

Foreign Direct Investment (FDI), Foreign Institutional Investment (FIIs) And International Financial Management

BASIC CONCEPTS AND FORMULAE

1. Introduction

Foreign direct investment (FDI) is that investment, which is made to serve the business interest of the investor in a company, which is in a different national (host country) distinct from the investor's country of origin (home country).

2. Cost Involved

Although FDI improves balance of payments position but it involves following costs for the host country :

- (a) MNCs are reluctant to hire and train local persons.
- (b) Damage to environment and natural resources.
- (c) Higher prices of products.
- (d) Foreign culture infused.

Apart from the above costs, FDI causes a transfer of capital, skilled personnel and managerial talent from the country resulting in the home country's interest being hampered. Further, the objective of maximization of profit of MNCs also leads to deterioration in bilateral relations between the host country and the home country.

3. Benefits Derived

(i) For the Host Country

- (a) Improves balance of payment.
- (b) Faster forward and backward economic linkages.
- (c) Develop a support base essential for quick industrialization.
- (d) Maintain a proper balance amongst the factor of production by supply of scarce resources.

- (e) Make available key raw materials alongwith updated technology and also provide access to continued updation of R & D work.

(ii) **For the Home Country**

- (a) BOP situation improves due to receipt of dividend, royalty, fee for technical services.
- (b) Develop closer political relationships between the home country and the host country, which is advantageous to both.

4. Foreign Institutional Investment

An investor or investment fund that is from or registered in a country outside of the one in which it is currently investing. Institutional investors include hedge funds, insurance companies, pension funds and mutual funds. In Indian context, it refers to outside companies investing in the financial markets of India. International Institutional investors must register with the Securities and Exchange Board of India to participate in the market. One of the major market regulations pertaining to FIIs involves placing limits on FII ownership in Indian companies.

5. Raising of Capital Abroad (ADRs, GDRs, ECBs)

The various sources of international finance are as follows :

- (a) **External Commercial Borrowings:** Mainly it includes commercial bank loans, buyer and supplier's credit credit from official export credit agencies and investment by FIIs in dedicated debt funds. The external commercial borrowing can be obtained and utilized for specified purposes only.
- (b) **International Capital Market:** Lending and borrowing in foreign currencies to finance the international trade and industry has led to the development of international capital market. In international market, International bond is known as a "Euroboard".

6. Instruments of International Finance

The various financial instruments dealt with in the international market are briefly described below :

- **Euro Bonds:** Denominated in a currency issued outside the country of that currency.
- **Foreign Bonds:** Example a British firm placing dollar denominated bonds in U.S.A.
- **Fully Hedged Bonds:** Currency risk eliminated by selling in forward market entire stream of interest and principal payments.

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- **Floating Rate Notes:** Interests are adjusted to reflect the prevailing exchange rate, Not so popular.
- **Euro Commercial Papers:** Designated in US Dollar, they are short-term instruments.
- **Foreign Currency Options:** Provide hedge against financial and economic risk.
- **Foreign Currency Futures:** Obligation to buy or sell a specified currency in the present for settlement at a future dates.

7. Indian Depository Receipts (IDRs)

Like ADRs and GDRs, foreign companies are now available for investments in India in the form of IDRs. Investment in these companies can be made by Indian investors. However, such companies would be required to fulfill a number of guidelines for listing in India through IDRs.

8. International Financial Instruments and Indian Companies

Now Indian Companies have been able to tap global markets to raise foreign currency funds by issuing various types of financial instruments which are as follows :

- (a) **Foreign Currency Convertible Bonds (FCCBs)** – A type of convertible bond issues in a currency different than the issuer's domestic currency. FCCBs are issued in accordance with the guidelines dated 12th November 1993 and as amended from time to time.
- (b) **Global Depository Receipts (GDRs)** – GDR is a depository receipt (a negotiable certificate denominated in US Dollars, representing a non-US company's publicly – traded local currency (Indian rupees) equity shares.
- (c) **Euro-Convertible Bonds (ADRs)** – A Convertible bond is a debt instrument which gives the holders of the bond an option to convert the bond into a predetermined number of equity shares of a company. The payment of interest on and the redemption of the bond will be made by the issuer company in US dollars.
- (d) **American Depository Receipts (ADRs)** – Depository receipts issued by a company in the United States of America (USA) issued in accordance with provisions stipulated by the Securities and Exchange Commission of USA. ADRs are following types:
 - (i) **Unsponsored ADRs** – Issued without any formal agreement between the issuing company and the depository.

