

INTERNATIONAL BANKING AND FINANCE

COURSE CODE: B21CM02DE
Bachelor of Commerce
Discipline Specific Elective Course
Self Learning Material



SREENARAYANAGURU
OPEN UNIVERSITY

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The State University for Education, Training and Research in Blended Format, Kerala

SREENARAYANAGURU OPEN UNIVERSITY

Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

International Banking and Finance

Course Code: B21CM02DE

Semester - V

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(With Model Question Paper Sets)



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Semester - V

Discipline Specific Elective Course
Bachelor of Commerce

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Edition
February 2026

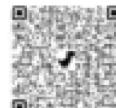
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ISBN 978-0-99-702549-1



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Dear learner,

I extend my heartfelt greetings and profound enthusiasm as I warmly welcome you to Sreenarayanaguru Open University. Established in September 2020 as a state-led endeavour to promote higher education through open and distance learning modes, our institution was shaped by the guiding principle that access and quality are the cornerstones of equity. We have firmly resolved to uphold the highest standards of education, setting the benchmark and charting the course.

The courses offered by the Sreenarayanaguru Open University aim to strike a quality balance, ensuring students are equipped for both personal growth and professional excellence. The University embraces the widely acclaimed “blended format,” a practical framework that harmoniously integrates Self-Learning Materials, Classroom Counseling, and Virtual modes, fostering a dynamic and enriching experience for both learners and instructors.

The University aims to offer you an engaging and thought-provoking educational journey. The Bachelor of Commerce is one of the highly popular programmes due to the current need for skilled professionals in the field. This demand guided our approach as we developed the programme's curriculum. The programme offers a comprehensive grasp of theoretical concepts alongside clear explanations of practical applications. We are careful to maintain a balance in the management components to preserve the integrity of the discipline. The Self Learning Material has been thoughtfully crafted to include illustrative examples. The Self-Learning Material has been meticulously crafted, incorporating relevant examples to facilitate better comprehension.

Rest assured, the university's student support services will be at your disposal throughout your academic journey, readily available to address any concerns or grievances you may encounter. We encourage you to reach out to us freely regarding any matter about your academic programme. It is our sincere wish that you achieve the utmost success.



Warm regards.
Dr. Jagathy Raj V. P.

01-02-2026

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BLOCK

BANKING

Unit

Introduction to Banking

Learning Outcomes

After completing this unit, learners will be able to:

- ◇ comprehend the concept of banking
- ◇ identify the objectives of banking
- ◇ get an overview of different banking functions
- ◇ describe different types of banks

Prerequisite

Banking is a fundamental component of modern economies, serving as a mechanism for the safe management and mobilisation of money. The primary objectives of banking include safeguarding deposits, providing credit, facilitating payments, and supporting economic growth. For example, when a farmer deposits money in a bank, it is safely stored, and the bank can use a portion of these deposits to provide loans to a local shopkeeper, thus supporting business activities in the community. Banks perform a variety of functions, such as accepting deposits, granting loans, creating credit, and offering financial services that meet the diverse needs of individuals, businesses, and governments. Furthermore, banks can be classified into different types based on their functions and ownership, including commercial banks, cooperative banks, central banks, and development banks. Understanding these concepts provides a comprehensive overview of the role and significance of banking in economic development.

Keywords

Bank, Banking, Primary functions, credit creation, secondary functions

Discussion

Banking is one of the most essential services in a modern economy. Every day, millions of people and organisations deposit money, withdraw cash, and borrow funds through banks. When a person saves part of their salary in a bank, that money does not simply remain idle; it becomes part of a larger financial system where banks lend these funds to others who need them. For example, the same money deposited by a teacher may later be lent to a small entrepreneur who wants to start a grocery shop. In this way, banks act as a bridge between savers and borrowers, keeping the flow of money active in society.

Thus, banking may be understood as the business of accepting and safeguarding money owned by individuals and organisations, and then using it for lending or investment to earn profit. It ensures that money keeps moving from those who have a surplus to those who require it for productive use. The presence of banking helps to create trust in financial dealings, supports business growth, and makes daily transactions smooth and reliable.

1.1.1 Meaning of a Bank

A bank is not just a building with counters and cash machines; it is a vital institution that keeps the economy running. It accepts deposits from the public, promises to repay them on demand or after a specific period, and lends money to those who require financial support. For example, when a young couple decides to purchase a house, they may not have the full amount immediately. They approach a bank, which provides a housing loan using the money collected from other customers' deposits. The couple pays back the loan in instalments, while the depositors earn interest on their savings. In this manner, a bank performs the dual role of protecting money and promoting productive activity.

A bank also provides various services that make life convenient such as issuing debit cards, enabling online payments, transferring money to distant places, and even offering advice on investments. It operates under the supervision of the Central Bank of the country, which ensures that the bank functions safely and follows the required regulations.

A bank can be defined as a financial institution licensed to receive deposits, make loans, and offer a range of services to its customers. This simple definition covers all the key roles of a bank. Every time a person deposits their salary, receives interest, or pays



a bill through online banking, they are engaging with a system that depends on mutual trust and legal structure. In India, banks function according to the rules laid down by the Reserve Bank of India (RBI), which acts as the guardian of the entire banking system.

When we look around, we can see many different types of banks: commercial banks such as State Bank of India or HDFC, co-operative banks that support local communities, and specialised banks like NABARD that help farmers and rural enterprises. Each one serves the same basic purpose to keep money moving efficiently through the economy.

1.1.2 Meaning and Definition of Banking

Banking, as an activity, refers to all the functions performed by banks in dealing with money. It includes accepting deposits, lending funds, providing credit facilities, issuing cheques and debit cards, and ensuring smooth transfer of money from one place to another.

The Banking Regulation Act of 1949 in India defines banking as “accepting, for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.”

This means that when a farmer deposits his seasonal earnings in a nearby branch, that money becomes part of the bank’s fund. Later, the same branch might lend a loan to another farmer who wishes to buy new equipment. The first farmer earns interest on his deposit, while the second farmer benefits from easy access to credit. Both transactions are parts of the same cycle of banking activity that keeps the local economy vibrant. Thus, banking is not only about storing money safely but also about using money productively for the benefit of individuals, businesses, and the nation.

1.1.3 Objectives

Imagine a town where people keep their savings at home, businesses struggle for funds, and farmers have no access to credit. Economic activity would slow down, unemployment would rise, and progress would stop. Banks exist precisely to prevent this situation. By collecting savings, lending responsibly, and maintaining trust, they become the heart of economic life.

1. Accepting Deposits and Safeguarding Money

The primary objective of every bank is to provide a safe and convenient place for people to keep their money. In the past, people were often worried about theft or loss when they kept cash at home. But today, when a person deposits money in a bank, they know it is secure and can be withdrawn whenever needed. This confidence encourages people to save more regularly. An employee may deposit a part of her salary each month in her savings account. She can withdraw the money through an ATM, online transfer, or cheque whenever required. Thus, banks fulfil their first and most basic objective the protection and management of public savings.

2. Providing Credit and Loans

Once banks collect deposits, their next important objective is to lend money to those who need it for productive purposes. This lending helps businesses to expand, farmers

to buy seeds or machinery, and students to pursue higher education. For example, when a small business owner takes a bank loan to open a new bakery, he not only earns an income but also creates jobs for others. The same money, which was once idle in someone's savings account, now becomes the source of new economic activity. In this way, banks ensure that money flows where it is most useful, contributing to growth and employment.

3. Earning Profit through Productive Use of Funds

Although banks serve society, they also aim to earn profit, as they are commercial institutions. Their profit does not come from selling goods but from the difference between the interest they pay on deposits and the interest they charge on loans. For example, if a bank pays 4% interest to depositors and charges 8% from borrowers, it earns a 4% margin. This income helps the bank cover its operating costs, expand services, pay employees, and reward shareholders. Hence, profitability ensures stability, enabling banks to continue serving the community effectively.

4. Promoting Savings and Thrift Habits

Banks play an important role in teaching people the value of saving. They encourage even those with small incomes to put aside a little money regularly. When a student starts saving her pocket money in a bank account, she develops a sense of financial discipline. Over time, such habits spread across society, creating a culture of thrift and self-reliance. The introduction of recurring deposit schemes, fixed deposits, and savings accounts has made it easier for everyone to save in a planned and organised way. This, in turn, provides the bank with more funds to lend and invest in development projects.

5. Supporting Trade, Industry, and Agriculture

Another important objective of banks is to support the productive sectors of the economy trade, industry, and agriculture. Businesses need capital to purchase raw materials, expand production, or manage day-to-day operations. Farmers require credit during the sowing season to buy seeds, fertilisers, and equipment. When banks provide these funds, they not only help individuals but also stimulate national growth. For instance, a farmer's loan may lead to a good harvest, creating demand for transport and storage services. In this way, the bank's credit indirectly supports multiple layers of economic activity.

6. Encouraging Balanced Regional Development

Banks aim to reduce the economic gap between developed and underdeveloped regions. By setting up branches in rural and semi-urban areas, they make financial services accessible to everyone. A villager can now open an account, receive government benefits directly, or apply for a small loan without travelling to a distant city. This flow of funds into backward regions encourages local business, supports employment, and prevents migration. Thus, banks contribute to balanced regional development, which is essential for national progress.

7. Maintaining Liquidity and Financial Stability

Banks have to maintain a balance between profitability and liquidity. Liquidity means the ability to pay depositors when they demand their money. A bank cannot lend out all



its funds, because some of it must always remain available for withdrawals. Therefore, one of the key objectives of banking management is to ensure that there is enough cash in hand and reserves to meet daily demands. This careful management of deposits and loans keeps the banking system strong and trustworthy. When people trust that their money is safe, the entire financial system remains stable.

8. Contributing to National Development

Beyond their commercial goals, banks also serve national objectives. They participate in government programmes that promote self-employment, rural development, housing, and education. For example, schemes like Mudra loans or Kisan Credit Cards help small entrepreneurs and farmers to access credit easily. By supporting such initiatives, banks help raise the standard of living and reduce poverty. They thus act as an instrument for achieving inclusive growth, ensuring that the benefits of development reach every section of society.

Banks operate with several objectives not only to earn profit, but also to serve people and promote economic welfare. Their main goals include collecting and safeguarding money, granting credit, promoting savings, supporting business and agriculture, maintaining liquidity, and assisting in national development. Through these activities, banks become more than financial institutions; they become agents of progress, connecting individual prosperity with the nation's overall growth. To serve all these diverse purposes efficiently, the banking system has developed different types of banks. Let us discuss in detail the different types of banks in detail:

1.1.4 Classification of banks

The banking system as a big financial family; each member has a unique role, yet all work together to keep the economy alive and thriving. Just like in a family where some members handle money, others save, and some help others in need, banks too have different purposes. The classification of banks based on the following:

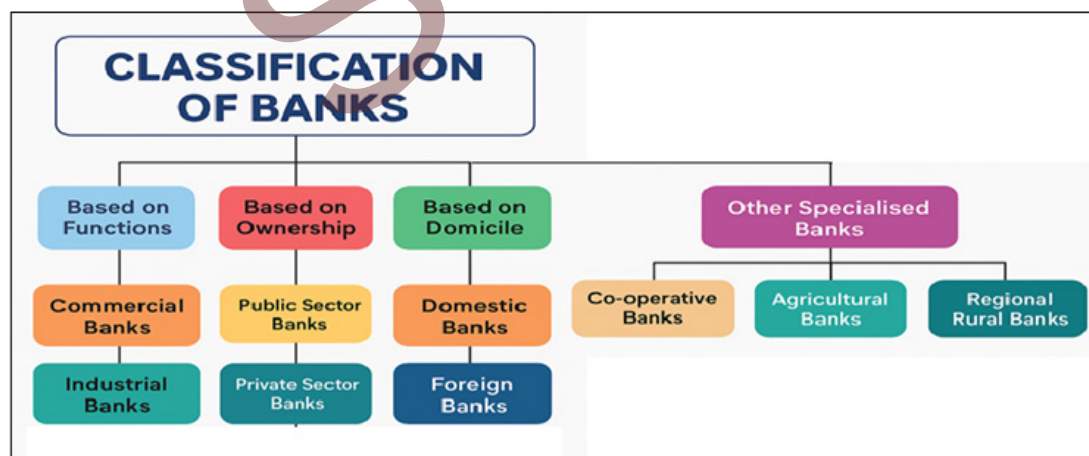


Figure 1.1.1 Classification of Banks

1. Based on functions
2. Based on ownership
3. Based on domicile
4. Other specialised banks

1. Based on Functions

a. Commercial Banks or deposit banks

Commercial banks are the most common and important type of bank. They are financial institutions that accept deposits from the public and provide short-term loans mainly for trade, commerce, and industry. These banks are often called Deposit Banks because they collect savings from individuals and businesses and lend them for productive purposes.

For example, State Bank of India (SBI), HDFC Bank, and ICICI Bank are leading commercial banks in India that provide loans for working capital, vehicle purchases, or housing, and also offer services such as deposits, internet banking, and credit cards.

Commercial banks are further divided into two categories:

- i. Scheduled bank
- ii. Non-scheduled bank

i. Scheduled bank

A Scheduled Bank is one, that is included in the Second Schedule of the Reserve Bank of India Act, 1934. Scheduled banks are eligible for important facilities from the RBI, including refinance facilities, loans at bank rate, and membership of the clearing house, which enhances their liquidity and operational efficiency. They also come under stricter regulation and supervision by the RBI, ensuring greater financial stability and public confidence. Scheduled banks in India include Scheduled Commercial Banks (such as public sector banks, private sector banks, foreign banks, and regional rural banks) and Scheduled Co-operative Banks. Due to RBI oversight and access to central banking support, scheduled banks play a vital role in the country's banking system and overall economic development.

