its existing securities to deposit these securities with a domestic custodian, so that DRs can be issued abroad by the foreign depository. This is not a capital raising exercise for the Indian issuer, as the proceeds from the sale of the DRs go to the holders of the underlying securities.

**2. Un-sponsored:** Un-sponsored DRs are where there is no formal agreement between the foreign depository and the Indian issuer. Any person other than the Indian issuer may, without any involvement of the issuer, deposit the securities with a domestic custodian in India. A foreign depository then issues DRs abroad on the back of such deposited securities. This is not a capital raising exercise for the Indian issuer, as the proceeds from the sale of the DRs go to the holders of the underlying securities.

Based on whether a DR is traded in an organized market or in the over the counter (OTC) market, the DRs can be classified as listed or unlisted.

### **Global Depository Receipts (GDRs)**

GDR can be defined as a foreign currency denominated derivative instrument in the form of depository receipt created outside India and issued to non-resident investors entitling them to

the benefits of specific number of ordinary equity shares or fully convertible bonds of a domestic company.

Global Depository receipt refers to the name given for the depository receipt where the security certificate is issued by financial intermediaries such as depository bank, that purchases the securities of a foreign country, then creates a bank certificate that which consists of such shares and finally selling them in the stock exchange.

GDR is an instrument issued abroad by a company to raise funds in some foreign currencies and is listed and traded on a foreign stock exchange.

Global Depository Receipts are securities certificates issued by intermediaries such as banks for facilitating investments in foreign companies.

A GDR represents a certain number of shares in a foreign company that is not traded on the local stock exchange. One GDR usually holds 10 shares, but the ratio can be anything higher or lower than this. The shares in the GDR trade on their domestic stock exchange.

### **Characteristics of GDRs**

1. GDR's are issued to investors in more than one country and may be denominated in any acceptable freely convertible currency.
2. GDR's are issued to investors by the depository bank and not the issuing company. This means that in the books of issuing company, the depository bank appears as the shareholder. GDR holder therefore does not acquire any voting rights. The voting rights accrue only to the depository bank.
3. Although the GDR is quoted and traded in a foreign currency the underlying shares are denominated in INR. Thus the GDR derives its value through the price of the underlying shares and the current exchange rate. It is therefore exposed to exchange rate risk.
4. GDR holders have the option of cancelling GDR's and arranging sale of the underlying shares in the domestic market if the international price is less than the corresponding domestic price. This provision can however be used only after a "Cooling off" period of 45 days from the date of the issue.
5. GDR holders are entitled to all corporate benefits available to equity holders such as dividend, bonus and rights in the same proportion as their entitlement.
6. The foreign currency funds acquired by the company through a GDR issue are permitted to be used for any normal business activity, but cannot be used for trading in international securities or real estate.

### **Advantages of GDR**

GDR provides access to foreign capital markets.

A company can get itself registered on an overseas stock exchange or over the counter and its shares can be traded in more than one currency.

GDR expands the global presence of the company which helps in getting international attention and coverage.

GDR are liquid in nature as they are based on demand and supply which can be regulated.

The valuation of shares in the domestic market increase, on listing in the international market.

With GDR, the non-residents can invest in shares of the foreign company.

GDR can be freely transferred.

Foreign Institutional investors can buy the shares of company issuing GDR in their country even if they are restricted to buy shares of foreign company.

GDR increases the shareholders base of the company.

GDR saves the taxes of an investor. An investor would need to pay tax if he purchases shares in the foreign company, whereas in GDR same is not the case.

### **Disadvantages of GDR**

Violating any regulation can lead to serious consequences against the company.

Dividends are paid in domestic country's currency which is subject to volatility in the forex market.

It is mostly beneficial to High Net-Worth Individual (HNI) investors due to their capacity to invest high amount in GDR.

GDR is one of the expensive sources of finance.

### **Important Terminologies**

**Issuing Company:** The company intending to raise money in foreign land

**Depository Bank:** Financial Institute/International Investment Bank in Foreign Country (appointed by Issuing Company)

**Lead Manager:** International Merchant Bank (hired by Depository Bank)

**Book Runners:** Credit-rating Agencies (hired by Lead Manager)

**Custodian Bank:** Financial Institute in Foreign Country (appointed by Depository Bank)

**Clearing System:** Financial Institute in Foreign Country (appointed by Depository Bank)

### **Important pointers**

**Cooling Off Period (45 Days)** – Time between purchase of DRs (date of issue) to their cancellation

**Green Shoe Option** – Lead managers are allowed to place additional (upto 15% more) GDRs beyond the GDR issue size

### **DRs Arbitrage**

**Dual Fungibility of DRs** – Fungibility means as asset can be interchanged into another asset of the same class

### **American Depository Receipts (ADRs)**

American Depositary Receipts (ADR) are negotiable security instruments that are issued by a US bank, that represent a specific number of shares in a foreign company that is traded in US financial markets.

ADRs pay dividends in US dollars and trade like regular shares of stock. Companies can now purchase stocks of foreign companies in bulk and reissue them on the US market.

ADRs are listed on the NYSE, NASDAQ, AMEX and can be sold over-the-counter.

### **History of ADR**

The first ADR was created in 1927 by J.P. Morgan, to allow Americans to invest in shares of Selfridges, a British department store. Today there are more than 2,200 ADRs available, representing shares of companies located in more than 70 countries. The Bank of New York, JPMorgan, Deutsche Bank, and Citigroup are among the leading depository banks, which create and issue ADRs.

### **Sponsored ADR**

For a sponsored ADR, the foreign company issuing shares to the public enters into an agreement with a US depository bank to sell its shares in US markets. The US bank is responsible for recordkeeping, sale, and distribution of shares to the public, distribution of dividends, etc. Sponsored ADRs can be listed on the US stock exchanges.

### **NON-Sponsored ADR**

A non-sponsored ADR is created by brokers/dealers without the cooperation of the foreign company issuing the shares. Non-sponsored ADRs are traded in US over-the-counter markets without requiring registration with the Securities and Exchange Commission (SEC). Before 2008, any brokers and dealers trading in ADRs were required to submit a written application before being allowed to trade in the US. The 2008 SEC amendment provided an exemption to foreign issuers that met certain regulatory conditions. Non-sponsored ADRs are only traded on over-the-counter markets.

### **Sponsored Level I ADR**

Level I is the lowest level at which sponsored ADRs can be issued. It is the most common level for foreign companies that do not qualify for other levels or that do not want their securities listed on US exchanges. Level I ADRs are subject to the least reporting requirements with the Securities and Exchange Commission, and they are only traded over the counter. The companies are not required to issue quarterly or annual reports like other publicly-traded companies. However, Level I issuers must have their stock listed on one or more exchanges in the country of origination. Level I can be upgraded to Level II when the company is ready to sell through US exchanges.

### **Sponsored Level II ADR**

Level II ADRs have more requirements from the SEC than Level I, and the company gets an opportunity to establish a higher trading presence on the US stock markets. The company must file a registration statement with the SEC. Also, the company must file Form-20-F in accordance with the GAAP or IFRS standards. Form 20-F is the equivalent of Form-10-K

which is submitted by US publicly-traded companies. If the issuer fails to comply with these requirements, it may be delisted or downgraded to Level I.

### **Sponsored Level III ADR**

Level III is the highest and most prestigious level that a foreign company can sponsor. A foreign company at this level can float a public offering of ADRs to raise capital from American investors through US exchanges. Level III ADRs also attract stricter regulations from the SEC. The company must file Form F-1 (prospectus) and Form 20-F (annual reports) in accordance with GAAP or IFRS standards. Any materials distributed to shareholders in the issuer's home country must be submitted to the SEC as Form 6-K. Examples of foreign companies that have managed to enter this ADR level include Vodafone, Petrobras, and China Information Technology.