(ii) **Sponsored ADRs** – Created by a single depository which is appointed by the issuing company under rules provided in a deposit agreement. These can be further classified into following two types :

- **Restricted** – With respect to types of buyers, which are allowed.
- **Unrestricted** – Issued to and traded by the general investing public in US capital markets.

(e) **Other Sources**

Following are some other sources

- Euro Bonds
- Euro-convertible Zero Bonds
- Euro-bond with Equity Warrants.
- Syndicated Bank Loans.
- Euro Bonds.
- Foreign Bonds
- Euro Commercial Papers
- Credit Instruments.

(f) **Euro-Issues** – In Indian context, it denotes the issue that is listed on a European Stock Exchange. However, subscription can come from any part of the World except India. GDRs and FCCBs are most popular in this category.

9. **Cross Border Leasing**

In this type of leasing, the lessor and the lessee are situated in two different countries. This type of arrangement means more complications in terms of different legal, fiscal, credit and currency requirements and risk involved. Cross border lease benefits are more or less the same as are available in domestic lease viz 100% funding off-balance sheets.

10. **International Capital Budgeting**

Multinational Capital Budgeting has to take into consideration the different factors and variables which affect a foreign project and are complex in nature than domestic projects. An important aspect in multinational capital budgeting is to adjust cash flows or the discount rate for additional risk arising from location of the project. Adjusted Present Value (APV) is used in evaluating foreign projects. The APV model is a value additive approach under which each cash flow is considered individually and discounted at a rate consistent with risk involved in the cash flow.

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11. International Working Capital Management

The management of working capital in an international firm is very much complex as compared to domestic one because of the following reasons :

- A multinational firm has a wider option for financing its current assets.
- Interest and tax rates vary from one country to other.
- Presence of foreign exchange risk.
- Limited knowledge of the politico-economic conditions prevailing in different host countries.

12. Multinational Cash Management

The main objectives of multinational cash management are minimizing various risk and transaction costs associated with cash management. Broadly, following are two basic objectives of International Cash Management – first is optimizing cash flow movements and second is investing excess cash.

(a) Optimizing Cash Flow Movements

Following are ways by which cash flow movement can be optimized:

- (i) Accelerating Cash Inflows.
- (ii) Managing Blocked Funds.
- (iii) Leading and Lagging.
- (iv) Netting.
- (v) International Transfer Pricing.

(b) Investing Excess Cash

Through centralized cash management, decision about stock piling (EOQ) is to be weighted in light of cumulative carrying cost vis-à-vis expected increase in the price of input due to changes in the exchange rate. Normally, final decision on the quantity of goods to be imported and how much of them are locally available.

13. International Receivables Management

International receivables management can be discussed under two heads which are as follows :

- (a) **Inter-firm Sales** – The focus is on the currency of denomination.
- (b) **Intra-firm Sales** – The focus is on global allocation of firm's resources.

Question 1

Write a short note on Euro Convertible Bonds.

Answer

Euro Convertible Bonds: They are bonds issued by Indian companies in foreign market with the option to convert them into pre-determined number of equity shares of the company. Usually price of equity shares at the time of conversion will fetch premium. The Bonds carry fixed rate of interest.

The issue of bonds may carry two options:

Call option: Under this the issuer can call the bonds for redemption before the date of maturity. Where the issuer's share price has appreciated substantially, i.e., far in excess of the redemption value of bonds, the issuer company can exercise the option. This call option forces the investors to convert the bonds into equity. Usually, such a case arises when the share prices reach a stage near 130% to 150% of the conversion price.

Put option: It enables the buyer of the bond a right to sell his bonds to the issuer company at a pre-determined price and date. The payment of interest and the redemption of the bonds will be made by the issuer-company in US dollars.

Question 2

Write short note on American Depositary Receipts (ADRs).

Answer

American Depositary Receipts (ADRs): A depository receipt is basically a negotiable certificate denominated in US dollars that represent a non- US Company's publicly traded local currency (INR) equity shares/securities. While the term refer to them is global depository receipts however, when such receipts are issued outside the US, but issued for trading in the US they are called ADRs.

An ADR is generally created by depositing the securities of an Indian company with a custodian bank. In arrangement with the custodian bank, a depository in the US issues the ADRs. The ADR subscriber/holder in the US is entitled to trade the ADR and generally enjoy rights as owner of the underlying Indian security. ADRs with special/unique features have been developed over a period of time and the practice of issuing ADRs by Indian Companies is catching up.