The following conditions should be fulfilled by a bank for inclusion in the Schedule:

- i. The bank concerned must be carrying on a business of banking in India
- ii. The bank must have paid-up capital and reserve of an aggregate value of not less than 5 lakhs.
- iii. It must satisfy Reserve Bank of India that its affairs are not being conducted in a manner detrimental to the interest of the depositor.



Presently, the RBI has prescribed a minimum capital of 100 crores for starting a new commercial bank. The scheduled banks come within the direct purview of the credit control measures of the Reserve Bank. They are entitled to borrowings and rediscounting facilities from the Reserve Bank of India. `

Example: SBI, Punjab National Bank (PNB), and Axis Bank are scheduled banks.

◇ **Features of Scheduled Banks are as follows:**

1. **Inclusion in RBI Schedule:** Scheduled banks are those included in the Second Schedule of the Reserve Bank of India Act, 1934.
2. **Minimum Capital Requirement:** They must maintain the minimum paid-up capital and reserves as prescribed by the RBI.
3. **RBI Regulation and Supervision:** Scheduled banks are strictly regulated and supervised by the Reserve Bank of India to ensure financial stability and depositor protection.
4. **Eligibility for RBI Facilities:** They can avail refinance, loans at bank rate, and repo facilities from the RBI.
5. **Clearing House Membership:** Scheduled banks are eligible to become members of the clearing house, enabling easy inter-bank cheque clearing and settlements.
6. **Maintenance of CRR and SLR:** They are required to maintain Cash Reserve Ratio (CRR) with RBI and Statutory Liquidity Ratio (SLR) as per RBI norms.
7. **Public Confidence:** Inclusion in the RBI schedule enhances public trust and credibility of the bank.
8. **Access to Inter-bank Market:** Scheduled banks can participate freely in the inter-bank call money and money markets.
9. **Wide Range of Banking Services:** They offer services such as deposits, loans, remittances, credit creation, and payment services.
10. **Types of Scheduled Banks:** They include Scheduled Commercial Banks (public sector, private sector, foreign banks, RRBs) and Scheduled Co-operative Banks.

These features make scheduled banks an essential part of India's organized and regulated banking system.

ii Non-scheduled bank

These are smaller banks not listed in the Second Schedule of the RBI Act. Although they perform similar banking functions, they are not entitled to borrow from the RBI for normal banking operations.

They operate under the Banking Regulation Act, 1949, but enjoy limited facilities from the RBI compared to scheduled banks. Non-scheduled banks generally have a smaller scale of operations and limited geographical presence.

◇ **Features of Non-Scheduled Banks**

1. **Not Listed in RBI Schedule:** They are not included in the Second Schedule of the RBI Act, 1934.
2. **Limited RBI Facilities:** They cannot avail refinance or loans at the bank rate from RBI.
3. **Restricted Clearing House Access:** Non-scheduled banks are usually not members of the RBI clearing house.
4. **Lower Capital Base:** They generally have lower paid-up capital and reserves.
5. **Limited Area of Operation:** Their operations are often confined to a particular region or locality.
6. **RBI Regulation Applies:** Though not scheduled, they are still regulated by RBI under the Banking Regulation Act.
7. **Lower Public Confidence:** Since they lack scheduled status, public confidence is comparatively lower.
8. **Fewer Banking Services:** Services offered are limited when compared to scheduled banks.

In India today, the number of non-scheduled banks is very small, as most banks prefer to meet RBI norms and obtain scheduled status due to the associated benefits.

(b) Industrial Banks

Industrial banks, also known as Investment Banks, cater to the long-term financial needs of industries. They provide medium and long-term credit to industrial enterprises for purchasing machinery, constructing plants, or expanding operations. Industrial Finance Corporation of India (IFCI) and Industrial Development Bank of India (IDBI) have played a crucial role in financing industrial development in the country. Such banks act as the backbone for industrial growth and contribute significantly to the nation's economic development.

Industrial Banks are specialized financial institutions established primarily to promote industrial development by providing medium- and long-term finance to industries. Unlike commercial banks, which mainly focus on short-term working capital needs, industrial banks cater to the capital requirements necessary for setting up, expanding, modernizing, or diversifying industrial enterprises.

These banks provide financial assistance in the form of term loans, underwriting of shares and debentures, subscription to securities, and sometimes equity participation. In addition to finance, industrial banks often offer technical, managerial, and advisory services, helping industries improve efficiency, adopt modern technology, and strengthen overall performance. Their role is especially significant in developing economies, where access to long-term industrial finance is limited.



By mobilizing savings and channeling them into productive industrial investments, industrial banks contribute to economic growth, employment generation, and balanced regional development. Institutions such as Industrial Development Banks and Industrial Finance Corporations are typical examples of industrial banking, playing a crucial role in strengthening a country's industrial base.

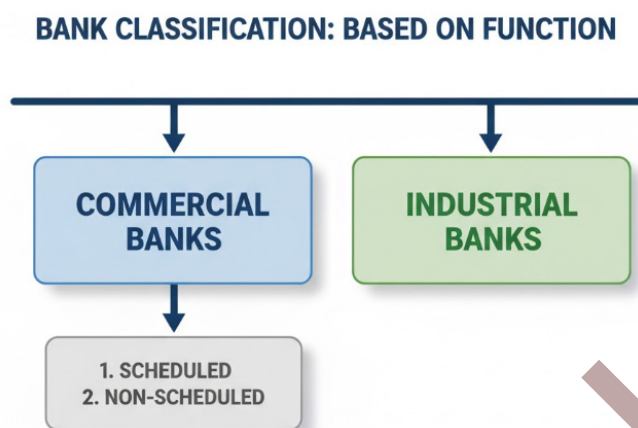


Figure 1.1.2 Banks' classification based on function

2. Based on Ownership

a. Public Sector Banks

Public sector banks are owned, managed, and controlled by the Government of India. These banks aim to promote financial inclusion and ensure equitable distribution of credit among various sectors of society. They have a wide rural and semi-urban reach, providing financial services even in remote areas. For example, State Bank of India (SBI), Bank of Baroda, and Punjab National Bank (PNB) are major public sector banks. They offer credit to farmers, small-scale industries, and rural entrepreneurs. Public sector banks were nationalised in two phases in 1969 and 1980 to expand banking access to the masses.

b. Private Sector Banks

Private sector banks are owned and managed by private individuals or corporations. They focus on efficiency, innovation, and customer service. With the adoption of digital technologies, private sector banks have introduced modern facilities such as mobile banking, online transfers, and instant loan approvals. Notable examples include HDFC Bank, ICICI Bank, and Axis Bank, which have significantly contributed to improving service quality and introducing new banking products in India. Their competition with public sector banks has led to an overall improvement in the efficiency of the Indian banking system.

3. Based on Domicile

a. Domestic Banks

Domestic banks are registered and operated within India. They are governed by

Indian laws and regulations and primarily serve the domestic population. Examples include Canara Bank, Bank of India, and SBI, which operate across the country and provide various financial services to individuals and businesses.

b. Foreign Banks

Foreign banks are incorporated outside India but operate within the country through their branches. They mainly finance foreign trade and international transactions, assisting exporters and importers. HSBC, Citibank, and Standard Chartered Bank are prominent foreign banks operating in India. They provide trade finance, foreign exchange services, and international remittances, helping Indian businesses connect with global markets.

4. Other Specialised Banks

a. Co-operative Banks

Co-operative banks form an essential part of India's rural credit system. They originated under the Co-operative Credit Societies Act of 1904, which aimed to provide farmers with access to affordable credit. Co-operative banks operate on the principles of mutual help and co-operation and follow a three-tier structure:

- ◇ Primary Agricultural Credit Societies (PACS) at the village level,
- ◇ Central Co-operative Banks at the district level, and
- ◇ State Co-operative Banks at the state level.

For example, the Kerala State Co-operative Bank and Maharashtra State Co-operative Bank are key institutions that provide credit to farmers, rural artisans, and small traders.

b. Agricultural Banks

Agricultural banks provide both short-term and long-term finance to farmers for purchasing seeds, fertilisers, and agricultural equipment. These include Land Development Banks and Agricultural Co-operative Banks. An example is the National Bank for Agriculture and Rural Development (NABARD), which refinances agricultural and rural development projects through state and co-operative institutions.

c. Regional Rural Banks (RRBs)

To meet the credit needs of rural populations, the Government of India established Regional Rural Banks (RRBs) in 1975, based on the recommendations of the Banking Commission (1972). RRBs combine the local feel of co-operative banks with the financial strength of commercial banks. Examples include Prathama Bank in Uttar Pradesh and Andhra Pragathi Grameen Bank in Andhra Pradesh.

5. Other Important Types of Banks

a. Foreign Exchange Banks

These banks specialise in foreign currency transactions and help in promoting international trade. They facilitate import and export payments and provide foreign



currency loans. For instance, Deutsche Bank and Standard Chartered Bank play a key role in handling foreign exchange transactions in India.

b. Savings Banks

Savings banks encourage individuals to develop the habit of saving small amounts regularly. In India, this role is largely performed by the India Post Payments Bank and Post Office Savings Bank, which allow citizens, especially in rural areas, to deposit small savings safely.

c. Central Bank

The Reserve Bank of India (RBI) serves as the Central Bank of the country. Established in 1935, it acts as the apex financial authority. The RBI formulates monetary policy, regulates the issue of currency, and supervises other banks to ensure financial stability. It is rightly referred to as the guardian of the banking system.

d. Development Banks

Development banks provide medium and long-term finance for large-scale industrial and infrastructural projects. They also assist in preparing project reports, offering technical advice, and supporting entrepreneurship. Key examples include Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), and NABARD.

e. World Bank

The World Bank, officially known as the International Bank for Reconstruction and Development (IBRD), was established in 1944. It provides financial and technical assistance to developing nations. India has been a major recipient of World Bank aid for projects in infrastructure, health, and education.

f. New Generation Banks

In the modern era, new generation banks such as Kotak Mahindra Bank, IndusInd Bank, and Bandhan Bank have emerged. These institutions rely heavily on technology, offering digital banking, mobile apps, and cashless transactions. They represent a shift towards innovation and customer convenience in the financial sector.

The Indian banking system is a diverse and dynamic network that serves the financial needs of every segment of society. From commercial and industrial banks that fuel business growth, to co-operative and rural banks that empower farmers and rural populations, every category of bank contributes to inclusive economic development. The Reserve Bank of India, at the apex, ensures stability and coordination across the system. Together, these institutions form a strong financial framework that supports India's growth and integration into the global economy.

After understanding the various types of banks and how they are classified based on functions, ownership etc., it becomes essential to explore what these banks actually do in the economy. Every category of bank whether commercial, co-operative, or development performs specific roles that contribute to the smooth functioning of the financial system. These roles are collectively known as the functions of banks. Thus, studying the functions of banks provides a deeper insight into how banks serve

individuals, businesses, and the nation as a whole. Let us discuss the functions of banks in detail:

1.1.5 Functions of banks

Imagine a small town where a farmer deposits his savings, a shopkeeper applies for a loan to expand her business, and a student opens her first account all in the same place. This place is the commercial bank, one of the oldest and most familiar institutions in our financial system. With their wide network of branches, commercial banks quietly support almost every economic activity, from daily deposits and withdrawals to large-scale business financing. Over time, they have become important tools for promoting both economic growth and social justice. For example, schemes such as priority sector lending help farmers, small industries, and weaker sections receive fair access to credit. To understand how these banks perform such a wide range of roles, their functions are generally grouped into two main categories:

1. Primary functions
2. Secondary functions.

1.1.5.1 Primary functions

Primary functions of commercial banks are further classified as

- i. Accepting deposits
- ii. Lending money
- iii. Creation of Credit

By accepting deposits, banks provide a safe place for individuals and businesses to keep their funds. Through lending, they make these funds available to borrowers for various personal, commercial, and productive purposes. In addition, banks create credit by generating new deposits when loans are issued, thereby increasing the overall money supply in the economy. Together, these primary functions enable commercial banks to facilitate financial transactions, promote economic growth, and maintain the smooth flow of money in the financial system. Let us discuss each primary function detail:

i Accepting deposit

One of the core primary functions of commercial banks is accepting deposits, which forms the foundation of all banking activities. In everyday economic life, people and institutions need a safe place to store their money, earn interest, and access funds when required. Commercial banks meet these needs by offering a variety of deposit schemes designed for different financial purposes and income groups. These deposit accounts collectively help the bank mobilise savings from the public and convert them into productive financial resources. To understand this better, imagine a bank as a secure financial storehouse where each deposit type acts as a specialised locker store room, some designed for long-term savings, some for daily operations, and others for future goals. Deposits are the following types:



- a. Fixed deposits
- b. Current / Demand deposits
- c. Recurring /Cumulative deposits
- d. Savings Deposits
- e. Endowment Deposits
- f. Miscellaneous Deposits



Figure 1.1.3 – Types of deposits

a. Fixed Deposits

A Fixed Deposit (FD) is like placing your money in a time-locked vault. Once deposited for a fixed period, you agree not to withdraw it until the chosen maturity date. Because the bank can use this money more confidently, it offers a higher interest rate. At the time of deposit, the bank issues a Fixed Deposit Receipt (FDR) as proof. Unlike a normal account, you cannot use a cheque to withdraw from an FD.

b. Current or Demand Deposits

A Current Account works like a high-speed financial tool, mainly used by businesses, companies, and institutions that handle frequent transactions. There is no limit on deposits or withdrawals, making it ideal for daily operations. Banks often provide an overdraft facility, allowing customers to withdraw more than the balance. However, these accounts usually do not carry interest, as they serve the purpose of liquidity rather than savings.