### **Restricted ADRs**

#### **Section 144A:**

Raising capital through private placement of ADRs with large institutional investors (QIBs)

The issues are similar to level 1 ADR and cannot be listed on stock exchange

They are traded on OTC basis

The details of deed aren't disclosed and dealings of such ADRs are associated with heavy international investment risks

#### **Regulation S:**

Raising capital through placement of ADRs to off shore non US investors

Section S of SEC regulations are permitted to operate as level 1

### **Termination or Cancellation**

ADRs are subject to cancellation at the discretion of either the foreign issuer or the depository bank that created them. The termination results in the cancellation of all ADRs issued and delisting from the US exchange markets where the foreign stock was trading. Before the termination, the company must write to the owners of ADRs, giving them the option to swap their ADR for foreign securities represented by the receipts. If the owners take possession of the foreign securities, they can look for brokers who trade in that specific foreign market. If the owner decides to hold onto their ADR certificates after the termination, the depository bank will continue holding onto the foreign securities and collect dividends, but will not sell more ADR securities.

### **Advantages**

The issuer of the ADRs can get access to the capital available in the market of the US and get the diversified base of the shareholders (U.S. shareholders).

ADR makes it easy for the issuer to go for Merger and Acquisition activities as they can use ADR as the currency for the acquisition.

For the investor, ADRs are easy to use as they can buy and sell the shares of the other country's company like their own country company. Also, there is no need for a new broker or to open a foreign brokerage account as investors can use the same broker with whom they normally deal.

An investor gets the opportunity to diversify their investment portfolio on a global scale.

Everything is done as per the U.S. working. ADRs are purchased by the investors in U.S. dollars, dividends are given in dollars, traded during the normal trading hours in the U.S., and are subject to similar settlement procedures as that of the American stocks.

This gives more accessibility of research and information to the investors and investors can customize their portfolio according to their requirements like which countries they are interested in or which sector etc.

### **Disadvantages**

The unsponsored ADRs may not be compliant with the Securities and Exchange Commission (SEC)

The investors might have limited companies for the selection as all the foreign companies are not available as ADRs.

For the purpose of diversification, an investor needs enough capital investment otherwise it will not be possible to create a properly diversified portfolio.

The investor might have to face the double taxation in case the dividend is taxed differently as ADRs dividends received may be subject to the tax in the home country of the company.

### **Indian Depository Receipts (IDR)**

The financial instruments that allow foreign companies to mobilise funds from Indian Markets by offering entitlement foreign equity and getting listed on Indian Stock Exchanges

Requirements

Paid up Capital USD 100 Million

Average turnover USD 500 Million (last 3 years)

Only Qualified Institutional Investors and Indian Companies allowed

NRIs allowed with restrictions

### **Financial Markets**

Financial markets, from the name itself, are a type of marketplace that provides an avenue for the sale and purchase of assets such as bonds, stocks, foreign exchange, and derivatives. Often, they are called by different names, including "Wall Street" and "capital market," but all of them still mean one and the same thing. Simply put, businesses and investors can go to financial markets to raise money to grow their business and to make more money, respectively.

To state it more clearly, let us imagine a bank where an individual maintains a savings account. The bank can use their money and the money of other depositors to loan to other individuals and organizations and charge an interest fee.

The depositors themselves also earn and see their money grow through the interest that is paid to it. Therefore, the bank serves as a financial market that benefits both the depositors and the debtors.

### **Functions of the Markets**

The role of financial markets in the success and strength of an economy cannot be underestimated. Here are four important functions of financial markets:

1. Puts savings into more productive use
2. Determines the price of securities
3. Makes financial assets liquid
4. Lowers the cost of transactions

### **Types of Financial Markets**

There are so many financial markets, and every country is home to at least one, although they vary in size. Some are small while some others are internationally known, such as the New York Stock Exchange (NYSE) that trades trillions of dollars on a daily basis. Here are some types of financial markets.

1. Stock market
2. Bond market
3. Commodities market
4. Derivatives market

### **Importance of Financial Markets**

There are many things that financial markets make possible, including the following:

Financial markets provide a place where participants like investors and debtors, regardless of their size, will receive fair and proper treatment.

They provide individuals, companies, and government organizations with access to capital.

Financial markets help lower the unemployment rate because of the many job opportunities it offers

### **Financial Markets: Segments and Financing Options**

#### **Stock Market**

The stock market is a place where the shares of companies that are publicly owned can be bought and sold either OTC (Over-The-Counter) or through centralized exchanges. The equity market, as it is also known by, has established itself as a free-market economy, in that

it offers companies the ability to access capital in exchange for offering interested outside parties a portion in the ownership of the company.

The stock market or equity market offers opportunity to investors to increase their income without the high risk of entering into their own businesses with high overheads and startup costs. On the other hand, selling of stocks did help the companies themselves expand exponentially. When you purchase a company's shares it is generally associated with the increased in the company's worth. Therefore, trading on the stock or equity markets can be a win-win for both investor and owner.

There is a negative risk however small or large depending on the amount of stock bought, that one can lose money in a trading environment. If the stocks traders hold from the company lose value, then so does the trader. If he decides to sell his stocks when the value is lower, he will sell at a loss.

### **New York Stock Exchange (NYSE)**

It was established on May 17, 1792 in New York. USA.

It consists of 2,400 listed companies.

It is the world's largest stock exchange and has a market capitalization of US\$ 30.1 trillion.

Back to the back of mergers has aided the New York Stock Exchange to gain its colossal size and global footprint.

The blue-chip companies which are listed under NYSE are : Berkshire Hathaway Inc, Coca-Cola, Walt Disney Company, McDonald's Corporation, etc.

### **National Association of Securities Dealers Automated Quotations (NASDAQ)**

It was established on February 8, 1771 in New York. USA.

It is sighted as the world's first electronically traded stock market.

It has a combined market capitalization of \$10.8 trillion.

It consists of more than 3,000 stocks listed under it and comprises of the world's humongous tech giants such as Apple, Microsoft, Google, Facebook, Amazon, Tesla, and Intel.

### **Tokyo Stock Exchange (TSE)**

The Tokyo Stock Exchange (TSE) which is also known as Tōshō is located in Tokyo, Japan.

It was validated on May 15, 1878.

TSE has close to 3,500 listed companies with a syndicated market capitalization surpassing the US\$ 5.67 trillion.

The TSE's metric indicator is Nikkei 225 and it is home to some of the voluminous Japanese giants with international exposure, including Toyota, Suzuki, Honda, and Mitsubishi and Sony.

### **Shanghai Stock Exchange (SSE)**

The Shanghai Stock Exchange (SSE) is located in the city of Shanghai, China.

Although its foundation traces back to 1866, it was adjourned after the Chinese Revolution in 1949. However, The Shanghai Exchange in its contemporary outlook was laid down in 1990.

Currently, Shanghai SSE is the world's fourth-largest stock exchange with a combined market capitalization US\$ 5.01 trillion.

The most interesting fact is that the absolute market cap of the SSE is constructed out of formerly state-run insurance companies & commercial banks.

### **Hong Kong Stock Exchange (SEHK)**

The Hong Kong Stock Exchange (SEHK) is located in Hong Kong.

It consists of 2,315 listed companies with a wholesome market capitalization of HK\$29.9 trillion.

Its origin can be traced back to the mid-1800s and since then it has gone through a series of mergers and agglomeration with other exchanges.

Some of the gigantic and eminent companies listed under the Hong Kong Stock Exchange are China Mobile, and HSBC Holdings & Petro China.

### **London Stock Exchange (LSE)**

The London Stock Exchange (LSE) is based in London.