Only such Indian companies that can stake a claim for international recognition can avail the opportunity to issue ADRs. The listing requirements in US and the US GAAP requirements are fairly severe and will have to be adhered. However if such conditions are met ADR becomes an excellent sources of capital bringing in foreign exchange.

These are depository receipts issued by a company in USA and are governed by the provisions of Securities and Exchange Commission of USA. As the regulations are severe,

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Indian companies tap the American market through private debt placement of GDRS listed in London and Luxemburg stock exchanges.

Apart from legal impediments, ADRS are costlier than Global Depository Receipts (GDRS). Legal fees are considerably high for US listing. Registration fee in USA is also substantial. Hence, ADRS are less popular than GDRS.

Question 3

Write a short note on Global Depository Receipts (GDRs).

Answer

Global Depository Receipt: It is an instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India denominated in dollar and issued to non-resident investors against the issue of ordinary shares or FCCBs of the issuing company. It is traded in stock exchange in Europe or USA or both. A GDR usually represents one or more shares or convertible bonds of the issuing company.

A holder of a GDR is given an option to convert it into number of shares/bonds that it represents after 45 days from the date of allotment. The shares or bonds which a holder of GDR is entitled to get are traded in Indian Stock Exchanges. Till conversion, the GDR does not carry any voting right. There is no lock-in-period for GDR.

Impact of GDR's on Indian Capital Market

Since the inception of GDR's a remarkable change in Indian capital market has been observed as follows:

- (i) Indian stock market to some extent is shifting from Bombay to Luxemburg.
- (ii) There is arbitrage possibility in GDR issues.
- (iii) Indian stock market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with worldwide economic events.
- (iv) Indian retail investors are completely sidelined. GDR's/Foreign Institutional Investors' placements + free pricing implies that retail investors can no longer expect to make easy money on heavily discounted rights/public issues.

As a result of introduction of GDR's a considerable foreign investment has flown into India. This has also helped in the creation of specific markets like

- (i) GDR's are sold primarily to institutional investors.
- (ii) Demand is likely to be dominated by emerging market funds.
- (iii) Switching by foreign institutional investors from ordinary shares into GDR's is likely.
- (iv) Major demand is also in UK, USA (Qualified Institutional Buyers), South East Asia (Hong Kong, Singapore), and to some extent continental Europe (principally France and

Switzerland).

The following parameters have been observed in regard to GDR investors.

- (i) Dedicated convertible investors.
- (ii) Equity investors who wish to add holdings on reduced risk or who require income enhancement.
- (iii) Fixed income investors who wish to enhance returns.
- (iv) Retail investors: Retail investment money normally managed by continental European banks which on an aggregate basis provide a significant base for Euro-convertible issues.

Question 4

What is the impact of GDRs on Indian Capital Market?

Answer

Impact of Global Depository Receipts (GDRs) on Indian Capital Market

After the globalization of the Indian economy, accessibility to vast amount of resources was available to the domestic corporate sector. One such accessibility was in terms of raising financial resources abroad by internationally prudent companies. Among others, GDRs were the most important source of finance from abroad at competitive cost. Global depository receipts are basically negotiable certificates denominated in US dollars, that represent a non-US company's publicly traded local currency (Indian rupee) equity shares. Companies in India, through the issue of depository receipts, have been able to tap global equity market to raise foreign currency funds by way of equity.

Since the inception of GDRs, a remarkable change in Indian capital market has been observed. Some of the changes are as follows:

- (i) Indian capital market to some extent is shifting from Bombay to Luxemburg and other foreign financial centres.
- (ii) There is arbitrage possibility in GDR issues. Since many Indian companies are actively trading on the London and the New York Exchanges and due to the existence of time differences, market news, sentiments etc. at times the prices of the depository receipts are traded at discounts or premiums to the underlying stock. This presents an arbitrage opportunity wherein the receipts can be bought abroad and sold in India at a higher price.
- (iii) Indian capital market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with worldwide economic events.
- (iv) Indian retail investors are completely sidelined. Due to the placements of GDRs with Foreign Institutional Investor's on the basis free pricing, the retail investors can now no longer expect to make easy money on heavily discounted right/public issues.

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- (v) A considerable amount of foreign investment has found its way in the Indian market which has improved liquidity in the capital market.
- (vi) Indian capital market has started to reverberate by world economic changes, good or bad.
- (vii) Indian capital market has not only been widened but deepened as well.
- (viii) It has now become necessary for Indian capital market to adopt international practices in its working including financial innovations.