c. Recurring or Cumulative Deposits

A Recurring Deposit (RD) supports individuals who wish to save gradually. It functions like a disciplined monthly savings plan, where a fixed amount is deposited every month. Over time, these small contributions grow with interest similar to planting a seed each month and watching a small garden of savings develop steadily.

d. Savings Deposits

A Savings Account is the most common deposit type for regular households. It allows individuals to deposit money, withdraw it when needed, and earn modest interest. To promote savings, banks place certain restrictions on withdrawals. For many people, this account acts as a secure financial cushion for day-to-day money management.

e. Endowment Deposits

Endowment Deposits help customers save specifically for future events such as children's education or marriage. These accounts act as goal-oriented savings plans, ensuring that money is available when important life events arise.

f. Miscellaneous Deposits

Banks also introduce innovative deposit schemes to meet diverse customer needs. These include children's gift plans, pension-linked deposits for senior citizens, and fixed deposits combined with insurance benefits. Such schemes make banking more flexible and inclusive for different social groups.

ii Lending Money

Accepting deposits forms the foundation for banking, another role is to lend this money to those who needed. The difference in the interest rate of accepting deposit and lending money is the income of banking. By this function banks act as a bridge between those who have surplus funds and those who need funds for business, industry, or personal purposes. In this way, commercial banks not only support individual financial needs but also strengthen economic growth by ensuring that money circulates productively through the economy. Lending may be secured (based on collateral) or unsecured, depending on the nature and creditworthiness of the borrower. The main forms of bank lending are explained below .

a. Overdraft

An overdraft is a flexible facility offered mainly to current account holders who may require temporary additional funds. When a bank allows a customer to withdraw

more than the balance available in their current account, it is called an overdraft. This facility is usually provided on the basis of a written request and a promissory note. The customer can withdraw money as needed and repay whenever funds are available. Interest is charged only on the amount overdrawn and only for the period it is actually used, making it a convenient short-term financial tool for businesses with irregular cash flows.

b. Cash Credit

Cash credit is another important lending method, commonly used by businesses to meet their working capital requirements. Here, the bank sanctions a certain credit limit based on security such as stock or receivables. The sanctioned amount is placed in a separate account from which the borrower can withdraw funds any number of times. Interest is charged only on the amount actually withdrawn, not on the total limit sanctioned. Cash credit thus offers greater flexibility to business units that require regular access to funds.

c. Discounting of Bills of Exchange

Discounting a bill of exchange allows a business to receive immediate cash instead of waiting for the bill's maturity date. The bank purchases the bill at a price slightly lower than its face value, and the difference represents the discount or interest earned by the bank. This method is considered a clean advance because the bank relies primarily on the creditworthiness of the parties involved in the bill. Discounting helps traders maintain steady cash flow while ensuring that banks earn income through the discount charged.

d. Loans and Advances

Banks also provide loans and advances in the form of a lumpsum amount for a fixed period at an agreed rate of interest. The amount may be given in cash or credited to the borrower's current account. Loans may be secured or unsecured, depending on the borrower's financial position and the purpose of borrowing.

Loans are generally classified as:

- ◇ Demand Loans – Payable on demand, usually granted for a short duration, and often used to meet working capital needs.
- ◇ Term Loans – Offered for medium or long periods.
 - Medium-term loans (1–5 years) are commonly used for purchasing vehicles, tractors, tools, and equipment.
 - Long-term loans (above 5 years) are used for capital expenditure such as purchasing land, constructing factory buildings, buying new machinery, or modernising plant operations.

iii Creation of credit

Credit creation means that commercial banks are able to create more money in the economy by giving loans to people, businesses, and industries. When banks give more loans, the total amount of money in circulation increases, even though the bank does not actually print any money. It is one of the most important functions of commercial

banks. In everyday business, banks accept deposits from the public and lend money to customers. When a bank gives a loan, it does not hand over the money in cash. Instead, the bank opens a new account in the borrower's name and credits the loan amount into that account. The borrower can then withdraw the money using a cheque, ATM card, or online transfer. In this way, the bank creates a new deposit, even though no physical cash was given out. This new deposit acts just like money. It can be used for buying goods, paying bills, settling debts, or making investments, just like currency notes. Thus, by giving loans and creating new deposits, commercial banks increase the amount of money available in the economy. This process is known as credit creation. Because banks deal in money, they are often called dealers in money or suppliers of money. However, banks do more than simply borrow and lend; they also create money. When banks create credit, they increase the total money available in the economy, even though no new physical currency is printed. Banks achieve this through different types of deposits. The following are the different types of Deposits in Credit Creation

a. Primary Deposits

Primary deposits are the deposits that customers make in the form of cash. When a depositor gives money to a bank, the bank opens an account in the depositor's name and credits the amount. These deposits are also called Passive deposit or Cash deposits. They form the base on which banks can grant loans and begin the process of credit creation. For example, a customer deposits ₹10,000 in cash. The bank records this amount as a primary deposit. This money becomes part of the bank's reserves and can be used to support future lending.

b. Derivative Deposits

Banks use the cash deposited by customers to give loans to businessmen or to buy assets like bills and bonds. When a bank gives a loan or buys an asset, it normally does not pay cash; instead, it credits the amount to the borrower's account, creating a new deposit. This new deposit is called a derivative or secondary deposit, because it is created from the original primary deposit. Banks know from experience that all customers do not withdraw their money at the same time, so they keep only a small amount as cash reserve for daily needs and lend the rest. The money lent out often returns to the same bank or another bank as new deposits, allowing further lending. This cycle continues until the total deposits in the banking system become many times greater than the original cash deposit. For example, a shopkeeper gets a loan of ₹20,000 from the bank. The bank does not give cash it simply credits ₹20,000 to the shopkeeper's account. This new amount is a derivative deposit.

If banks have more primary deposits, they can create more derivative deposit, which increases the money supply in the economy.

Commercial banks can create money in several ways. In all these cases, the bank does not pay cash. Instead, it creates a new deposit in the name of the customer, which increases the total money supply in the economy. Banks can create money in several ways. They are as follows:



1. Loans and Advances:

Banks provide credit to businesses and individuals through loans, advances, overdrafts, and cash credit. When a loan or overdraft is granted, the bank credits the borrower's account with the amount, allowing them to withdraw money by cheque up to the agreed limit. This process creates a new deposit in the borrower's name. By giving more loans and advances, banks can create more credit in the economy.

2. Discounting of Bills:

When a bank discounts a bill of exchange, the proceeds are usually not paid in cash. Instead, the bank credits the amount to the account of the customer (the discounter), who can then use it like any other deposit. Discounting bills therefore increases the money supply and is another way banks create money.

3. Investments:

Banks also create deposits when they invest in securities such as government bonds, shares, or debentures. Instead of paying cash to the seller, the bank credits the seller's account with the amount of the investment. This creates a new deposit and adds to the total money in the system.

4. Purchasing Fixed Assets:

When a bank buys fixed assets like buildings or equipment, it usually does not pay cash. Instead, it opens a deposit account in the seller's name and credits it with the purchase price. The seller can then use this deposit for payments or other transactions, which increases the money supply.

By this way 'Loans create deposits' and 'deposits create loans'. According to Hartley Withers, 'Loans make deposits', i.e., loans and advances create new deposits. This statement is absolutely correct. When a loan or overdraft or cash credit is granted to a borrower, the amount sanctioned by the banker is usually not given to the borrower in cash. But it is credited to the deposit account opened in the name of the borrower. Therefore, one is right in saying that all form of advances, create deposits or deposits are the children of loan. Just as loans create deposits, primary deposits also create loans. A bank can advance money in various forms only it has cash or primary deposits in its hands. Thus, the various forms of advances are made possible by the primary deposits in the hands of a bank. Hence, the statement 'deposits create loans or loans are children of deposits' is apt.

Credit creation is the process by which banks create new money in the economy. In simple terms: deposits create loans, and loans create deposits. Banks can lend money in various forms such as loans, overdrafts, and cash credit only if they have primary deposits (cash from depositors) in hand. These deposits form the base for further credit creation.

The process of credit creation works based on a few assumptions :

1. There are number of banks in the country, so money borrowed from one bank often ends up as deposits in another.

2. There is no leakage all lent money returns to the banking system as deposits.
3. All banks keep the same percentage of cash reserves as required by law (Cash Reserve Ratio, CRR).

Example:

1. Suppose Mr. Jayan deposits ₹10,000 in Bank A. The bank now has ₹10,000 in cash, which becomes the primary deposit

Balance Sheet of Bank A:

Liabilities	Assets
Deposits ₹10,000	Cash ₹10,000

2. Bank A keeps 10% as cash reserve (₹1,000) and can lend the remaining ₹9,000 to a borrower, say Mr. Y.
3. Mr. Y buys goods from Mr. M worth ₹9,000. Mr. M deposits this money in Bank B. Now Bank B has ₹9,000 as a new deposit and keeps 10% as reserve (₹900), leaving ₹8,100 available for lending.
4. Bank B can now lend this ₹8,100 to another borrower, who will spend it, and the money will again be deposited in the banking system.

This process of credit creation can continue until the total credit reaches many times the original cash deposit. For example, under ideal conditions, credit can be created up to ten times the initial deposit. However, if a bank keeps reserves higher than the minimum required, or if customers do not deposit the full amount back into banks, the total credit created will be less than ten times. The expansion of deposits depends on the cooperation of depositors, banks, and borrowers. If depositors do not put their money in banks, or if borrowers withdraw money and keep it outside the banking system, credit creation cannot continue. Similarly, if a bank holds more cash in reserve than necessary, the amount of credit it can create will be reduced.

When all conditions are met, the total credit created depends on the cash reserve ratio, which is determined by the credit multiplier. The credit multiplier is calculated using the formula:

$$\text{Credit Multiplier} = \frac{1}{C}$$

where C is the percentage of cash reserves to be maintained by the bank.

Example:

- ◇ If the cash reserve ratio is 20%, the credit multiplier is 5. This means total credit can be 5 times the original deposit.
- ◇ If the cash reserve ratio is 25%, the multiplier is $1/0.25 = 4$, so the credit created will be 4 times the deposit.

In short, the higher the cash reserve ratio, the lower the multiplier, and the lower the ratio, the more credit banks can create.



The factors affecting credit creation are as follows:

◇ **Amount of Deposits**

Banks can create more credit when they have higher cash deposits from the public. If depositors are reluctant to deposit money or lose faith in the banking system, banks will have less cash, reducing their ability to lend and create new deposits.

◇ **Cash Reserve Ratio (CRR)**

By law, banks must keep a certain percentage of deposits as reserves with the central bank. A higher CRR means less money is available for lending, limiting credit creation. A lower CRR allows banks to advance more loans, increasing credit creation.

◇ **Security for Loans**

Banks grant loans only when borrowers provide adequate security or collateral. Without sufficient security, banks cannot lend, which restricts credit expansion.

◇ **Liquidity Preference**

If people prefer to hold cash rather than deposit it back into banks, the process of credit creation slows down. For example, if a borrower pays a creditor who keeps the money in cash instead of depositing it, further credit expansion stops.

◇ **Business Conditions**

Economic conditions influence credit creation. During depressions, traders may face losses and avoid loans, reducing credit. During boom periods, businesses actively seek loans, increasing credit in the economy.

◇ **Monetary Policy**

The central bank controls credit through interest rates, cash reserve requirements, and other tools. Changes in monetary policy directly affect how much credit banks can create.

◇ **Leakages**

Certain leakages reduce the potential credit created:

- **Excess Reserves:** Banks may keep more funds than required, often due to fear of rising interest rates or economic slowdown, limiting credit expansion.
- **Currency Drains:** Money lent by banks is not fully redeposited into the banking system, reducing further credit creation.

◇ **Development of Banking System**

Well-developed banking systems and good banking habits encourage credit creation. In underdeveloped areas or where deposit habits are weak, credit creation is limited.

◇ **Behaviour of Other Banks**

If some banks do not lend sufficiently, the chain of credit creation is broken, reducing the overall ability of the banking system to create deposits.

◇ **Use of Cheques**

When people settle payments using cheques instead of cash, banks' cash positions are maintained, allowing them to continue lending and creating credit efficiently.

Credit creation is one of the most important functions of commercial banks, as it allows banks to expand the money supply and support economic activity. By accepting deposits and advancing loans in various forms, banks not only help individuals and businesses meet their financial needs but also stimulate trade, investment, and overall growth in the economy. The extent of credit creation depends on factors such as the amount of deposits, cash reserve requirements, borrower security, economic conditions, and public banking habits. Effective credit creation ensures that funds circulate efficiently within the economy, making banks key contributors to financial stability and economic development.

1.1.5.2 Secondary functions

In addition to their primary functions of accepting deposits, lending money, and creating credit, modern commercial banks also perform a wide range of secondary functions to provide extra facilities and convenience to their customers. These functions go beyond the basic banking activities and are designed to support both individuals and businesses in their financial and transactional needs. Broadly, the secondary functions of banks can be classified into two categories:

- i. Agency services and
- ii. General utility services

Each serving a specific purpose in enhancing the overall banking experience.

i. Agency services

Commercial banks perform a variety of services as agents of their customers, providing convenience in financial and administrative matters. The main agency services are as follows:

◇ **Payment and Collection**

Banks make payments and collect money on behalf of customers. This includes payment of insurance premiums, club or professional association subscriptions, rent and salaries, and collection of dividends, pensions, and rents. They also facilitate the transfer of funds between accounts.