It was established in 1571 and is the oldest stock exchange in the world.

It has more than 3,000 listed companies with a combined market capitalization of \$4.59 trillion.

LSE is also the maiden source of benchmark prices, equity-market liquidity and market data in Europe.

Some of the massive companies listed under the LSE are Barclays, British Petroleum and GlaxoSmithKline.

### **EURONEXT**

The Word EURONEXT is an acronym for European New Exchange Technology and has its corporate address at La Défense in Greater Paris.

EURONEXT was established in 2000 by the consolidation of the exchanges in Amsterdam, Paris, and Brussels.

Over the years, it amalgamated with multiple exchanges, most particularly the New York Stock Exchange. It steers financial markets in Amsterdam, London, Brussels, Lisbon, Oslo, Dublin, and Paris.

It has around 1,500 listed companies leading to a market capitalization worth €4.1 trillion.

EURONEXT provided the segments which are equities, warrants, exchange-traded, bonds, commodities, funds and certificates, derivatives, indices, and foreign exchange trading platforms.

### **Shenzhen Stock Exchange (SZSE)**

The Shenzhen Stock Exchange (SZSE) is oriented in the city of Shenzhen, China and was founded on December 1, 1990.

It has approximately 1,300 listed companies with a combined market capitalization of \$3.92 trillion.

Most of the companies under this SZSE are corporate firms of companies in which the Government Of China has a controlling interest. The Shenzhen Stock Exchange had introduced the “ChiNext Board” in 2009 comprising of high-tech & high-growth startups, quite similar to NASDAQ.

### **Toronto Stock Exchange (TSX)**

The Toronto Stock Exchange (TSX) is situated in Toronto, Canada.

It was introduced in 1852 and is held and wielded as a subsidiary of the TMX Group. It has 2,207 listed companies with a combined market capitalization of \$2.3 trillion.

The financial instruments include equities, investment trusts, exchange-traded funds, bonds, commodities, futures, options, and other products.

It is also to be noted that mining and oil and gas companies are listed in more numbers under the Toronto Stock Exchange compared to other stock exchanges around the world.

### **Bombay Stock Exchange (BSE)**

The Bombay Stock Exchange (BSE) is an Indian stock exchange located at the high-wheeled Dalal Street in Mumbai.

It was established in 1875 and is Asia’s first-ever stock exchange.

A total market capitalization of more than \$2.2 trillion.

The BSE has approximately 5,000 listed companies and has assisted in the growth of the country’s corporate sector and financial markets.

Securities listed under BSE comprises of stocks, futures, options, index futures, index options, and weekly options. However, the BSE’s benchmark is measured by the Sensex which nearly covers all the sectors of the Indian economy.

### **New Waves in Stock Market**

Artificial Intelligence

#### **Scams**

A Scam is referred to as the process of obtaining money from someone by deceiving him/her. The majority of the securities market scams that took place in India eventually led to a lot of financial distress to the retail investors. They adversely affected the normal functioning of the markets and degraded the trusts of lakhs of investors on the Indian share market.

#### **Harshad Mehta Scam**

24,000 Crore valuation today

New India Assurance Company

Grow More Research

Minimum Balance of Government Bonds

ACC- Rs. 200 to Rs. 9000

Sucheta Dalal from TOI

### **Ketan Parekh**

Circular Trading – BADLA System

Pump and Dump

Pay Order of 1.3 Million from Madhavapura Mercantile Commercial Bank

### **Satyam Case**

India's Biggest Accounting Fraud

Indian Version of Enron Shock

Fraud of Rs. 7,000 Crores

1987 Formation - 1991 Listing in BSE, oversubscribed 17 times

Merger of Matyas - 7,561 fake bills were created as identified by PWC

### **Other Honorary Mentions**

Saradha Scam – Sudipta Sen-Chairman – Ponzi Scheme

National Spot Exchange Limited – Jignesh Shah and Shreekant Javalgekar– Rs. 5,600

Nirav Modi Scam – Punjab National Bank – Rs. 11,300 Crores (Latest and Largest Banking Fraud ) – Letters of Undertakings

Connection of Nirav Modi to Mehul Choksi

**Euro Currency  
Markets &  
International Bond  
Market**

## **What are International Bonds?**

International bonds are bonds issued by a country or company that is not domestic for the investor.

An international bond is a debt obligation that is issued in a country by a non-domestic entity. Generally, it is denominated in the currency of its issuer's native country. Like other bonds, it pays interest at specific intervals and pays its principal amount back to bondholder at maturity.

International bonds are generally corporate bonds

The international bond market is quickly expanding as companies continue to look for the cheapest way to borrow money. By issuing debt on an international scale, a company can reach more investors. It also potentially helps decrease regulatory constraints.

## **Three Categories of International Bonds**

There are three general categories for international bonds: domestic, euro, and foreign. The categories are based on the country (domicile) of the issuer, the country of the investor, and the currencies used.

**Domestic bonds:** Issued, underwritten and then traded with the currency and regulations of the borrower's country.

Example: A British company issues debt in the United Kingdom with the principal and interest payments based or denominated in British pounds.

**Foreign bonds:** Issued in a domestic country by a foreign company, using the regulations and currency of the domestic country.

Example: A British company issues debt in the United States with the principal and interest payments denominated in dollars.

**Eurobonds:** Underwritten by an international company using domestic currency and then traded outside of the country's domestic market.

Example: Eurobonds: A British company issues debt in the United States with the principal and interest payments denominated in pounds.

### **Dollar-denominated Bonds**

Dollar-denominated bonds are issued in US dollars and offer investors more choices to increase diversity. The two types of dollar-denominated bonds are Eurodollar bonds and Yankee bonds. The difference between the two bonds is that Eurodollar bonds are traded outside of the domestic market while Yankee bonds are issued and traded in the US.

**1. Eurodollar bonds:** Eurodollar bonds are the largest component of the Eurobond market. A Eurodollar bond must be denominated in U.S. dollars and written by an international company. Since Eurodollar bonds are not registered with the SEC, they can not be sold to the U.S. public. However, they can be traded on the secondary market. Even though many portfolios do include Eurodollar bonds in U.S. portfolios, U.S. investors do not participate in the primary market for such bonds. Therefore, the primary market is dominated by foreign investors.

**2. Yankee bonds:** Yankee bonds are another type of dollar-denominated bonds. However, unlike the Eurodollar bonds, the Yankee bonds' target market is within the U.S. These bonds are issued by a foreign company or country that has registered with the Securities and Exchange Commission (SEC). Since Yankee bonds are meant to be purchased by U.S. citizens in the primary market, they must follow regulations set by the SEC. For example, the company issuing the bond needs to be financially stable and capable of making payments throughout the period of the bond.

### **Non-Dollar-denominated Bonds**

Non-dollar-denominated international bonds are all the issues denominated in currencies other than the dollar. Since there is currency volatility, U.S. investors face the question of whether to hedge their currency exposure. The different types of non-dollar-denominated bonds depend on the domicile of the issuer and the location of the primary trading market. The three major types are the domestic market, the foreign market, and the Euro market.

**1. Domestic market:** The domestic market includes bonds that are issued by a borrower in their home country using that country's currency. Domestic markets have seen significant growth for several reasons. First of all, for companies, issuing debt in the domestic currency allows them to better match liabilities with assets. By doing so, they also don't need to worry about the currency exchange risk. Also, by issuing debt in dollar-denominated markets and the domestic market, companies gain access to more investors. This allows them to obtain a better borrowing rate.