Question 5

Write a brief note on External Commercial Borrowings (ECBs).

Answer

ECB include bank loans, supplier credit, securitised instruments, credit from export credit agencies and borrowings from multilateral financial institutions. These securitised instruments may be FRNs, FRBs etc. Indian corporate sector is permitted to raise finance through ECBs within the framework of the policies and procedures prescribed by the Central Government. Multilateral financial institutions like IFC, ADB, AFIC, CDC are providing such facilities while the ECB policy provides flexibility in borrowing consistent with maintenance of prudential limits for total external borrowings, its guiding principles are to keep borrowing maturities long, costs low and encourage infrastructure/core and export sector financing which are crucial for overall growth of the economy. The government of India, from time to time changes the guidelines and limits for which the ECB alternative as a source of finance is pursued by the corporate sector. During past decade the government has streamlined the ECB policy and procedure to enable the Indian companies to have their better access to the international financial markets.

The government permits the ECB route for variety of purposes namely expansion of existing capacity as well as for fresh investment. But ECB can be raised through internationally recognized sources. There are caps and ceilings on ECBs so that macro economy goals are better achieved. Units in SEZ are permitted to use ECBs under a special window.

Question 6

Explain briefly the salient features of Foreign Currency Convertible Bonds.

Answer

FCCBs are important source of raising funds from abroad. Their salient features are –

1. FCCB is a bond denominated in a foreign currency issued by an Indian company which can be converted into shares of the Indian Company denominated in Indian Rupees.
2. Prior permission of the Department of Economic Affairs, Government of India, Ministry of Finance is required for their issue
3. There will be a domestic and a foreign custodian bank involved in the issue

4. FCCB shall be issued subject to all applicable Laws relating to issue of capital by a company.
5. Tax on FCCB shall be as per provisions of Indian Taxation Laws and Tax will be deducted at source.
6. Conversion of bond to FCCB will not give rise to any capital gains tax in India.

Question 7

Write a short note on Debt route for foreign exchange funds.

Answer

Debt route for foreign exchange funds: The following are some of the instruments used for borrowing of funds from the international market:

- (i) *Syndicated bank loans:* The borrower should obtain a good credit rating from the rating agencies. Large loans can be obtained in a reasonably short period with few formalities. Duration of the loan is generally 5 to 10 years. Interest rate is based on LIBOR plus spread depending upon the rating. Some covenants are laid down by the lending institutions like maintenance of key financial ratios.
- (ii) *Euro bonds:* These are basically debt instruments denominated in a currency issued outside the country of the currency. For example, Yen bond floated in France. Primary attraction of these bonds is the shelter from tax and regulations which provide Scope for arbitraging yields. These are usually bearer bonds and can take the form of (i) traditional fixed rate bonds (ii) floating rate notes (FRN's) (iii) Convertible bonds.
- (iii) *Foreign bonds:* Foreign bonds are foreign currency bonds and sold at the country of that currency and are subject to the restrictions as placed by that country on the foreigners' funds.
- (iv) *Euro Commercial Papers:* These are short term money market securities usually issued at a discount, for maturity in less than one year.
- (v) *External Commercial Borrowings (ECB's):* These include commercial bank loans, buyer's credit and supplier's credit, securitised instruments such as floating rate notes and fixed rate bonds, credit from official export credit agencies and commercial borrowings from multi-lateral financial institutions like IFCI, ADB etc. External Commercial borrowings have been a popular source of financing for most of capital goods imports. They are gaining importance due to liberalization of restrictions. ECB's are subject to overall ceilings with sub-ceilings fixed by the government from time to time.
- (vi) All other loans are approved by the government.

Question 8

Explain the term 'Exposure netting', with an example.

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Answer

Exposure Netting refers to offsetting exposures in one currency with Exposures in the same or another currency, where exchange rates are expected to move in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure.

The objective of the exercise is to offset the likely loss in one exposure by likely gain in another. This is a manner of hedging foreign exchange exposures though different from forward and option contracts. This method is similar to portfolio approach in handling systematic risk.

For example, let us assume that a company has an export receivables of US\$ 10,000 due 3 months hence, if not covered by forward contract, here is a currency exposure to US\$.

Further, the same company imports US\$ 10,000 worth of goods/commodities and therefore also builds up a reverse exposure. The company may strategically decide to leave both exposures open and not covered by forward, it would be doing an exercise in exposure netting.