◇ **Purchase and Sale of Securities**

Banks buy and sell shares and debentures of joint-stock companies for customers. Transactions are carried out strictly according to customer instructions to ensure accuracy.

◇ **Acting as Executor, Administrator, and Trustee**

Banks manage the estates of deceased customers:



- **Executor:** Administers the estate as per the will.
- **Administrator:** Manages property according to the law, appointed by the court.
- **Trustee:** Holds property in trust for beneficiaries named in the will. Many banks have specialised departments for executors and trustees to handle these functions.

◇ **Acting as Attorney**

Banks can receive dividends, interest, and manage securities on behalf of customers when authorised via a power of attorney, including signing transfer forms for government or stock exchange securities.

◇ **Acting as Correspondents and Representatives**

Banks represent customers in administrative matters such as preparing income tax returns, paying income tax, and assisting with foreign travel arrangements, including passports, tickets, and hotel bookings.

◇ **Collection of Information**

Banks gather information on stock market securities and investments and advise customers on suitable investment options when requested.

◇ **Remittance of Funds**

Banks arrange safe and efficient transfers of money from one place to another using bank drafts, mail transfers, or telegraphic transfers.

ii **General utility services**

All banks perform non-banking activities along with their traditional functions. The banker provides the following general utility services to customers and general public.

1. **Safe custody of valuables:** Banks accept shares, debentures, bonds, fixed deposit receipts, deeds of property, life insurance policies and sealed boxes and packets containing will or valuables such as jewellery from their customers for safe custody. Banks are equipped with strong, fireproof and theft-proof rooms for safe maintenance of the articles. There are two ways through which a banker ensures the safety of its customers' valuables -
 - ◇ By accepting valuables for safe custody Banking and Insurance
 - ◇ By hiring out safe deposit lockers to the customers.
2. **Letter of Credit:** It assumes great importance in international trade. The letter of credit is a sort of guarantee to the exporter that his draft will be honoured by a specified bank up to a certain amount as per the specified terms.
3. **Travellers' Cheque:** A traveller's cheque can be purchased by anyone. These are useful to persons who frequently travel within the country or abroad. The purchaser has to deposit money with the issuing bank equivalent to the amount of the traveller's cheque he intends to buy. These cheques are usually encashable only at the branches of the issuing bank. Moreover, there is no expiry period for the travellers' cheques.

4. **Remittance of Funds:** Banks remit funds from one place to another through the network of their branches. The main instruments for transfer of funds are bank drafts, mail transfer, telegraphic transfer and travellers' cheques.
5. **Merchant Banking:** The merchant banking division of commercial banks offer wide range of services, financial, technical, managerial etc. The main services include:
 - a. Facilitate in the formation of corporate units
 - b. Assisting in formation of a financial plan
 - c. Management of public issue by corporates
 - d. Assisting companies in matters relating to restructuring, amalgamations, mergers and takeovers, etc.
6. **Dealings in Foreign Exchange Business:** The Bank offers varied services in respect of foreign exchange business. They include Deferred payments, import packing facility. Export finance, forward contracts, etc.
7. **Lease Financing:** A lease is a method of financing for purchasing equipment and machinery. It is the mechanism by which a person acquires the use of an asset by paying a predetermined amount called 'Lease rental' periodically over a period of time. A subsidiary company promoted by a bank may undertake equipment leasing and such other activities incidental thereto.
8. **Factoring:** It is a facility provided to finance on trade debt of corporate. It is an arrangement between the factor agent and the business concern selling goods/services to trade customers whereby the factor purchases the book debts either with or without recourse to the client and in relation to controls the credit extended to the customers and administers the sales budget.
9. **Underwriting of Securities:** Commercial banks underwrite a portion/whole of the public issue of shares, bonds and debentures of joint stock companies. Such underwriting provides an indirect form of insurance to the companies on the event of public subscriptions falling short of expectations. Moreover, banks act as bankers to the public issue.
10. **Tax Consultancy:** The Bank Income Tax Department offers a complete tax service which consists of advice on income tax and other personal taxes, preparing customers' annual statement, claiming allowances, filing appeals etc.
11. **Gift Cheques:** Banks in India sell gift cheques against payment in cash or by debit to the customer's account. As the name indicates, these are intended to be given as gifts on occasions such as weddings, birthdays etc. The payee can encash them at any time.
12. **Teller System:** Under this system, the teller is authorised to receive cash and make payments up to limited amounts without reference to the ledger balance or the specimen signature.



13. **Credit Cards:** Credit cards are issued to good customers having current or saving accounts, free of charge. It enables a customer to purchase goods or services from retail and service establishment upto a certain limit without making immediate payment. The bank assumes the risk and responsibility of collecting the due from the customers.
14. **Consultancy Service:** State Bank of India and Indian Bank have set up consultancy cell to provide consultancy services to small-scale industries. The consultancy service covers technical, financial, managerial and economic aspects. This service is offered not only at the project stage but also at every stage of implementations of the project.
15. **Debit Card:** A debit card facilitates purchases/payments by the card holder in the same way as a credit card does. The card holder presents the card to the merchant establishment after a purchase and signs on the payment slip. The merchant verifies the signature electronically by inserting the card into an electronic data capture machine that links up with the cardholder's bank through a payment gateway like Visa or Master Card. The bank then debits the amount from the card holder's account and verifies the transaction. While the credit card extends credit to the card holder, a debit card debits money from his account during a transaction. This implies that the Debit Card holder can spend only if his account permits.
16. **Bank Drafts:** Bank issues bank drafts to customers and general public. For remitting money from one place to another, bank issues bank drafts or demand drafts on their branches at the place of destination. According to Sec. 85 A of Negotiable Instrument Act, a bank draft is an order from one branch to another branch of the same bank to pay a specified sum of money to the person named therein or his order. A draft is always payable on demand.

Banking plays a vital role in the economy by safely managing money, providing credit, facilitating payments, and supporting overall economic growth. Its functions, including accepting deposits, lending, creating credit, and offering various financial services, ensure the smooth flow of funds within society. Understanding the different types of banks such as commercial, cooperative, central, and development banks helps in recognising how each institution contributes to meeting the diverse financial needs of individuals, businesses, and governments. Together, the objectives, functions, and types of banks form the foundation of an effective and stable financial system.

Recap

- ◇ A bank is a financial institution that accepts deposits, provides loans, and offers various financial services to individuals, businesses, and governments.
- ◇ Banking is the process of accepting deposits, granting loans, and providing financial services to facilitate the management and flow of money in the economy.

- ◇ The objective of banks is to safeguard deposits, provide credit, facilitate payments, and support economic growth.
- ◇ Banks can be classified based on their functions, ownership, domicile, and other specialised types.
- ◇ Credit creation is the process by which banks generate new money in the economy by lending more than the deposits they hold.

Objective Questions

1. What are the two classifications under secondary functions of bank
2. Write down any one base for classification of banks?
3. list out the three primary functions of bank?
4. Different types of Deposits in Credit Creation?
5. State any one general utility function performed by commercial banks?
6. Which type of deposit allows unlimited deposits and withdrawals, mainly for businesses?
7. Which deposit involves regular monthly contributions to save gradually?
8. Which deposit is designed for specific future goals like education or marriage?
9. In which bases domestic and foreign banks are classified?

Answers

1. Agency services and General utility services
2. Public bank and Private bank
3. Accepting deposit, Lending money and Credit creation.
4. Primary deposit and Derivative deposit.
5. Safe custody of valuables
6. Current
7. Recurring
8. Endowment
9. Based on Domicile



Self Assessment Questions

1. Discuss the objectives of banking
2. Briefly explain the credit creation function of bank
3. Essay on different types of banks with suitable examples.
4. Explain the functions of banking.
5. Short note on general utility services of commercial banks.
6. Describe the primary functions of commercial banks?
7. Explain the different types of banks based on domicile.

Assignment Questions

1. Visit your near bank branch and assess the different types of deposits available there and also analyse the interest pattern.
2. Analyse the functions and prepare a report of the bank in which you have an account.
3. Briefly explain the credit creation function of banks and evaluate its significance in increasing the money supply in the economy.
4. “Banks do not just store money; they create money.” Explain this statement with reference to the credit creation function. Critically evaluate its impact on economic growth and inflation.

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Unit

CORE Banking and Retail Banking

Learning Outcome

After completing this unit, learners will be able to;

- ◇ get an overview of the concept of core banking
- ◇ comprehend the merits of core banking
- ◇ describe the concept of retail banking
- ◇ identify retail banking products and services

Prerequisite

Assuming that you walk into a bank in your hometown, deposit money in the morning, and later travel to another city and withdraw the same amount within minutes has become a normal experience today. You may also think of shopping online late at night and paying instantly through a service provided by your bank. These everyday conveniences are possible because modern banks operate through advanced systems like core banking and retail banking. This unit will be prepared to grasp the concept and advantages of core banking, understand the meaning of retail banking, and identify the wide range of retail banking products and services offered to customers

Keywords

Core banking, Retail banking

Discussion

Mr. X, a businessman who maintains his bank account in Trivandrum. Earlier, if he travelled to Ernakulam for business, he would have to go back to Trivandrum to repay his loan, check his account balance or branch related services. This inconvenience was common in traditional banking systems, where each branch maintained its own records, and updates were often delayed. However, the introduction of Core Banking Solutions (CBS) has completely transformed this experience.

1.2.1 Core banking

Core Banking refers to a centralised banking system where a bank's branches are interconnected through a network of computers. Customer data and accounts are stored in a central database. It allows customers to access their accounts and carry out financial transactions from any branch of the bank, anywhere in the country or even globally. The term "Real-Time" implies that every transaction, whether a deposit, withdrawal, loan repayment, or fund transfer, is immediately reflected in the customer's account without delay. Mr. X can repay a loan taken from the Trivandrum branch while staying in Ernakulam. The repayment is credited to his loan account instantly, eliminating the need to travel and wait for manual updates.

Core banking enables banks to provide a wide range of services such as deposits, withdrawals, fund transfers, loan processing, ATM services, internet banking, and mobile banking in a fast and efficient manner. It improves operational efficiency, reduces paperwork, enhances accuracy, and ensures real-time processing of transactions. For customers, core banking offers convenience, transparency, and better service delivery, while for banks it supports better risk management, centralised control, and scalability. Overall, core banking is the backbone of modern banking operations.

1.2.2 Features of Core Banking

Ms. Priya, who maintains a savings account in Mumbai, can transfer funds to her daughter's account in Kolkata instantly from her local branch without visiting Mumbai. Key features such as a centralised database, easy access to information, branch-independent services, real-time fund transfers, and integration with ATMs, online banking, and mobile banking collectively ensure convenience, efficiency, and reliability for both customers and banks. Understanding these features demonstrates how modern banking systems offer seamless, customer-focused services across multiple locations. Let us discuss each feature in detail :

1. **Centralised Database:** Core banking systems maintain all customer and transaction data on a central server, ensuring accuracy and consistency across the bank. When a customer deposits money at one branch, the updated balance is immediately available at all other branches, preventing discrepancies and allowing bank staff to access uniform information for decision-making.

2. **Easy Access to Database:** Bank employees and authorised personnel can securely access the central database from any location through internet connections. This allows loan officers, customer service staff, or branch managers to retrieve account information or approve transactions quickly, even if the customer originally opened the account at a different branch.
3. **Access to Any Branch:** Customers can perform all banking activities, including deposits, withdrawals, loan repayments, and account inquiries, at any branch of the bank. For example, a person with an account in Trivandrum can repay a loan or withdraw funds from an Ernakulam branch, eliminating the need to travel to their home branch and improving convenience.
4. **Real-Time Fund Transfers:** Core banking enables instant transfer of funds between accounts across branches. This means businesses can pay suppliers in other cities immediately, and individuals can transfer money between accounts without delays, enhancing the efficiency of financial operations and liquidity management.
5. **Integrated Services:** Core banking integrates multiple services such as ATMs, debit/credit cards, online banking, mobile banking, and corporate banking solutions into a single platform. Customers can check balances via mobile apps, withdraw cash at any ATM, or make online payments without visiting a branch, while corporate clients can manage payroll and vendor payments seamlessly. This integration ensures a smooth and efficient banking experience for all types of customers.

◇ **Importance of Core Banking**

1. **Anywhere and Anytime Banking:** Core banking allows customers to access their accounts and conduct transactions from any branch or through digital channels at any time, ensuring greater convenience.
2. **Improved Customer Service:** Real-time access to customer information enables faster transactions, reduced waiting time, and personalized banking services.
3. **Operational Efficiency:** Centralized data processing reduces duplication of work, manual errors, and paperwork, leading to cost efficiency for banks.
4. **Better Management Information System (MIS):** Core banking provides accurate, real-time data that helps banks in decision-making, monitoring performance, and managing risks effectively.
5. **Support for Digital Banking:** It forms the backbone for services like ATM networks, internet banking, mobile banking, NEFT, RTGS, UPI, and other electronic payment systems.
6. **Enhanced Security and Control:** Centralized systems improve data security, internal controls, and compliance with regulatory requirements.
7. **Faster Product Innovation:** Banks can easily introduce new products and services such as online loans, digital accounts, and customized financial solutions.

8. **Scalability and Growth:** Core banking systems enable banks to expand operations across regions without compromising service quality.

Core banking has transformed the traditional banking system into a modern, technology-driven service industry. By integrating all branches and services into a single platform, it enhances customer convenience, operational efficiency, and financial inclusion. In today's digital era, core banking is not just a technological upgrade but a strategic necessity for banks to remain competitive, secure, and responsive to the evolving needs of customers and the economy.