**2. Foreign market:** The foreign bond market includes the bonds that are sold in a country, using that country's currency, but issued by a non-domestic borrower. For example, the Yankee bond market is the U.S. dollar version of this market. This is because they are sold in the U.S. using the dollar, but issued by a syndicate outside of the U.S. Other examples include the Samurai market and the Bulldog market. The Samurai market is Yen-

denominated bonds issued in Japan but by non-Japanese borrowers. The Bulldog market is pound-denominated bonds issued in the U.K. by non-British groups.

**3. Euro market:** Securities that are issued into the international market are called Eurobonds. This market encompasses all the bonds that are not issued in a domestic market and can be issued in any currency. Eurodollar bonds are an example of a U.S. dollar-denominated version of a Eurobond as they are sold in the international markets.

Most of the time, the bonds are written by an international syndicate and sold in several different national markets simultaneously. Issuers of Eurobonds include international corporations, supranational companies, and countries.

### **Foreign Currency Convertible Bonds(FCCBs)**

Foreign currency convertible bond is a special type of bond issued in the currency other than the home currency. In other words, companies issue foreign currency convertible bonds to raise money in foreign currency.

In today's scenario of globalization, FCCBs hold high significance especially for multinational companies wherein they are constantly dealing with different currencies of the world.

### **Features of FCCBs**

Like any other type of bond, an FCCB makes regular coupon and principal payments till a certain date, after which it can be converted into equity.

FCCBs retain all the features of a convertible bond and hence remain attractive to both issuers and investors.

Another attractive feature of FCCBs is that these are equity-linked debt securities which give the holder the right to convert the bond into equity or a depository receipt (DR) after a certain period of time.

FCCBs are tradable on the stock exchange.

Like any other debt raising instrument, FCCBs appear on the liabilities side of the balance sheet of the company issuing them.

### **Advantages of FCCBs**

FCCBs issuance allows companies to raise money outside the home country there by enabling tapping new markets for investment options

FCCBs are generally issued by companies in the currency of those countries where interest rates are usually lower than the home country or the foreign country economy is more stable than the home country economy.

FCCB holders may choose to convert the bonds into equity to benefit out of the equity price appreciation that may have taken place.

FCCB holders enjoy the safety of guaranteed payments on the bond and may opt to continue with the bond if equity or depository receipt if conversion isn't more beneficial.

Since these bonds come with an advantage to the bond holder, the coupon payments on these bonds are usually lower than a straight coupon bearing plain vanilla bond. This helps the issuer to reduce the cost of borrowing.

Exchange rate fluctuations in favour of the issuer can further reduce the cost of debt capital.

The conversion of FCCBs into equity usually happens at a price already decided at the time of issuance and is usually at a premium, so dilution of the company is lower.

### **Disadvantages of FCCBs**

Companies that borrow funds via FCCB in foreign currency shall have to make the repayment in foreign currency on the maturity of the bond. The exchange rate prevailing on the day of maturity, if has moved considerably as compared to the rate prevailing on the day of the borrowing, may result in losses for the company. The exchange rate in a volatile scenario may cause cash outflows on repayment to be much higher than the saving in the interest rate. Thus, a cost-saving motive may be totally taken off if home currency depreciates beyond the interest rate saving.

FCCBs continue to remain on the books of accounts as a debt until the time it is converted and continues to hamper the debt to equity ratio and other debt and interest service coverage ratios

Issuing bonds in foreign currency in a foreign market may always be exposed to a legal, political and economic risk of that foreign country. One may have much better idea about the macro-economic conditions of the home country compared to those in a foreign country.

If the stock prices do not appreciate and instead depreciate, the bond holders might refrain from converting bonds to equity and the money might have to be repaid by the issuer on bond maturity. Hence, if the company is going through a bad phase, the stocks may not do well and therefore, may not be converted to equity by FCCB holders. In such a scenario, the already troubled company may face an additional burden of interest and principal repayment to be made to the bondholders. Hence, an FCCB may be suitable in a bull market scenario and may be affected by bear market phases.

### **Foreign Currency Exchangeable Bonds (FCEBs)**

The Union Finance Minister in his budget speech of 2007-08 had proposed the introduction of FCEBs.

Pursuant to the announcement, the RBI (Reserve Bank of India) initially issued guidelines with respect to such bonds in form of a scheme being the issue of Foreign Currency Exchangeable Bonds Scheme, 2008 (Scheme).

Thereafter, the Scheme was notified in February 2009 by amendments to the Foreign Exchange Management Regulations with retrospective effect from September 2008.

### **What is FCEB**

A bond expressed in foreign currency.

The principal and the interest of which is payable in foreign currency.

The issuer of the bond is an Indian company.

The bonds are subscribed by a person resident outside India.

The bonds are exchangeable into equity shares of another company which is also called the offered company.

It may be noted that issuing company is to be the part of promoter group of offered company and the offered company is to be listed and be eligible to receive foreign investment.

### **Issue of FCEBs**

Issue of foreign currency exchangeable bonds (FCEB) are regulated by Foreign Currency Exchangeable Bond Scheme 2008 issued by Ministry of Finance, Department of Economic Affairs.

The launch of the FCEB scheme affords a unique opportunity for Indian promoters to unlock value in group companies. FCEBs are another arrow in the quiver of Indian promoters to raise money overseas to fund their new projects and acquisitions, both Indian and global, by leveraging a part their shareholding in listed group entities.

An FCEB involves three parties: The issuer company, offered company (OC) and an investor.

Under this option, an issuer company may issue FCEBs in foreign currency, and these FCEBs are convertible into shares of another company (offered company) that forms part of the same promoter group as the issuer company.

For example, company ABC Ltd issues FCEBs, then these FCEBs will be convertible into shares of company XYZ Ltd that are held by company ABC Ltd and where companies ABC Ltd and XYZ Ltd form part of the same promoter group.

Thus FCEBs are exchangeable into shares of offered company. They have an inherent advantage that it does not result in dilution of shareholding at the offered company level.

### **Differences between FCCBs and FCEBs**

Foreign Currency Convertible Bonds (FCCBs) mean a bond issued by an Indian company expressed in foreign currency, and the principal and interest in respect of which is payable in foreign currency.

Further, the bonds are required to be issued in accordance with the scheme viz., "Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993", and subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part, on the basis of any equity related warrants attached to debt instruments

Foreign Currency Exchangeable Bond (FCEB) means a bond expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency, issued by an Issuing Company and subscribed to by a person who is a resident outside India, in foreign currency and exchangeable into equity share of another company, to be called the Offered Company, in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments.

The FCEB must comply with the “Issue of Foreign Currency Exchangeable Bonds (FCEB) Scheme, 2008”, notified by the Government of India, Ministry of Finance, Department of Economic Affairs vide Notification G.S.R.89(E) dated February 15, 2008.

1. Unlike an FCCB which is convertible into new shares of the issuing company, an FCEB is convertible into existing shares of the offered company held by the issuing company.
2. The shares issued on conversion of FCCB would be issued a fresh by issuing company on conversion, whereas when the investor in FCEB want shares in exchange, he has to approach to issuing company which has already hold shares of offered listed company.
3. The Company that issue FCCB and the Company that issue shares on conversion are same and whereas in case of FCEB the Company that issue FCEB and the Company whose shares are offered on exchange will be different but should belong to the same promoter group.
4. FCCBs are issued by an Indian Company to a person resident outside India giving them an option to convert them into shares of the company at a pre determined price. On the other hand, FCEBs are issued by Indian Investment Company or Holding Company of a group to non-resident which are exchangeable for the shares of aspecified group company at a pre determined price.
5. In case of FCCBs issue, there is a change in the shareholding of issuing company on the other hand, in case of FCEBs issue there is no changes in the shareholding of issuing company.

### **Eurocurrency Market**

Euro-Currency Market is described as an international financial market which specializes in borrowing and lending of currencies, from/to residents and non-residents, outside the country of issue of the currencies.