Despite the difficulties in managing currency risk, corporates can now take some concrete steps towards implementing risk mitigating measures, which will reduce both actual and future exposures. For years now, banking transactions have been based on the principle of netting, where only the difference of the summed transactions between the parties is actually transferred. This is called settlement netting. Strictly speaking in banking terms this is known as settlement risk. Exposure netting occurs where outstanding positions are netted against one another in the event of counter party default.

Question 9

Write a short note on Forfaiting.

Answer

Forfaiting: During recent years the forfaiting has acquired immense importance as a source of financing. It means 'surrendering' or relinquishing rights to something. This is very commonly used in international practice among the exporters and importers. In the field of exports, it implies surrenders by an exporter of the claim to receive payment for goods or services rendered to an importer in return for cash payment for those goods and services from the forfaiter (generally a bank), who takes over the importer's promissory notes or the exporters' bills of exchange. The forfaiter, thus assumes responsibility for the collection of such documents from the importer. This arrangement is to help exporter, however, there is always a fixed cost of finance by way of discounting of the debt instruments by the forfaiter. Forfaiting assumes the nature of a purchase transaction without recourse to any previous holder in respect of the instrument of debts at the time of maturity in future.

The exporter generally takes bill or promissory notes to the forfaiter which buys the instrument at a discount from the face value. The importer party's bank has already guaranteed payment

unconditionally and irrevocably, and the exporter party's bank now takes complete responsibility for collection without recourse to exporter. Thus a forfaiting arrangement eliminates all credit risks. It also protects against the possibility that interest rate may fluctuate before the bills or notes are paid off. Any adverse movement in exchange rate, any political uncertainties or business conditions may change to the disadvantage of the parties concerned. The forfaiting business is very common in Europe and has come as an important source of export financing in leading currencies.

Question 10

Distinguish between Forfeiting and Factoring.

Answer

Forfeiting was developed to finance medium to long term contracts for financing capital goods. It is now being more widely used in the short-term also especially where the contracts involve large values. There are specialized finance houses that deal in this business and many are linked to some of main banks.

This is a form of fixed rate finance which involves the purchase by the forfeiture of trade receivables normally in the form of trade bills of exchange or promissory notes, accepted by the buyer with the endorsement or guarantee of a bank in the buyer's country.

The benefits are that the exporter can obtain full value of his export contract on or near shipment without recourse. The importer on the other hand has extended payment terms at fixed rate finance.

The forfeiture takes over the buyer and country risks. Forfeiting provides a real alternative to the government backed export finance schemes.

Factoring can however, broadly be defined as an agreement in which receivables arising out of sale of goods/services are sold by a "firm" (client) to the "factor" (a financial intermediary) as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Henceforth, the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer(s). In a full service factoring concept (without recourse facility) if any of the debtors fails to pay the dues as a result of his financial instability/insolvency/bankruptcy, the factor has to absorb the losses.

Some of the points of distinction between forfeiting and factoring have been outlined in the following table.

Factoring	Forfeiting
This may be with recourse or without recourse to the supplier.	This is without recourse to the exporter. The risks are borne by the forfeiter.
It usually involves trade receivables of short maturities.	It usually deals in trade receivables of medium and long term maturities.
It does not involve dealing in negotiable	It involves dealing in negotiable instrument

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instruments.	like bill of exchange and promissory note.
The seller (client) bears the cost of factoring.	The overseas buyer bears the cost of forfeiting.
Usually it involves purchase of all book debts or all classes of book debts.	Forfeiting is generally transaction or project based. Its structuring and costing is case to case basis.
Factoring tends to be a 'case of' sell of debt obligation to the factor, with no secondary market.	There exists a secondary market in forfeiting. This adds depth and liquidity to forfeiting.

Question 11

Write a short note on the application of Double taxation agreements on Global depository receipts.

Answer

- (i) During the period of fiduciary ownership of shares in the hands of the overseas depository bank, the provisions of avoidance of double taxation agreement entered into by the Government of India with the country of residence of the overseas depository bank will be applicable in the matter of taxation of income from dividends from the underline shares and the interest on foreign currency convertible bonds.
- (ii) During the period if any, when the redeemed underline shares are held by the non-residence investors on transfer from fiduciary ownership of the overseas depository bank, before they are sold to resident purchasers, the avoidance of double taxation agreement entered into by the government of India with the country of residence of the non-resident investor will be applicable in the matter of taxation of income from dividends from the underline shares, or interest on foreign currency convertible bonds or any capital gains arising out of the transfer of the underline shares.