1.2.3 Merits of Core Banking

1. **Customer Convenience:** One of the main advantages of core banking is the convenience it offers to customers. Individuals can access their accounts and perform financial transactions from any branch of the bank, regardless of where their account was originally opened. A customer with a savings account in Delhi can withdraw cash or repay a loan while visiting Mumbai, eliminating the need to travel long distances and saving considerable time.
2. **Efficiency and Time-Saving:** Core banking processes transactions in real time, which significantly reduces waiting time for both customers and bank staff. Activities such as deposits, withdrawals, and fund transfers are completed almost instantly, allowing customers to receive immediate confirmation of their transactions. This enhances the overall service quality and ensures that routine banking operations are faster and more reliable.
3. **Operational Effectiveness:** Core banking improves the operational efficiency of banks by providing staff with real-time access to accurate information. Employees can handle queries, approve loans, and monitor account activities without delays. A bank officer can instantly verify a customer's credit history and outstanding balances while approving a loan, reducing errors and avoiding duplication of work, which was common in traditional branch-based systems.
4. **Better Cash and Credit Management:** Banks can monitor deposits, withdrawals, loan repayments, and fund flows efficiently with a centralised system. This enables better management of liquidity, ensures that funds are available when needed, and assists in risk management. If a large corporate client transfers funds between accounts, the bank can immediately adjust its cash reserves and plan lending or investment activities more effectively.
5. **Support for Corporate Clients:** Core banking provides businesses with a seamless way to manage multiple accounts across different branches. Companies can process payroll, make vendor payments, and manage cash flow efficiently. A business operating office in several cities can use core banking to disburse salaries simultaneously across branches and ensure vendors are paid on time, enhancing operational smoothness and financial discipline.
6. **Transparency and Security:** With centralised databases, all transactions are recorded and updated in real time, reducing the risk of fraud. The system

maintains detailed audit trails, making it easier to monitor suspicious activities and ensure secure handling of customer funds. Any irregular transaction can be tracked immediately, improving trust and accountability between banks and customers.

- 7. Financial Inclusion:** Core banking facilitates wider access to banking services, especially in remote or rural areas. Customers do not need to rely on a single branch and can use digital channels such as mobile banking, online portals, or ATMs to access services. This promotes financial inclusion, allowing people who were previously outside the formal banking system to save, transfer money, or take loans conveniently.

Consider a corporate client, Mr. Y, operating offices in Mumbai, Kolkata, and Bangalore. Previously, each branch maintained separate records, causing delays in payroll and inter-branch fund transfers. With Core Banking, Mr. Y can manage all accounts from any branch or online portal. Salaries can be disbursed, vendor payments made, and inter-branch fund transfers executed in real time, improving efficiency and reliability.

Core Banking is not just a technological innovation; it is a strategic approach that enhances convenience, efficiency, transparency, and customer satisfaction in banking. It ensures that banks can manage cash, loans, and deposits effectively while providing uninterrupted services to customers, irrespective of location or branch. The introduction of Core Banking has made banking faster, safer, and more customer-friendly, addressing the limitations of traditional branch-based systems.

1.2.4 Retail banking Products and Services

Retail banking, often known as consumer banking, refers to the range of financial products and services offered directly to individuals and small businesses. Unlike corporate banking, where banks deal with large firms and complex financing, retail banking focuses on meeting the everyday financial needs of households. Retail banking has expanded rapidly due to rising incomes, technological advancements, and customers' growing expectations for convenience. A widely accepted principle guiding retail banking is "do not keep all eggs in one basket", meaning that banks diversify risks by offering various consumer credit products to many individuals rather than relying on a few large borrowers.

To understand retail banking better, imagine the story of Meera, a young schoolteacher living in Chennai. Like many individuals, Meera interacts with her bank through multiple retail services: her savings account for salary deposits, her debit card for daily purchases, an education loan she took earlier, and the housing loan she is now planning to apply for. Through Meera's experiences, we can understand how retail banking supports the financial needs of ordinary people. At the same time, her brother Arun, who runs a small snack shop, uses a current account to manage daily transactions and accepts digital payments through UPI. Both Meera and Arun depend on retail banking for their financial activities; this is how retail banking supports everyday life.

Retail banking services can be grouped into following:

1. Deposit products
2. Loan products, and
3. Payment services.

1. 2.4.1 Deposit products

Deposit products are the everyday tools that help people keep their money safe, manage their payments, and earn some return on their savings. For the bank, these deposits act as a steady and low-cost pool of funds that can be used for lending and investment. In a typical town, you will find different people using different deposit products depending on their needs, habits, and financial plans, and each product serves a unique purpose.

a. Savings account

Savings accounts are often the first step into formal banking for most individuals. They are designed to hold personal savings securely while allowing frequent access whenever needed. A young teacher, may find her salary credited directly into her savings account every month. She might use the same account to pay her electricity bill online in the evening, withdraw money from an ATM on the way home, and make small purchases using her debit card during the week. Although the interest she earns is modest, the real value lies in the convenience, safety, and flexibility the account offers.

b. Fixed deposit

Fixed deposits, also known as time deposits, suit customers who want safety with a predictable return. Here, the depositor agrees to keep the money locked in for a chosen period perhaps three months, a year, or even five years in return for a higher interest rate. The terms are fixed from the start, and withdrawing the money early usually involves a penalty. Imagine parents who receive a lump sum from a maturity benefit, instead of letting it lie idle, they place it into a one-year fixed deposit so that it grows securely while they prepare for an education-related expense the following year. They sacrifice quick access but gain a better return and peace of mind.

c. Money market accounts

Money market accounts are suitable for people or businesses who maintain larger balances and want slightly higher interest without giving up access to their funds completely. Banks invest these deposits in short-term instruments such as treasury bills or commercial paper, which helps them offer a better return compared to normal savings accounts. A small business with fluctuating monthly income may keep its surplus funds in such an account. During most months, the balance earns a reasonable return, and when the business needs to make a large supplier payment, it can still withdraw the amount with minimal restrictions.



d. Safe deposit boxes

Safe deposit lockers offer a different kind of “deposit” service, focusing on physical security rather than money. These lockers, usually located within reinforced bank vaults, help customers safeguard valuable items such as property documents, jewellery, or family heirlooms. A family preparing for a long trip might store their gold ornaments and property papers in a locker to avoid the risk of burglary at home. Although the bank provides a highly secure environment, the responsibility for the contents remains with the customer, who pays an annual fee and accesses the locker only through authorised signatures and identification.

1.2.4.2 Loan products

Loan products are the financial tools through which banks provide money to people and businesses, with the expectation that the amount will be repaid over time along with interest. These loans support everyday needs such as buying a home, pursuing education, travelling, purchasing vehicles, and running small enterprises. In any town, you will find individuals using different types of loans based on their goals, income, and life situations, and each loan product is designed to match a particular need.

a. Home loans

Home loans are long-term loans that help people purchase or build a house. Because the amounts are usually large and the repayment period can stretch from 10 to 30 years, the bank secures the loan by keeping the house itself as collateral. Before agreeing, the bank studies the borrower’s income documents, credit behaviour, and the value of the property to ensure that the loan is affordable and safe. A young couple buying their first flat may find the bank assessing their joint salary, checking their credit scores, and then fixing their monthly instalments for the next two decades. Even within the same neighbourhood, another family might use a home loan to build a small independent house, while someone else might take one to add an extra room to accommodate elderly parents. Interest may remain fixed, move with market rates, or combine both, depending on what the borrower prefers.

b. Mortgage refinancing

Mortgage refinancing becomes useful when a borrower wants to change the terms of an existing home loan often to take advantage of lower interest rates or to adjust the repayment period. It is similar to shifting to a better-priced loan so that the monthly burden reduces. A homeowner who has been paying EMIs for several years may notice a dip in market interest rates and approach the bank to refinance, thereby reducing the EMI and freeing some income for other expenses. Alongside this, home-equity loans allow people to borrow against the portion of the house they already own. For example, a family that has repaid half of its mortgage may use the built-up equity to borrow for their child’s overseas education or to renovate an ageing kitchen. These loans tend to be cheaper than unsecured credit because the property continues to act as security, though they also increase the overall mortgage obligation.

c. Vehicle loans

Vehicle loans are shorter-term loans designed to help customers purchase cars, two-wheelers, or even commercial vehicles like vans, lorries, or autorickshaws. Banks look at the customer's repayment capacity and the expected value of the vehicle over time. A delivery company may rely on a vehicle loan to purchase a new van so that it can expand its service area, planning its business cash flow around a fixed monthly EMI. In another situation, a college student buying her first scooter might choose a small two-wheeler loan with bundled insurance and easy instalments, while a taxi driver upgrading his old car may use an auto loan to replace it with a more fuel-efficient model and improve his earnings.

d. Personal loans

Personal loans offer flexibility because they do not require collateral. People turn to them when they need quick funds for purposes such as medical treatment, travel, skill training, or urgent household expenses. Since the bank has no asset to rely on if repayment becomes difficult, it charges a higher interest rate and limits the repayment period to a few years. A working professional who wants to take a short digital-marketing course may choose a personal loan because the approval is fast and no security is needed. Families also use such loans when faced with sudden medical bills, or when they wish to cover wedding expenses without disturbing long-term savings. The bank decides based mainly on income stability, credit scores, and past repayment habits.

1.2.4.3 Payment services

Payment services act like the hidden plumbing of the financial system, quietly ensuring that money moves smoothly from one person to another. Whether someone is paying for groceries, withdrawing cash, sending money abroad or managing a business account, these services reduce effort, save time and make every day financial life more convenient. In any town or city, you will find people using these services without even noticing the complex systems working in the background.

A. Debit and ATM cards

Debit and ATM cards are among the most familiar payment tools. They give customers direct access to the money already sitting in their bank accounts, allowing them to withdraw cash from ATMs or make quick payments at shops. The moment a person taps their card at a supermarket checkout or enters a PIN at an ATM, the bank's systems immediately deduct the amount from their account. Modern cards carry security features such as EMV chips, PIN protection and contactless technology, which make them both safer and faster to use. It is common to see a commuter tapping a contactless debit card to buy a sandwich on the way to work, and later withdrawing some cash at an ATM, with both transactions instantly recorded by the bank.

B. Credit cards

Credit cards operate differently because they offer short-term borrowing. Instead of using their own money immediately, customers spend up to a limit set by the bank and settle the amount later. Many people find this helpful when their cash flow is uneven.



A small shopkeeper, may purchase inventory using a credit card when stock is running low, knowing that customer payments will come in during the week. If the bill is paid in full before the due date, no interest is charged. But if left unpaid it begins to attract interest. Banks manage these cards carefully by checking credit history, setting limits, offering reward schemes and monitoring repayment behaviour.

◇ Differences Between Debit Card vs Credit Card

1. **Source of Money:** Debit card uses the account holder's own money, while a credit card uses money borrowed from the bank.
2. **Account Requirement:** Debit card is linked to a savings or current account; credit card is linked to a credit account.
3. **Spending Limit:** Debit card spending is limited to available bank balance; credit card spending is limited to the credit limit sanctioned.
4. **Interest:** Debit card does not involve interest; credit card attracts interest if dues are not paid on time.
5. **Repayment:** No repayment is required for debit card usage; credit card usage requires repayment to the bank.
6. **Billing Cycle:** Debit card has no billing cycle; credit card has a monthly billing cycle.
7. **Credit Score:** Debit card usage does not affect credit score; credit card usage helps build credit history.
8. **Eligibility:** Debit card is issued automatically with a bank account; credit card is issued based on income and creditworthiness.
9. **Risk of Overspending:** Debit card has lower risk of overspending; credit card has higher risk due to easy credit.
10. **Cash Withdrawal:** Debit card allows easy cash withdrawal without interest; credit card cash withdrawal attracts high charges and interest.

C. Student-banking products and low-balance accounts

Student-banking products and low-balance accounts are designed to support young adults who may not yet have steady income. Banks often allow students to open accounts with minimal balances, simple identification procedures and lower service charges, encouraging financial literacy from an early age. A university student might receive scholarship funds into a zero-balance account and use a prepaid campus card for daily purchases such as printing, meals or books. These arrangements not only help students manage money responsibly but also introduce them to formal banking at an early stage.

D. Foreign Currency and Remittance Services

Foreign currency and remittance services play an essential role in families that depend on income from abroad. Banks help customers convert foreign money into local

currency and make sure transfers from overseas arrive quickly and safely. In many communities, you might see households relying on monthly remittances sent by relatives working in places such as the Middle East, Europe or Southeast Asia. When the funds arrive, the bank handles the currency conversion and credits the amount directly to the family's account, allowing them to meet household expenses or save for future needs.

E. Current Accounts

Current accounts, sometimes known as checking accounts, are vital for businesses and professionals who need to carry out frequent transactions. These accounts are designed for efficiency rather than for earning interest. A restaurant owner, for example, may deposit the day's cash collections into a current account every evening, use the same account to pay suppliers through UPI or bank transfers, and issue cheques for staff salaries. Because these accounts allow unlimited transactions, they help businesses maintain smooth cash flow and meet operational requirements without delay.

Modern retail banking services

A young professional maintains a savings account, pays rent via UPI, invests spare cash through the bank's mutual fund platform, and uses a BNPL option at checkout etc. Bank's app consolidates these services and provides analytics on spending. Retail banking now blends traditional products with digital platforms and additional financial services.