This market consists of specific banking operations of accepting deposits and giving loans in non-resident currencies.

### **Reasons for growth of Eurocurrency Market**

Cold War

Vietnam War

Flow of US Aid

Decline in the importance of Pound Sterling

Regulation Q of Federal Reserve Act

Regulation M of Federal Reserve Act

Mandatory requirement of banks

Interest Equalization Tax 1963

Voluntary Restraint Program 1965

Petrodollars

BOP deficit of USA

Innovative Banking

### **Features of Eurocurrency Market**

Transactions take place outside the country of origin of that currency

Transactions are held in the country of issue

Fall outside the regulatory and supervisory control of the monitoring authority in the country of origin

Euro-currency markets is different from foreign exchange markets

Market which deal with freely convertible currencies

Euro-banks are exposed to both liquidity and interest-rate risk due to unsecured and short and long term deposits and loans

LIBOR-London Interbank Offered Rate

LIBOR and MARKUP

### **Euro-Currency Deposits Market**

Deposits placed with the banks in currencies outside their home country

The deposits are normally accepted for a period of one day to one year

The minimum size of deposit is USD 50,000 or equivalent in other currencies

The deposits are unsecured and un-insured

The deposits are not subject to any regulatory control in the form of reserve requirements, interest rate ceilings etc

### **Euro-Currency Loan/Credit Market**

Euro-credits are provided for a period of short and medium term i.e. 5-8 months

The market operates on wholesale basis

Euro-credits are provided on a syndicated basis to distribute credit risk

They provide revolving credit or term loans

They provide flexibility of borrowing with multi-currency options which reduces exchange rate risk and cost of borrowing

They are drawn in stages as per the project requirement – drawdown schedule in loan agreement

They are always given on floating rate basis and rolled over normally on 6 monthly basis

They provide for pre-payment of the loans without commitment charges at the time of periodic roll overs

## **London Interbank Offered Rate-LIBOR**

A benchmark to gauge the cost of unsecured borrowing in the global interbank market

It represents average rate at which a bank can obtain unsecured funding in a given currency for a period of time

British Bankers' Association with the help of Euro-Banks contribute to interest rate for 10 currencies and 15 maturities for overnight to one year

The rates are traded at 11 am everyday

The list is made top to bottom (25% of which is removed to eliminate extreme) and remaining represents "LIBOR FIXING"

150 LIBOR calculations on every trading day (10 Currencies \* 15 Maturities)

GBP,USD,JPY,CHF,CAD,AUD,EUR,DKK,SEK and NZD are ten currencies

## **Euro-Currency Bonds Market**

**Straight Bonds** – Bonds providing a fixed coupon rate for a duration with interest paid on half-yearly basis. The bonds have long maturity periods with bullet repayments. These are issued by only those with good credit rating.

**Sinking Fund Bonds** – The repayment of bonds is done in installments which are issues by companies with average credit rating. It helps to reduce interest liability of the issuer.

**Bonds with Options** – These are issued for pre-payment either to issuer or investor. These bonds are of two types- 1) Bonds with Call Option 2) Bonds with Put Option

**Floating Rate Bonds** – Bonds are issued with a variable coupon rate

**Collared Bonds** – Bonds which provide for both ceiling and floor rates of interest

**Junk Bonds** – Companies with very poor credit or entering into high risk business ventures for short term gains on temporary surplus liquidity

**Zero Coupon Bonds** – issued at discount to face value whereas the redemption takes place on maturity at face value: the difference represents capital gains

**Deep Discount Bonds** – issued at discount to face value whereas the redemption takes place on maturity at face value: the difference represents interest income to the investor

## **Eurocurrency/Offshore Notes Market**

Instruments of borrowing issued by borrowers directly to investors without using banks as intermediaries with or without the underwriting support for the issues from 15 days to 5 years

## **INSTRUMENTS USED IN NOTES MARKETS**

**Commercial Paper:** The short term security issued for maturity of less than one year without underwriting support from the banks.

**Note Issuance Facility (NIF):** The borrowing entity requires resources for the medium term but investors desire to invest on short term basis, the reconciliation is achieved through this mechanism.

**Medium Term Notes (MTN):** The medium term, fixed interest rate instruments issued without underwriting support from banks for a period from one to ten years.

**Bankers Acceptance(BA):** The borrower importing project requirements on credit basis, gets the Bill of Exchange “accepted” by the bank.

**Repurchase Obligations (REPO):** The borrower “sells” securities to the lender with the commitment to “repurchase” the same at predetermined rate on a fixed future date.

### **Offshore Banking Units/ Offshore Financial Centers**

Offshore banking involves the securing of assets in financial institutions in foreign countries, which may be limited by the laws of the customer’s home nation, can be used to avoid certain unfavorable circumstances should the funds be kept in a financial institution in the home nation. This can include the avoidance of tax obligations as well as making it more difficult for these assets to be seized by a person or entity in the home nation.

For those who work internationally, the ability to save and use funds in a foreign currency for international dealings can be a benefit, which can provide a simpler way to access funds in the needed currency without the need to account for rapidly changing exchange rates. Because banking regulations vary from nation to nation, it is possible the country in which offshore banking is conducted does not offer the same protections as other nations.

Offshore Banking can be defined on the basis of two dimensions

- Location
- Currency Denomination

Offshore financial centers are lightly regulated, generally having no or very low tax implications which make it suitable to lend a cheaper rate thus becoming an attractive destinations of investment

Offshore centers provide service to a foreign entity/ external financial intermediation

### **Advantages of Offshore Banking**

#### **TO THE HOST COUNTRY**

Business Opportunity

Additional Income for the banks

Foreign Exchange inflows

Development of Infrastructure

#### **TO THE NON-RESIDENT CLIENTS**

Stable location to park funds

Offer better interest on deposits

Also act as tax havens

Provide services at low cost

Promotes more privacy and less legal regulations

## **DISADVANTAGES OF OFFSHORE BANKING**

Financial crimes and Money Laundering

Problem for countries from where the money is diverted

Capital flight leading to volatility and uncertainty in the market

Tax evasion

### **Tax Havens**

A tax haven, or offshore financial center, is any country or jurisdiction that offers minimal tax liability to foreign individuals and businesses. Tax havens do not require businesses to operate out of their country or the individuals to reside in their country to receive tax benefits.

There is no universal definition, but tax havens, or offshore financial centers, are generally countries or places with low or no corporate taxes that allow outsiders to easily set up businesses there. Tax havens also typically limit public disclosure about companies and their owners. Because information can be hard to extract, tax havens are sometimes also called secrecy jurisdictions. Tax havens nearly always deny being tax havens.

### **Where are these tax havens?**

All over the world. Some are independent countries, like Panama, the Netherlands and Malta. Others are within countries, like the U.S. state of Delaware, or are territories, like the Cayman Islands.

ICIJ investigations have focused on different tax havens, often depending on the origin and content of documents. Panama Papers, for example, exposed how Mossack Fonseca, one of the biggest offshore law firms in the world, sold thousands of shell companies in the British Virgin Islands to clients around the globe. Mauritius Leaks examined how companies used Mauritius to avoid taxes, while Paradise Papers revealed the secrets of Bermuda, the island where the law firm Appleby was founded.

Some tax havens, like Niue and Vanuatu, have cleaned up their act under international pressure while others, like Dubai, are emerging as new hotspots of illicit wealth.

### **Why would a country, or state, decide to become a tax haven?**

Money. Tax havens make significant income from fees paid by people and companies who create and use shell companies. Tax havens also create work for lawyers, accountants and secretaries. Mauritius, for example, has said 5,000 people would lose jobs if the country stopped being a tax haven.