1. **Digital wallets & UPI:** Instant person-to-person (P2P) and merchant payments through apps reduce reliance on cash.
2. **Mobile and internet banking apps:** Full banking services (statements, bill pay, transfers) on mobile devices enhance access and reduce branch dependency.
3. **Automatic bill payments & standing instructions:** Customers can automate recurring payments (utilities, EMI) improving discipline and reducing missed payments.
4. **Investment & insurance intermediation:** Banks sell mutual funds, pensions and insurance products, providing one-stop financial solutions.
5. **Buy-Now-Pay-Later (BNPL) and embedded finance:** New retail credit models integrated with merchants are supplementing traditional credit cards and personal loans.
6. **Financial inclusion products:** Small-ticket micro-savings and micro-credit tailored for low-income customers expand access to the formal financial system.



Recap

- ◇ Core banking refers to a centralised system that allows customers to access their bank accounts and perform transactions from any branch of the bank, anytime.
- ◇ Core banking provides customers with faster, anytime access to their accounts and services across all branches, improving convenience and efficiency.
- ◇ Retail banking refers to banking services provided directly to individual customers for their personal financial needs, such as deposits, loans, and payment services.
- ◇ Retail banking products and services are classified as deposit products, loan products, and payment services.

Objective Questions

1. Expand BNPL
2. What are the different bases for classification retail banking products and services ?
3. State any retail banking product and services under the head payment services?
4. Name the retail product borrower used to change the terms of an existing home loan often to take advantage of lower interest rates or to adjust the repayment period.
5. Name any modern retail banking services?
6. State any one merit of core banking?
7. What is a centralised banking system where a bank's branches are interconnected through a network of computers.
8. What refers to the range of financial products and services offered directly to individuals and small businesses.
9. What is the another name for retail banking ?

Answers

1. Buy-Now-Pay-Later
2. Deposit products, Loan products, and Payment services
3. Debit and ATM cards
4. Mortgage refinancing
5. Digital wallets & UPI
6. Customer Convenience
7. Core banking
8. Retail banking
9. Consumer banking

Self Assessment Questions

1. What is core banking?
2. Discuss the features of core banking?
3. Briefly explain the advantages of core banking?
4. Essay on retail banking products and services
5. List out the products and services under the head of deposit of products in retail banking products and services?

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Unit

Central Bank

Learning Outcomes

After completing this unit, learners will be able to;

- ◇ get an insight into the concept of central banks
- ◇ discuss the evolution and development of Reserve bank of India
- ◇ describe the function Reserve Bank of India

Prerequisite

Assume a country as a living body, its people are the muscles, its industries the organs, and its money the lifeblood that keeps everything moving. But who controls this vital flow to keep the body healthy and balanced? That's where the central bank steps in the heart that pumps money through the economy. In India, this heart is the Reserve Bank of India (RBI). From its humble beginnings in 1935, the RBI has grown into one of the most powerful and respected financial institutions in the world. It not only issues our currency but also guides the nation's credit, monitors banks, and ensures economic stability. In this unit, you will understand the concept of central banks, explore the evolution and development of the RBI, and learn about the crucial functions it performs to keep India's financial system strong and steady

Keywords

Central bank, Reserve bank of India, Credit control, Monetary policy

Discussion

Assume a country as a large and busy organisation. Just like any organisation needs a strong leader to guide the team, a country's financial system also needs a steady hand to ensure everything runs smoothly. This "leader" of the money world is the Central Bank, the institution that quietly works behind the scenes to keep the economy stable, the currency trusted, and the banking system safe. The Central Bank is the highest authority in a country's financial and banking structure. It does not deal with ordinary citizens like commercial banks do; instead, it supervises and guides other banks, manages the nation's money supply, and supports the government in financial matters. It is often described as the "heart of the financial system" because it pumps money and credit throughout the economy in a controlled and healthy way.

1.3.1 Central bank

A Central Bank manages the expansion and contraction of a nation's money and credit for the welfare of the country. It also acts as the fiscal agent of the Government. According to James Stephenson, "A Central Bank is the principal banking institution of a country, operating under some degree of state control and charged with the duty of regulating the volume of money and credit in the interest of the community." R.P. Kent, defined central bank as "An institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare."

To understand central banking, think of the financial system as a railway network. The trains (commercial banks) carry passengers (money) across the country. But who controls the signals, monitors the tracks, and ensures the trains run safely, without crashing or causing chaos? That responsibility lies with the Central Bank, which acts like the controller of the entire system. It ensures that every train follows the rules, maintains safe speeds, and works in coordination with others.

When India began developing its banking system, it looked towards England, which had already established a strong central banking model through the Bank of England. In England, commercial banks placed strong trust in the Bank of England, treating it like a financial guardian. Whenever a bank faced a shortage of funds, it could approach the central bank as a "lender of last resort", but this support was conditional on maintaining stable cash reserves, which served as a protective cushion for depositors and the wider economy. The Bank of England also regulated money supply through open market operations buying and selling government securities a strategy made effective by the presence of a highly active securities market. India later adopted this model because it promoted a disciplined and well-regulated banking environment. The underlying principle was straightforward: when commercial banks maintain adequate reserves and operate responsibly, the central bank is better positioned to assist them in times of difficulty and ensure financial stability across the economy.

The Central Bank holds a unique and authoritative position within a country's financial system, acting as the guiding institution that supervises, regulates and supports all other banks. Unlike commercial banks, its purpose is not to earn profit but to maintain monetary stability, safeguard the value of money and ensure a sound and disciplined banking structure. Because of its special role in controlling the supply of currency and credit, the Central Bank possesses several distinct features that set it apart from all other financial institutions. Let us discuss the features of central bank in detail.

A central bank is the supreme monetary authority of a country that controls and regulates the money supply, credit system, and banking operations to maintain economic stability. It is the highest financial institution of a country that controls and regulates the monetary system. It is responsible for issuing currency, controlling the supply of money and credit, maintaining price stability, and regulating commercial banks. The central bank also acts as the banker to the government and works to ensure economic stability and growth in the country.

In addition, the central bank supervises commercial banks to ensure a safe and stable banking system. It also acts as the banker, agent, and financial advisor to the government, playing a key role in promoting economic stability and growth. Other definitions of central bank are as follows :

“A central bank is the apex institution which controls, regulates, and supervises the monetary and banking system of a country.”

According to Hawtrey:

“A central bank is the lender of last resort.”

According to Samuelson:

“A central bank is a bank of bankers that controls the monetary system of a nation.”

According to De Kock:

“A central bank is a bank which constitutes the apex of the monetary and banking structure of a country.”

1.3.2 Characteristics of a Central Bank

1. Only one Central Bank in a country

This means a nation has a single authority to control money and banking; for example, India has only the Reserve Bank of India, which ensures uniform monetary policy across the whole country.

2. Owned and managed by the government

A Central Bank works under government control to safeguard public interest; for instance, the RBI is fully owned by the Government of India, ensuring decisions are made for national welfare and not private gain.



3. Main objective is to regulate and control the volume of money

Its key role is to maintain price stability and economic balance; for example, the Central Bank may increase interest rates when inflation rises to reduce the excess money circulating in the economy.

4. Motto is service, not profit

It functions to support economic stability rather than earning profits; for example, the Bank of England may reduce rates to help businesses during economic slowdown, even if it earns less income.

5. It does not perform commercial banking functions

A Central Bank does not accept deposits or give loans to the public; for example, individuals cannot open a savings account with the RBI because it deals only with banks and the government.

6. Has statutory power to control other banks and financial institutions

It can issue rules and supervise banks to maintain financial discipline; for example, the Central Bank can require banks to maintain a specific Cash Reserve Ratio (CRR) to ensure safety of depositors' money.

7. Does not deal directly with the public

It operates only through commercial banks and does not provide services to ordinary customers; for example, if the public needs loans or deposits, they must approach commercial banks, not the Central Bank.

8. Sole authority to issue currency notes

It alone has the legal right to print and circulate national currency; for example, all Indian currency notes are issued by the RBI, giving it full control over the supply of money in the economy.

The Central Bank plays a crucial role in shaping a country's economic stability and growth. As the controller of money and credit, it works to ensure that the financial system remains stable, efficient and supportive of national welfare. To achieve this, the Central Bank follows several key objectives that guide its policies and actions in the interest of the entire economy.

1.3.3 Objectives of a Central Bank

The financial strength of any country depends largely on how effectively its Central Bank designs and implements monetary policies. To support economic stability and national welfare, every Central Bank works towards a few key objectives.

1. To serve national interest

Central Banks are created to work for the overall welfare of the country. Since a Central Bank functions as an organ of the government, it must support policies that benefit the people and strengthen the economy. During the COVID-19 period, many

central banks, including the RBI, reduced interest rates to support households and businesses, helping the nation manage the economic impact.

2. To stabilise monetary and fiscal activities

Most key monetary and fiscal measures depend on the Central Bank. It aims to keep money supply and credit levels stable so that the economy does not face sudden inflation or recession. By controlling currency and credit, the Central Bank prevents disturbances such as rapid price rises or severe cash shortages. For example, If inflation increases, the Central Bank may raise policy rates (such as the repo rate in India) to reduce borrowing and control excess money in circulation.

3. To promote economic development

A major objective of the Central Bank is to support long-term economic growth. In developed countries, where the risk of high inflation is greater, the Central Bank may reduce money supply to prevent prices from rising too quickly. In contrast, developing countries often need more credit to support industries, agriculture and employment, so the Central Bank may expand money supply to encourage growth. In India, the RBI often provides easier credit to priority sectors like agriculture and small industries to boost development and create jobs.

Every country relies on a central bank to guide its financial system, control the flow of money and maintain economic stability. Although their roles are similar, each nation's central bank has its own history, structure and way of functioning. From the powerful Federal Reserve in the United States to the long-established Riksbank in Sweden, central banks around the world play a vital role in shaping global economic trends. The following table highlights some of the major central banks across different countries.

Table 1.3.1 Central banks in different countries

Country	Name of Central Bank
United States	Federal Reserve System (The Federal Reserve)
United Kingdom	Bank of England
Switzerland	Swiss National Bank
Australia	Reserve Bank of Australia
Pakistan	State Bank of Pakistan
United Arab Emirates	Central Bank of the United Arab Emirates
Thailand	Bank of Thailand
Canada	Bank of Canada
Sweden	Sveriges Riksbank (The Riksbank)
China	People's Bank of China
India	Reserve Bank of India (RBI)
Japan	Bank of Japan
Germany	Deutsche Bundesbank
France	Banque de France

South Africa	South African Reserve Bank
Brazil	Central Bank of Brazil
Singapore	Monetary Authority of Singapore (MAS)
New Zealand	Reserve Bank of New Zealand
Russia	Central Bank of the Russian Federation (Bank of Russia)
Saudi Arabia	Saudi Central Bank (formerly SAMA)

After understanding the central banks of various countries, it is also important to recognise India's own central banking authority. In our country, the Reserve Bank of India performs the key functions of regulating currency, controlling credit and guiding the financial system. The following section highlights the role and functions of the Reserve Bank of India in the Indian economy.

1.3.3 Reserve Bank of India



Figure 1.3. 1- Reserve Bank of India

The Reserve Bank of India (RBI) is the central bank of our country, responsible for regulating the issue of currency and controlling the credit system to ensure monetary stability. The idea of establishing a central bank in India took shape during the British period when several financial problems emerged in currency and banking operations. After the First World War, India experienced economic instability, shortage of credit, and poor coordination among banks. These issues created the need for a central authority that could manage the currency, control credit, and supervise banks in a systematic way.

In 1926, the Hilton Young Commission also known as the Royal Commission on Indian Currency and Finance recommended the creation of a central bank for India.

The Commission highlighted the need for a separate institution to perform the functions of currency control, regulation of banking, and maintenance of exchange rate stability. Acting on these recommendations, the Reserve Bank of India Act was passed in March 1934. This Act laid down the legal foundation for establishing the Reserve Bank of India as the country's central banking authority.

The Reserve Bank of India commenced operations on 1st April 1935, with its headquarters in Calcutta (now Kolkata). However, in 1937, the central office was shifted permanently to Bombay (now Mumbai), where it remains today. Initially, the RBI was not fully owned by the Government of India. It started as a privately owned institution with a share capital of ₹5 crore, divided among private shareholders. The Bank was given the responsibility of issuing currency notes, maintaining monetary stability, and acting as a banker to the government.

During its early years, the RBI also performed central banking functions for neighbouring regions such as Burma (Myanmar) and Pakistan, until these countries set up their own central banks. The RBI played a vital role during the pre-independence period by managing India's currency and exchange system and supporting financial development.

After India gained independence in 1947, the government decided that such an important institution should be under public ownership to align with national interests. Consequently, the Reserve Bank of India was nationalised on 1st January 1949 under the Reserve Bank (Transfer to Public Ownership) Act, 1948. From this date, it became fully owned by the Government of India. This marked a new phase in the history of the RBI, as it began to undertake broader responsibilities for the economic development of the nation.

Post-nationalisation, the RBI's role expanded beyond currency management to include the promotion of agriculture, rural credit, and industrial finance. It introduced measures to strengthen commercial banks, regulate cooperative banks, and support financial inclusion. The Bank also started framing monetary policies to control inflation, stabilise prices, and maintain economic growth.

The preamble of the RBI Act clearly states its main purpose:

“To regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.”

Over time, the RBI has evolved with the changing needs of the Indian economy. With economic liberalisation in the 1990s, its focus widened to include modern functions such as supervising financial markets, developing payment systems, and ensuring financial stability. Today, the RBI acts as the guardian of India's monetary system and plays a central role in formulating and implementing policies that affect every sector of the economy.



Important Milestones in RBI's History

- ◇ 1926 – Hilton Young Commission recommended the establishment of a central bank.
- ◇ 6 March 1934 – The Reserve Bank of India Act was passed.
- ◇ 1 April 1935 – RBI began operations in Calcutta.
- ◇ 1937 – Headquarters shifted to Mumbai.
- ◇ 1 January 1949 – RBI was nationalised and became fully government-owned.

the history of the Reserve Bank of India reflects the country's journey from colonial economic control to financial independence. What began as a privately managed central bank in 1935 has grown into a strong and dynamic institution, guiding the Indian economy through monetary policy, financial regulation, and developmental initiatives. The RBI stands today as a symbol of stability and trust, ensuring that India's banking and financial systems function efficiently and securely.

1.3.3.1 Management

The management of the Reserve Bank of India (RBI) is designed to ensure smooth and efficient functioning of the country's central banking system. The RBI was established under the Reserve Bank of India Act, 1934, and began operations on 1st April 1935. According to the Act, the general superintendence and direction of the Bank's affairs are vested in the Central Board of Directors. This board is responsible for framing policies and overseeing the overall administration of the Bank. The Government of India retains the power to issue directions to the Bank in matters of public interest, ensuring that the RBI's functions are in harmony with national economic goals.

The Central Board of Directors is the highest authority in the management structure of the Reserve Bank of India. It is responsible for the general supervision and direction of the Bank's affairs. The composition of the Board is as follows:

1. **Governor** – Acts as the Chief Executive Officer of the Reserve Bank of India. The Governor is responsible for implementing the policies and decisions taken by the Central Board.
2. **Four Deputy Governors** – Assist the Governor in carrying out various functions such as monetary policy, currency management, banking supervision, and financial regulation.
3. **Ten Directors** – Nominated by the Central Government to represent different sectors of the economy such as finance, commerce, industry, and agriculture. They bring practical experience and expert knowledge to the Board.
4. **Two Government Officials** – Represent the Ministry of Finance, ensuring coordination between the Reserve Bank and the Government of India in framing economic and monetary policies.
5. **Four Directors representing Local Boards** – Nominated by the Central Government to represent the four regional offices of the RBI located in:

- ◇ Northern Zone
- ◇ Southern Zone
- ◇ Eastern Zone
- ◇ Western Zone

The Governor acts as the head of the institution and is primarily responsible for the implementation of the policies framed by the Central Board. The Governor is supported by the four Deputy Governors who supervise major departments such as banking regulation, currency management, monetary policy, and financial supervision. The RBI also has four Local Boards, each located in one of the four major zones of India (Northern, Southern, Eastern, and Western). Each Local Board consists of five members appointed by the Central Government for a term of four years. These boards represent the regional and cooperative banking interests of their respective zones and provide advice to the Central Board on local economic and financial issues. They act as a bridge between the central management and the regional operations, ensuring that local concerns are reflected in national policy decisions.

The management of the RBI follows a clear protocol order of authority to ensure effective governance. At the top is the Central Government, which provides broad policy guidance. The Central Board of Directors comes next, functioning as the highest decision-making body. Below the Board, the Governor serves as the chief executive authority, followed by the Deputy Governors who head key operational departments. Executive Directors and Departmental Heads are responsible for implementing policies in specialised areas, while the Local Boards play a consultative role by addressing regional issues.

To support effective functioning, the Central Board of the RBI constitutes several committees for specialised areas such as monetary policy, banking regulation, foreign exchange management, and internal audit. These committees assist in policy formulation and help maintain professionalism and efficiency in the Bank's operations. The Governor and Deputy Governors are appointed by the Central Government, generally for a period of five years, while the Directors of the Central Board serve for four years. The appointment system aims to ensure that experts from different sectors contribute to the functioning of the Bank.

The management of the RBI operates on the principles of autonomy, accountability, and transparency. Although the RBI enjoys operational independence, it works within the policy framework set by the Government of India. The Governor and members of the Board are accountable to Parliament through the Ministry of Finance. The Bank maintains transparency by publishing reports, reviews, and statements related to monetary and financial policies. The Local Boards further strengthen governance by ensuring that regional voices are heard in national decision-making.

In short, the management of the Reserve Bank of India is structured to balance central authority with regional representation. The Governor, supported by Deputy Governors and the Central Board, ensures the efficient functioning of the Bank in



alignment with the national economic interest. This hierarchical and well-organised management structure enables the RBI to perform its wide-ranging responsibilities, from formulating monetary policy to maintaining financial stability and regulating the banking sector across the country.

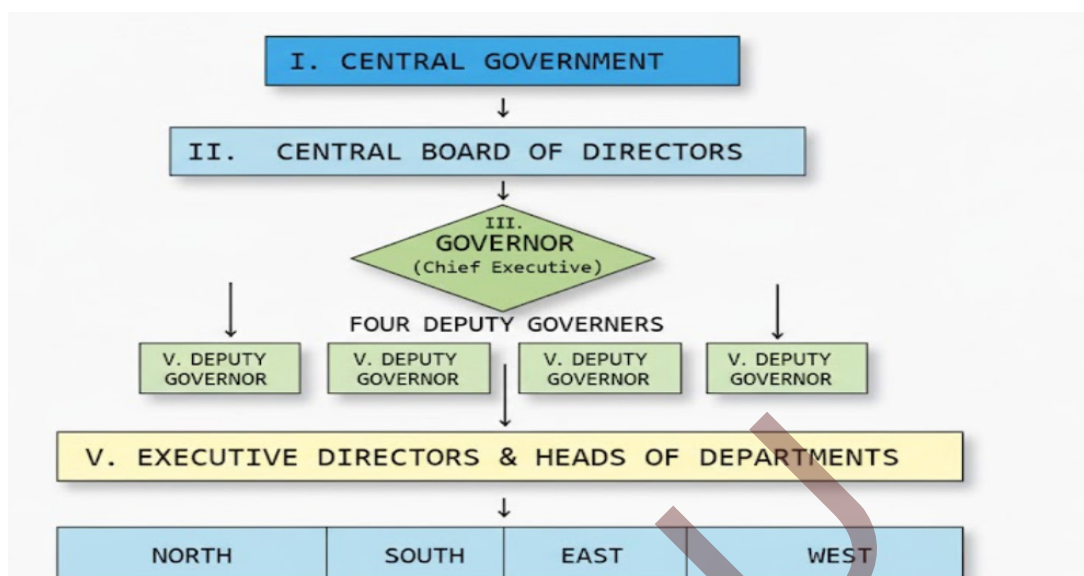


Figure 1.3.2 Organizational Structure

Assume the Indian economy as a giant, living system with money flowing like blood through its veins. The Reserve Bank of India (RBI) acts as the heart of this system, pumping and regulating the flow of money to keep the entire economy healthy, stable, and growing. Let's explore its major functions RBI.

1.3.3.2 Functions of RBI

1. Issuer of Currency

Every time you hold a ₹500 note, look closely you'll see the signature of the RBI Governor. That's because the RBI alone has the authority to issue currency notes in India (except ₹1 notes and coins, which are issued by the Government of India). This function ensures uniformity and public confidence in the nation's currency. When there's a sudden rise in cash demand, for example, during festivals or harvest seasons the RBI supplies more notes to banks so people have enough money to spend. Later, it carefully withdraws excess currency to prevent inflation. Thus, it controls the pulse of cash flow in the economy.

2. Banker to the Government

Just like individuals have bank accounts, the Government of India also keeps its main account with the RBI. The RBI manages all receipts and payments for both Central and State Governments. When the Government needs funds for new projects say, building highways or improving railways the RBI helps by issuing government securities and treasury bills. It also advises the Government on financial and monetary matters. During difficult times, like the pandemic, the RBI helped the Government manage borrowing efficiently to maintain stability in public finance.

3. Banker's Bank

Every commercial bank, whether it's SBI or a small cooperative, maintains a part of its deposits with the RBI as reserves. When a bank faces a temporary shortage of funds, it can borrow from the RBI just like how a student might borrow a reference book from the library when needed. If HDFC Bank suddenly needs extra money to meet withdrawals during Diwali shopping rush, it can borrow from the RBI through the repo rate mechanism. Through this role, the RBI ensures that no bank collapses due to short-term liquidity problems.

4. Controller of Credit

One of the most significant functions of the Reserve Bank of India (RBI) is to act as the controller of credit in the economy. This means that the RBI regulates the volume, cost, and direction of credit (or money supply) so that it supports economic growth without causing inflation or instability. Just like how a doctor monitors a patient's heartbeat, the RBI observes the economy's "credit pulse" and adjusts the flow of money to maintain balance. Too much credit leads to inflation, while too little causes economic slowdown. To keep this balance, the RBI uses a set of instruments known as credit control measures, which are broadly classified into two categories:

I. Quantitative (General) Credit Controls

II. Qualitative (Selective) Credit Controls

I. Quantitative Credit Control Measures

Quantitative controls influence the overall volume of credit in the economy. These methods are used to expand or contract the total money supply as required by economic conditions.

a. Bank Rate Policy

The bank rate is the standard rate at which the RBI lends money to commercial banks against approved securities. When the RBI increases the bank rate, borrowing becomes costlier for banks. They, in turn, raise their lending rates to customers. This reduces borrowing and helps control inflation. When the RBI reduces the bank rate, borrowing becomes cheaper, encouraging banks to lend more. This helps stimulate investment and economic growth. Within this, the RBI also uses two important short-term instruments:

- ◇ **Repo Rate:** The rate at which the RBI lends funds to banks for short periods.
- ◇ **Reverse Repo Rate:** The rate at which the RBI borrows money from banks to absorb excess liquidity.

During periods of high inflation, the RBI raises the repo rate to make loans costlier and reduce spending. Conversely, during slow growth, it lowers the rate to encourage borrowing and investment.

b. Variable Cash Reserve Ratio (CRR)

Every commercial bank in India must keep a certain percentage of its total deposits as cash with the RBI. This percentage is called the Cash Reserve Ratio (CRR). When



the RBI increases the CRR, banks have less money available to lend, reducing credit supply. When the RBI reduces the CRR, banks have more funds to lend, increasing credit flow in the economy. If inflation is rising rapidly, the RBI may increase the CRR to control money supply and stabilise prices.

c. Variation of Statutory Liquidity Ratio (SLR)

Apart from CRR, banks must also maintain a part of their deposits in the form of liquid assets like cash, gold, or government securities. This percentage is known as the Statutory Liquidity Ratio (SLR). An increase in SLR means banks must hold more funds in liquid form, leaving less money for lending this helps curb inflation. A decrease in SLR gives banks more freedom to lend, encouraging economic activity. Thus, by adjusting the SLR, the RBI can influence the availability of funds in the banking system.

d. Open Market Operations (OMO)

Open Market Operations refer to the buying and selling of government securities in the open market by the RBI. When the RBI sells securities, it absorbs excess money from the market, reducing credit availability. When it buys securities, it injects funds into the banking system, increasing liquidity. For example, during economic slowdown, the RBI may buy government bonds to infuse more cash into the economy, supporting growth and investment.

II. Qualitative or Selective Credit Control Measures

While quantitative methods deal with the total amount of credit, qualitative controls focus on the direction and purpose of credit. These measures ensure that credit is used for productive purposes and not for speculative or non-essential activities.

a. Control over Bank Advances

The RBI issues specific instructions to banks about the types of loans they can provide, the sectors they should prioritise, and the limits on advances. For example, banks may be directed to give more credit to agriculture, small industries, or exports, and to avoid lending excessively for speculative trading or luxury goods. This helps in directing credit towards sectors that promote real economic growth.

b. Credit Authorisation Scheme (CAS)

Under this scheme, commercial banks must obtain prior permission from the RBI before extending large loans to a single borrower or business group. This ensures that big corporate borrowers do not corner a major portion of bank credit at the cost of small or priority sectors. It also helps the RBI monitor the use of large-scale credit and prevent financial concentration in few hands.

c. Margin Requirements

Margin requirement refers to the difference between the value of security offered by a borrower and the amount of loan granted by the bank. For example, if a trader wants to borrow ₹1,00,000 by pledging goods worth ₹1,50,000, the margin is ₹50,000. By changing the margin requirement, the RBI can control speculative activities. Increasing margin requirements reduces the amount banks can lend against securities,

discouraging speculation. Decreasing margins makes borrowing easier, encouraging productive activities.

d. Moral Suasion

This method relies on persuasion and advice rather than compulsion. The RBI holds regular meetings with bank executives, appeals to their sense of responsibility, and advises them to follow sound credit policies. For example, during inflation, the RBI may urge banks to avoid giving loans for non-essential imports or luxury goods. Although not legally binding, banks usually follow these guidelines out of respect for the central bank's authority.

e. Issue of Directives

The RBI issues directives to commercial banks to regulate their lending policies in specific areas. These directives are binding instructions that guide banks on matters such as interest rates on deposits and advances, the proportion of credit to certain sectors, and terms of lending. For example, the RBI may issue directives requiring banks to provide a fixed percentage of credit to priority sectors such as agriculture, micro-enterprises, or housing. Through these directives, the RBI ensures that credit is distributed fairly and serves the broader goals of economic and social development.