### **What is a 'shell' company?**

A shell company is a legal entity created in a tax haven. Shell companies typically exist only on paper, with no full-time employees, and no office. A single office building in the Cayman

Islands, for example, is home to 19,000 shell companies. Rules differ, but the actual owners of many shells are not disclosed in incorporation documents. Some use the term “shell company” and “offshore company” interchangeably.

### **How Governments Earn Money From Tax Havens**

Tax havens are not completely tax-free. They charge a lower tax rate than other countries. Low tax jurisdictions generally charge high customs or import duties to cover the losses in tax revenues.

Tax havens may charge a fee for new registration of companies and renewal charges to be paid every year. Additional fees may also be charged such as license fees. Such fees and charges would add up to a recurring fixed income for the tax havens.

By attracting foreign individuals or businesses, even if they are only charged a nominal tax rate, the country may earn substantially more in tax revenues than it would otherwise. Also, the country may benefit from corporate investments in business operations that offer jobs to the country’s residents.

### **Benefits to a Tax Haven**

**Tax Haven Countries** benefit by way of attracting capital to their banks and financial institutions, which can then be used to build a thriving financial sector.

**Individuals or Businesses** benefit by saving tax, which in tax haven countries may range from zero to low single digits compared to high taxes in their country of citizenship or domicile.

### **Top Tax Havens in the World**

**Bermuda** – Declared the world’s worst (or best if you’re looking to avoid taxation) corporate tax haven in 2016 by Oxfam with a zero percent tax rate and no personal income tax.

**Netherlands** – Most popular tax haven among the world’s Fortune 500. The government uses tax incentives to attract businesses to invest in their country. One such tax incentive cost an estimated 1.2 billion euros in 2016 to the Netherlands.

**Luxembourg** – It gives benefits such as tax incentives and zero percent withholding taxes.

**Cayman Islands** – No personal income taxes, no capital gains taxes, no payroll taxes, no corporate taxes, and the country does not withhold taxes on foreign entities.

**Singapore** – Charges reasonable nominal corporate taxes. Reasonable corporate tax rates are provided through tax incentives, lack of withholding taxes, and what appears to be substantial profit shifting.

**The Channel Islands** – No capital gains taxes, no council taxes, and no value-added taxes.

**Isle of Man** – No capital gains tax, turnover tax, or capital transfer tax. It also imposes a low income tax, with the highest rates at 20%.

**Mauritius** – Low corporate tax rate and no withholding tax.

**Switzerland** – Full or partial tax exemptions, depending on the bank used.

**Ireland** – Referred to as a tax haven despite officials asserting that it is not. Apple discovered that two of the company’s Irish subsidiaries were not classified as tax residents in the United States or Ireland, despite being incorporated in the latter country.

### **Top Companies That Benefit From Tax Havens**

**Apple** – The amount booked offshore is \$214.9 billion. It uses Ireland as a tax haven. Apple would have owed the U.S. government \$65.4 billion in taxes if tax haven benefits were not used.

**Nike** – It holds \$10.7 billion offshore. It uses Bermuda as a tax haven. It would have paid \$3.6 billion for taxes if tax haven benefits were not used. This implies Nike pays a mere 1.4% tax rate to foreign governments on those offshore profits, indicating that nearly all of the money is officially held by subsidiaries in tax havens.

**Goldman Sachs** – It holds \$28.6 billion offshore and uses Bermuda as a tax haven.

Some of the 50 biggest U.S. companies that have stashed approximately \$1.6 trillion offshore include Microsoft, IBM, General Electric, Pfizer, Exxon Mobil, Chevron, Walmart. These 50 companies earned over \$4.2 trillion in profits globally, but they used offshore tax havens to lower their effective overall tax rate to just 25.9%, which was well below the U.S. statutory rate of 35% and even lower than the average levels paid in other developed countries.

### **Offshore Banking in India**

#### **OFFSHORE BANKING IN THE INDIAN CONTEXT**

India has made a cautious beginning in offshore banking by permitting for the first time Offshore Banking Units (OBUs) to be set up in Special Economic Zones (SEZs). The SEZs have been set up with a view to providing an internationally competitive and hassle free environment for export production.

SEZs will be specially delineated duty free enclave and deemed to be a foreign territory for the purpose of trade operations and duties / tariffs so as to usher in export-led growth of the economy. The OBUs virtually would be foreign branches of Indian banks located in India.

These OBUs, inter alia, would be exempt from reserve requirements and provide access to SEZ units and SEZ developers to international finances at international rates.

The Reserve Bank of India (RBI) has permitted banks operating in India, whether Indian, public/private sector or foreign, to set up OBUs in the SEZs.

The OBUs would carry out essentially wholesale banking operations. The OBUs will be set up as branches of the banks and therefore no separate assigned capital will be required. All prudential norms applicable to overseas branches of Indian Banks would apply to OBUs.

Thus, the necessary risk management practices that are in vogue internationally would have to be adopted by the OBUs. The OBUs will be regulated and supervised by RBI. They will be required to scrupulously follow “Know Your Customer” and other anti- Money laundering directives of RBI from time to time.

### **Features Of Offshore Banking In India**

They will be permitted to be set up in Special Economic Zones.

These banks will be virtually (almost) foreign branches of the banks but located in India.

The Overseas Banking Units (OBUs) would be exempted from CRR, SLR etc.

The OBUs would operate and maintain balance sheet only in foreign currency and would not be allowed to deal in Indian Rupees except for having a special Rupee account to meet their day to day expenses. These branches will not be allowed to participate in domestic call and money market etc.

These accounts can be opened by Non-Resident Individuals, Corporates, Trusts or Offshore companies.

### **Financial Services By Offshore Banking In India**

Acceptance of Multi-Currency Deposits

Multi-Currency borrowing option

Loans against deposits in foreign currency

Derivatives products

Issuance of L/C, Bank Guarantee, Bill Discounting and collection & negotiation of trade bills

Long term finance and short term finance (working capital) in all countries

External Commercial Borrowings (ECB) etc.

### **Statistics Concerning Offshore Banking**

Offshore banking is an important part of the international financial system. Experts believe that as much as half the world's capital flows through offshore centers.

Tax havens have 1.2% of the world's population and hold 26% of the world's wealth, including 31% of the net profits of United States multinationals.

According to Merrill Lynch and Gemini Consulting's "World Wealth Report" for 2000, one third of the wealth of the world's "HIGH NET-WORTH INDIVIDUALS"—nearly \$6 trillion out of \$17.5 trillion—may now be held offshore. Some \$3 trillion is in deposits in tax haven banks and the rest is in securities held by international business companies (IBCs) and trusts.

The IMF has said that between \$600 billion and \$1.5 trillion of illicit money is laundered annually, equal to 2% to 5% of global economic output.

Today, offshore is where most of the world's drug money is allegedly laundered, estimated at up to \$500 billion a year, more than the total income of the world's poorest 20%.

Add the proceeds of tax evasion and the figure skyrockets to \$1 trillion. Another few hundred billion come from fraud and corruption.

"These offshore centers awash in money are the hub of a colossal, underground network of crime, fraud, and corruption" commented Lucy Komisar quoting these statistics.

Among offshore banks, Swiss banks hold an estimated 35% of the world's private and institutional funds (or 3 trillion Swiss francs), and the Cayman Islands (1.9 trillion US dollars in deposits) are the fifth largest banking centre globally in terms of deposits.

# **Obstacles to International Investment**

## **MEANING OF INTERNATIONAL TAX ENVIRONMENT**

International taxation is the study of tax on a person or business subject to the tax laws of different countries or the International aspects of an individual country's tax laws.

Systems of taxation vary among governments, making generalization difficult. Specifics are intended as examples, and relate to particular governments and not broadly recognized multinational rules. Taxes may be levied on varying measures of income, including but not limited to net income under local accounting concepts (in many countries this is referred to as "profit"), gross receipts, gross margins (sales less costs of sale), or specific categories of receipts less specific categories of reductions. Unless otherwise specified, the term "income" should be read broadly.

Jurisdictions often impose different income based levies on enterprises than on individuals. Entities are often taxed in a unified manner on all types of income while individuals are taxed in differing manners depending on the nature or source of the income. Many jurisdictions impose tax at both an entity level and at the owner level on one or more types of enterprises. These jurisdictions often rely on the company law of that jurisdiction or other jurisdictions in determining whether an entity's owners are to be taxed directly on the entity income. However, there are notable exceptions, including U.S. rules characterizing entities independently of legal form.

In order to simplify administration or for other agendas, some governments have imposed "deemed" income regimes. These regimes tax some class of taxpayers according to tax system applicable to other taxpayers but based on a deemed level of income, as it earned by the taxpayer. Disputes can arise regarding what levy is proper. Procedures for dispute resolution vary widely and enforcement issues are far more complicated in the international arena. The ultimate dispute resolution for a taxpayer is to leave the jurisdiction, taking all property that could be seized. For governments, the ultimate resolution may be confiscation of property, incarceration or dissolution of the entity.

Other major conceptual differences can exist between tax systems. These include, but are not limited to, assessment vs. self-assessment means of determining and collecting tax; methods of imposing sanctions for violation, sanctions unique to international aspects of the system; mechanisms for enforcement and collection of tax; and reporting mechanisms.

### **Taxation System**

Countries that tax income generally use one of two systems:

1 Territorial

2 Residential

### **Territorial System**

In the territorial system, only local income from a source inside the country - is taxed

### **Residential System**

In the residential system, residents of the country are taxed on their worldwide local and foreign) income, while non-residents are taxed only on their local income.

In addition, a very small number of countries, notably the United States, also tax their non resident citizens on worldwide income

Countries with a residential system of taxation usually allow deductions or credits for the tax that residents already pay to other countries on their foreign income. Many countries also sign tax treaties with each other to eliminate or reduce double taxation. In the case of corporate income tax, some countries allow an exclusion or deferment of specific items of foreign income from the base of taxation

## **OBJECTIVES OF TAXATION**

Two basic objectives of taxation are -

Tax Neutrality and

Tax Equity

### **A. Tax Neutrality**

Tax neutrality has its foundations in the principles of economic efficiency and equity. Tax neutrality is determined by three criteria.

Capital-Export Neutrality

National Neutrality

Capital-Import Neutrality

#### **Capital-export neutrality**

Capital-export neutrality is the criterion that an ideal tax should be effective in raising revenue for the government and not have any negative effects on the economic decision-making process of the taxpayer. That is, a good tax is one that is efficient in raising tax revenue for the government and does not prevent economic resources from being allocated to their most appropriate use no matter where in the world the highest rate of return can be earned. Obviously, capital-export neutrality is based on worldwide economic efficiency.

#### **National Neutrality**

Second neutrality criterion is national neutrality. That is, taxable income is taxed in the same manner by the taxpayer's national tax authority regardless of where in the world it is earned. In theory, national tax neutrality is a commendable objective, as it is based on the principle of equality. In practice, it is a difficult concept to apply. In the United States, for example, foreign-source income is taxed at the same rate as U.S.-earned income and a foreign tax credit is given against taxes paid to a foreign government. However, the foreign tax credit is limited to the amount of tax that would be due on that income if it were earned in the United States. Thus, if the tax rate paid on foreign-source income is greater than the U.S. tax rate, part of the credit may go unused. Obviously, if the U.S. tax authority did not limit the foreign tax credit to the equivalent amount of U.S. tax, U.S. taxpayers would end up subsidizing part of the tax liabilities of U.S. MNCs' foreign earned income.

#### **Capital-Import Neutrality**

The third neutrality criterion is capital-import neutrality. To illustrate this criterion implies that the tax burden a host country imposes on the foreign subsidiary of a MNC should be the same regardless of the country in which the MNC is incorporated and the same as that placed on domestic firms. Implementing capital-import neutrality means that if the U.S. tax rate were greater than the tax rate of a foreign country in which a U.S. MNC earned foreign income, additional tax on that income above the amount paid to the foreign tax authority would not be due in the United States. The concept of capitalimport neutrality, like national neutrality, is based on the principle of equality, and its implementation provides a level competitive playing field for all participants in a single marketplace, at least with respect to taxation. Nevertheless, implementing capitalimport neutrality means that a sovereign government follows the taxation policies of foreign tax authorities on the foreign-source income of its resident MNCs and that domestic taxpayers end up paying a larger portion of the total tax burden. Obviously, the three criteria of tax neutrality are not always consistent with one another.

## **B. Tax Equity**

The underlying principle of tax equity is that all similarly situated taxpayers should participate in the cost of operating the government according to the same rules. Operationally, this means that regardless of the country in which an affiliate of a MNC earns taxable income, the same tax rate and tax due date apply. A dollar earned by a foreign affiliate is taxed under the same rules as a dollar earned by a domestic affiliate of the MNC. The principle of tax equity is difficult to apply; the organizational form of a MNC can affect the timing of a tax liability.

## **Tax Haven**

1 A tax haven is a country that offers foreign individuals and businesses a minimal tax liability in a politically and economically stable environment, with little or no financial information shared with foreign tax authorities.

2. Tax havens do not require individuals to reside in or businesses to operate out of their countries to benefit from local tax policies.

3. Due to the globalization of business operations, an increasing number of U.S. corporations, including Microsoft, Apple and Alphabet, are keeping cash in offshore tax havens to minimize corporate taxes.

4. Tax haven status benefits the host country as well as the companies and individuals maintaining accounts in them,

5 Tax haven countries benefit by drawing capital to their banks and financial institutions, which can form the foundation of a thriving financial sector.

6. Individuals and corporations benefit through tax savings resulting from tax rates ranging from zero to the low single digits versus relatively high taxes in their countries of citizenship or domicile.

7. The list of tax haven countries includes Andorra, the Bahamas, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, the Channel Islands, the Cook Islands, Hong Kong, The Isle of Man, Mauritius, Lichtenstein, Monaco, Panama, and St. Kitts and Nevis.

## **Benefits of Offshore Tax Havens**

The advantages of tax havens include the following:

### **1. Minimal or No Taxes**

The most common reason why individuals and corporations seek tax havens is to minimize their tax liability. The undeniable fact is that most countries use progressive taxation systems which unfairly tax high earners. In such countries, there is no legal way to minimize taxes.

Offshore tax havens provide the perfect remedy for minimizing taxes. This is because these tax havens tend to have extremely low or even non-existent taxes. A perfect example of this is the Cayman Islands. This tiny British territory has a law which permits corporations to be formed and own assets without paying any taxes.

As a result, the Cayman Islands has no corporate tax. This has made it a favored offshore location for multinationals. In fact, many Fortune 500 companies have subsidiaries in the Cayman, which they use to legally - minimize their tax bill.

Other tax havens have similar laws to the Cayman Islands. Most of them don't have a corporate tax, capital gains tax, personal income tax, inheritance tax, gift tax, and even stamp duty. Some like Ras Al Khaimah (RAK) don't have any personal or corporate taxes. This basically means that those who have companies in such tax havens don't incur the cost of taxes.

The minimal or zero taxes make offshore tax havens perfect for individuals who are eager to reduce their tax bill. It makes them especially great for companies which desire to maximize profits or start-ups which desire to minimize costs. The absence of taxes means that such corporations can meet their goals with ease.

### **2. Maximum Privacy**

Offshore tax havens provide maximum privacy for individuals and corporations. This is because most of them don't keep publicly accessible company or bank account information. As such, individual or company assets channeled through the haven are safe from prying eyes.

In Bermuda, for instance, it is illegal for banks to release the details of account holders to third parties. Not even the government of Bermuda can access this information. This means that those who keep their funds in Bermuda are 100% assured of their privacy.

Another great example of offshore tax haven privacy is Ras Al Khaimah (RAK). In RAK, there is no public registry of companies. There is also no available record of company shareholders and directors. As such, it is virtually impossible to know which companies are operating there. This can protect a company and its directors from a public backlash following revelations of their use of the tax haven.

Such a level of privacy isn't available in European tax havens like Ireland and Luxembourg. The information on companies using such tax havens is readily available. Over the past year, Amazon and Google have come under fire for channeling their funds through Luxembourg and Ireland respectively and have had to pull out due to a public backlash. Such a backlash cannot occur in an offshore tax haven because it is virtually impossible for such

information to come out. Therefore, any individual or company looking for the most secretive avenue for keeping their money would be best served by an offshore tax haven.

### **3. Security**

Security is a big deal for anyone searching for a tax haven. This is because in the US and most EU countries, not paying due taxes is a crime. Being found out can lead to hefty fines and other punishments. As such, people are always looking for the most secure tax havens possible. 52. In this respect, offshore tax havens are the most secure tax havens in the world. There are two reasons for this. The first is that offshore havens are often outside the jurisdiction of US and EU regulatory authorities. As such, they are outside the reach of the EU, US Internal Revenue Service, OECD, FAFT and similar bodies,

This means that even if these agencies and bodies suspect an individual or company of storing the assets in the tax haven, it is difficult for them to investigate. This is because they don't have access to the relevant financial

The second reason is that most offshore tax havens usually don't have Double Taxation Exchange Agreements (TIEAs) with the EU and US. As such, there is no legal framework for them to apply pressure on the tax havens if they suspect that their citizens are using them to avoid taxes. This basically reduces the likelihood of those who use offshore tax havens of ever being found out

### **4. Convenience**

The greatest advantage of offshore tax havens is that they are extremely convenient to use. Setting up an offshore company is incredibly easy. In most tax havens, the process can be completed within 2 to 4 working days. The cost of registration is extremely low, with some tax havens making it possible to register a company for \$500 or less. To make it even more convenient, most tax havens make it possible for people to register companies without even visiting the country.

The convenience isn't just at registration level. Tax havens typically make operating offshore companies extremely easy. For instance, in RAK, companies don't have to prepare and submit tax returns. There are also no exchange controls – meaning that moving money in and out of accounts is hustle-free. Many offshore tax havens have similar features which are designed to simplify starting and operating businesses.

The bottom line is that offshore tax havens offer a number of benefits to both individuals and corporations. The exact benefits actually vary from one tax haven to another. To get a clearer picture of what offshore tax havens typically offer here is a brief look at a few of them.

## **Tax Havens Countries**

### **1. Cayman Islands**

This is one of the most popular offshore tax havens. The Cayman Islands is popular because its law permits corporations to be formed and hold assets without paying any taxes. This means that any assets stashed away in the Cayman Islands are basically untaxed. This is precisely why Fortune 500 companies channel their profits there and save billions of dollars in corporate taxes.

The Cayman Islands are best suited for corporations or individuals with costly assets. It is especially suited for those from jurisdictions which levy high taxes on assets. The Cayman Islands can provide a safe avenue for owning assets without incurring taxes.

## **2. Bahamas**

The Bahamas is also a renowned tax haven. This is thanks to its lack of personal income tax, capital gains tax, gift tax, and inheritance tax. This makes it extremely popular with both corporations and individuals. According to the Citizens for Tax Justice, around 5% of Fortune 500 companies have subsidiaries in the Bahamas.

The Bahamas is best suited for wealthy individuals eager to minimize their taxes. It is especially perfect for older people who are eager to limit taxes on the inheritance due to their children. The absence of inheritance and gift tax means that they can give away their money without significant portions of it being siphoned off in taxes.

## **3. Bermuda**

This is another popular offshore tax haven. This is because it offers two advantages. First of all, it levies no corporate tax at all. Secondly, its banks have a reputation for secrecy which rivals that of Swiss banks. These two factors have made Bermuda a prime choice for US companies. According to Citizens for Tax Justice, in 2014, almost 25% of all Fortune 500 companies had subsidiaries in Bermuda.

Bermuda's zero corporate tax makes it perfect for both existing corporations and startups. This can reduce operational costs which could have been spiked by corporate taxes. Its secretive banking culture also makes it perfect for individuals who want to protect their wealth from prying eyes.

## **4. Mauritius**

Mauritius is a popular tax haven for companies which are targeting the Indian market. This is thanks to its strategic location in the Indian Ocean. However, its location aside, it is the country's tax laws which make it popular.

Unlike other offshore tax havens, Mauritius actually levies a 15% corporate tax. However, companies' resident on the island can benefit from its double tax treaties. This grants tax breaks for almost all companies originating in the US and EU. To add to the tax breaks, Mauritius also charges no capital gains tax.

Mauritius' strategic location makes it best suited for companies which are targeting the Indian subcontinent. It can provide a safe location from which to run business operations. This makes it perfect for companies eager to expand into India,

## **5. Other Offshore Tax Havens**

In a nutshell, that is a snapshot at some of the popular offshore tax havens the world, Other offshore tax havens include the British Virgin Islands, Belize, Vanuatu, and Seychelles.

## **TAX LIABILITY**

A tax liability is the amount of taxation that a business or an individual incurs based on current tax laws. A taxable event triggers a liability calculation, which is the tax base of the

event multiplied by a tax rate Tax liabilities are incurred due to earning income, a gain on The sale of an asset or other taxable events.

## **Strategies used by the companies to reduce Global tax Liability**

### **1. General Strategies**

A company in a high-tax country can reduce its global tax liability by carrying out highly profitable operations in low-tax jurisdictions while maintaining operations that cost money at home. It must develop strategies for financing such foreign operations without using its own, often already taxed resources. The new, foreign affiliate can then sell what it produces back to the head office, further reducing the mother company's profits.

### **2. Foreign Affiliates**

When starting up a foreign company in a low-tax jurisdiction, the mother company must ensure that it creates a completely separate corporation that will be taxed as a local company. At the same time, the mother company must retain control of the new entity and ensure its financing without transferring money that may already have been taxed or may be taxed when transferred. One way of accomplishing this is to guarantee a loan to the new entity at a foreign bank. The new company will then be self-financing and can start operations and generate profits under a low-tax regime.

### **3. Transfer Pricing**

One of the best ways for a company to reduce global tax liabilities is to let a foreign operation in a low-tax jurisdiction manufacture Products it sells back to the mother company for selling in the home market. The foreign affiliate generates substantial profits that are taxed at a low rate. Companies employing this tactic must be careful to document that the pricing of such transactions, called transfer pricing, is reasonable. The IRS conducts transfer pricing audits to ensure that such | pricing is not inflated to avoid tax.

### **4. Repatriating Profits**

Companies can successfully transfer operations and profits to low tax foreign locations but, at some point, some of these profits must be brought back to the home country to finance local operations, pay dividends and support acquisitions or other financial operations. Revenue classified as income from operations is often taxed at a higher rate than other revenue. As a result, foreign affiliates may pay royalties or dividends to the mother company, allowing it to reduce its tax liability in its own jurisdiction. Companies often hire specialized service providers to advise them on the optimal structures to achieve such benefits.