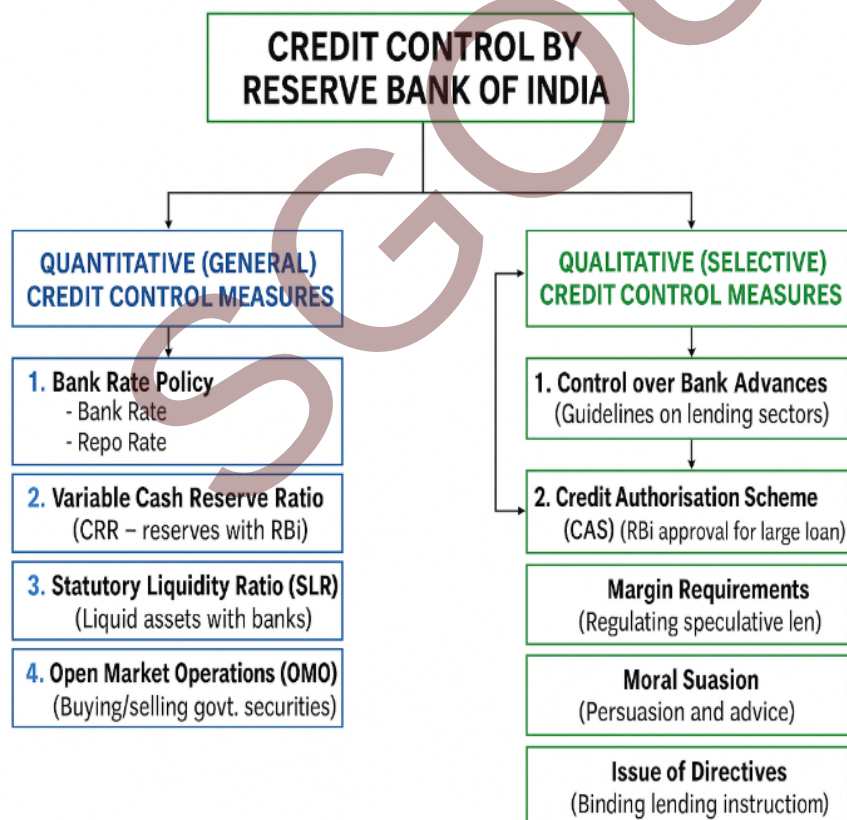


Figure 1.3.3 Methods for credit control

Through these quantitative and qualitative credit control measures, the Reserve Bank of India effectively regulates the supply, cost, and direction of credit in the economy. In times of inflation, it tightens credit to reduce spending, while during recession, it eases credit to encourage borrowing and investment. Thus, as the controller of credit, the RBI acts as the vigilant guardian of the nation's monetary stability ensuring that India's economic growth remains steady, sustainable, and inclusive.

5. Custodian of Foreign Exchange

When India trades with other countries, payments are made in foreign currencies like dollars, pounds, or yen. The RBI manages these through the Foreign Exchange Management Act (FEMA). If there's a sudden rise in demand for dollars say, because oil prices increase the RBI may sell some of its dollar reserves to stabilise the rupee. It also ensures that Indian importers and exporters get fair exchange rates, helping to maintain the stability of the rupee in the global market.

6. Promoter of Financial System

Beyond regulation, the RBI also plays a nurturing role in India's financial development. It has helped establish key institutions such as the NABARD for agriculture, SIDBI for small industries, and IDBI for industrial development. It also promotes financial inclusion by encouraging digital payments and expanding banking services to rural areas. For example, the Pradhan Mantri Jan Dhan Yojana saw huge success with RBI's support in guiding banks to open millions of zero-balance accounts for rural households.

7. Lender of Last Resort

In times of financial crisis, when no other institution is ready to help, banks turn to the RBI for emergency assistance. This ensures that public confidence in the banking system remains unshaken. For example, if a small cooperative bank faces sudden withdrawal pressure, the RBI may provide temporary funds to prevent panic among depositors.

8. Regulator of the Financial System

The RBI supervises and regulates the entire banking and financial system to ensure safety and soundness. It issues licences, inspects bank operations, and enforces norms for customer protection, transparency, and fair lending. When new technologies like digital wallets or fintech companies emerge, the RBI introduces guidelines to ensure innovation happens safely without risking customer trust.

9. Consumer Protection and Financial Education

The RBI not only protects consumers but also educates them. Through initiatives like the RBI Ombudsman Scheme, it provides a platform for customers to file complaints against banks. It also runs awareness campaigns such as "RBI Kehta Hai" to help people avoid frauds and understand banking services better. 10. Formulation and implementation of Monetary policy

Monetary policy and fiscal policy are the tools of macroeconomic policy of the country. In this fiscal policy is the tool used by the government to adjust spending levels and tax rates to monitor and influence a nation's economy. The Reserve Bank of India formulates, implements and monitors the monetary policy of the country. Monetary Policy is one of the most important tools of the Reserve Bank of India (RBI) for maintaining economic stability. It refers to the policy that controls the supply of money, availability of credit, and interest rates in an economy. Through monetary policy, the RBI influences overall demand, investment, and growth to achieve balanced economic development. The main objectives of India's monetary policy are to maintain price stability, ensure adequate credit flow for productive sectors, and promote sustainable economic growth. It also aims to achieve exchange rate stability, control inflation, and ensure financial stability in the banking system. By managing money supply and credit, the RBI tries to balance the twin goals of growth and stability.

The RBI uses two major types of instruments to implement monetary policy are the following

1. Quantitative and
2. Qualitative.

Quantitative tools such as the Bank Rate, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and Open Market Operations (OMO) regulate the overall volume of credit in the economy. Qualitative tools such as Moral Suasion, Credit Rationing, and Selective Credit Controls are used to direct credit towards priority or productive sectors of the economy. (These methods of credit control are explained in the above section). Monetary policy acts as a guiding framework for the RBI to maintain the flow of money in the economy. By adjusting credit and interest rates, it helps control inflation, encourages investment, and safeguards financial stability. Thus, monetary policy plays a vital role in ensuring the smooth functioning and steady growth of India's economy.

Recap

- ◇ The central bank is the apex monetary authority that regulates currency, credit, and the banking system while acting as a lender of last resort.
- ◇ Central Bank has monopoly over note issuance, controls credit and interest rates, supervises banks, and ensures financial stability.
- ◇ The Reserve Bank of India, established in 1935 and nationalised in 1949, serves as India's central bank and monetary authority.
- ◇ RBI issues currency, controls money supply, manages government accounts, provides emergency funds to banks, oversees foreign exchange, and regulates commercial banks.

Objective Questions

1. Who is the apex monetary authority of a country?
2. When was the Reserve Bank of India established?
3. RBI was nationalised in which year?
4. State any one quantitative method of credit control?
5. Write the rate at which RBI lends money to commercial banks.
6. State the rate of interest at which RBI borrows money from commercial banks
7. Which commission recommended the establishment of central bank in India?
8. State another name for Hilton Young?

Answers

1. RBI
2. 1935
3. 1949
4. Bank rate
5. Repo rate
6. Reverse repo rate
7. Hilton young commission
8. Lender of last resort
9. Royal Commission on Indian Currency and Finance

Self-Assessment Questions

1. Discuss the features of central bank?
2. Describe the functions of RBI?
3. Briefly explain the evolution of RBI?

4. Short note on Quantitative credit control methods followed by RBI?
5. Explain the qualitative credit control methods followed by RBI?

Assignments

1. Describe the major functions of the Reserve Bank of India with suitable real-life examples.
2. Explain the qualitative credit control methods used by the RBI to direct credit towards priority sectors.
3. Explain how the key features of a central bank contribute to maintaining monetary stability in an economy.
4. Trace the evolution of the Reserve Bank of India from its establishment in 1935 to its present role.

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BLOCK

International Banking

Unit

Introduction

Learning Outcomes

After reading this unit, learners will be able to:

- ◇ comprehend the meaning and features of international banking.
- ◇ explain the major functions performed by banks in global markets.
- ◇ recognize the benefits of international banking for individuals, businesses, banks, and the economy.
- ◇ identify the differences between domestic and international banking

Prerequisite

Before studying this unit on international banking, learners should have a basic understanding of how the general banking system works within a country. This includes knowing what banks do, the types of bank accounts, and common services such as deposits, withdrawals, loans, and digital banking. A simple idea about financial terms like interest, currency, and payments will help learners understand how banking operations function at the domestic level.

Learners should also be familiar with fundamental concepts of international trade, such as exports, imports, and foreign currency. Knowing that different countries use different currencies and that exchange rates change over time will make it easier to understand the need for international banking services. Basic knowledge of globalisation, cross-border business, and technology in banking will further support smooth learning of this unit.

Keywords

International Banking, Foreign Exchange, SWIFT, Letter of Credit, Correspondent Banking

Discussion

2.1.1 Introduction

International banking is a specialised branch of banking that deals with financial activities across national borders. With globalisation, countries, businesses, and individuals have become more interconnected, resulting in a significant increase in international trade, capital flows, and cross-border financial services.

Banks play a major role in this global environment by offering services that enable international payments, foreign currency transactions, overseas financing, and risk management tools. An Indian exporter receiving payments from a buyer in Germany, a student paying fees to a university in the UK, or a company investing in the USA are all supported by international banking systems.

International banking therefore promotes world trade, encourages foreign investment, and strengthens the global financial system.

2.1.2 Meaning of International Banking

International banking refers to banking activities conducted across international borders or involving foreign currencies. . In simple terms, international banking facilitates cross-border trade, investment, and financial flows by offering services such as foreign exchange, international payments, trade finance, overseas lending, and deposit services in different currencies. Banks engaged in international banking may operate through foreign branches, subsidiaries, correspondent banks, or representative offices in other countries. Overall, international banking plays a vital role in promoting global trade, capital movement, and economic integration among nations.

A bank becomes an international bank when it:

- ◇ Operates branches or subsidiaries in other countries
- ◇ Provides services to customers engaged in international business
- ◇ Deals in foreign currencies like USD(US Dollar), EUR(Euro), GBP(Pound Sterling), etc.
- ◇ Participates in global financial markets and regulations

Examples:

- ◇ HSBC, Citibank, Barclays, Standard Chartered operate worldwide.
- ◇ Indian banks like SBI, ICICI Bank, and Bank of Baroda have international branches in the UAE, Singapore, UK, and USA.



2.1.3 Features of International Banking

International banking operates through distinct structures like correspondent banking, where domestic banks partner with foreign counterparts for services; branches or subsidiaries established abroad; and representative offices for liaison activities. Core features include multi-currency accounts, handling diverse currencies for deposits and loans; regulatory compliance with varying international standards such as Basel accords; and advanced risk management for exchange rate fluctuations and geopolitical risks. Technology integration, like SWIFT for secure transfers, enhances efficiency in global operations. The features of international banking are as follows:

1. Cross-Border Operations

International banks operate beyond their home country by establishing foreign branches, subsidiaries, or representative offices. This helps them offer banking services to customers located in different parts of the world.

Example:

- ◇ State Bank of India (SBI) operates branches in Singapore, Dubai, and London to serve Non-Resident Indians (NRIs) and international businesses.
- ◇ HSBC, originally from Hong Kong and the UK, has branches in more than 60 countries, making it a truly global bank.

Operating in multiple countries helps banks support global customers and expand their business opportunities.

2. Multi-Currency Transactions

International banks deal with various foreign currencies like US Dollar (USD), Euro (EUR), Pound Sterling (GBP), Japanese Yen (JPY), etc. They convert funds from one currency to another to support travel, trade, remittances, and international investments.

Example:

- ◇ An Indian exporter receiving payment in USD can convert it into INR through the bank.
- ◇ A student sending university fees to Canada pays in Indian Rupees, but the bank converts the amount into Canadian Dollars (CAD) before transfer.

This ability to handle multiple currencies makes international transactions smooth and efficient.

3. Advanced Technology Networks

International banking uses advanced technology systems to make cross-border transactions fast and secure. The most widely used networks include:

- ◇ SWIFT (Society for Worldwide Interbank Financial Telecommunication) – used for secure messages and international money transfers.
- ◇ CHIPS (Clearing House Interbank Payments System) – a large-value payment

system in the United States.

- ◇ TARGET2 – the real-time payment system for the European Union.

Example:

When a person in the UAE sends money to India, the transaction is routed through the SWIFT network, ensuring the amount reaches the correct account safely. These systems reduce fraud, speed up payments, and improve global financial connectivity.

4. Compliance with Global Regulations

International banks must follow strict rules and standards set by global organisations to ensure safety, transparency, and financial stability. Some major bodies include:

- ◇ IMF (International Monetary Fund) – oversees global economic stability.
- ◇ Basel Committee on Banking Supervision – sets global banking regulations (Basel I, II, III).
- ◇ FATF (Financial Action Task Force) – fights money laundering and terrorist financing.

Example:

Banks must follow Basel III norms, which require them to maintain minimum capital to absorb potential losses.

They also verify customer identity (KYC) to comply with FATF rules.

This compliance prevents financial crimes and maintains trust in the global banking system.

5. Variety of Global Services

International banks provide a wide range of specialised services to meet the needs of global customers. These include:

- ◇ Trade finance (Letters of Credit, Bills of Exchange)
- ◇ Foreign exchange services
- ◇ International loans and project finance
- ◇ Investment banking (mergers, acquisitions, underwriting)
- ◇ Global wealth management for high-net-worth individuals

Example:

A company importing machinery from Germany uses Letter of Credit (LC) issued by an international bank to guarantee payment to the foreign supplier. This variety of services makes international banking multifunctional and wide-reaching.

6. Higher Exposure to Risk

Operating across countries exposes international banks to several unique risks, such as:

- ◇ Currency risk – changes in exchange rates



- ◇ Political risk – instability in foreign countries
- ◇ Regulatory risk – different rules in different countries
- ◇ Country risk – financial or economic crisis in a specific country

Example:

If the value of the Euro falls suddenly, an Indian bank holding assets in Euros may suffer losses (currency risk). If a country faces civil unrest or sudden policy changes, the bank's operations there may be affected (political risk). Because of such risks, international banking requires strong monitoring and risk management techniques

7. Support for Global Markets and Trade

International banks play a crucial role in promoting world trade, foreign investment, and global financial stability. They help businesses buy and sell goods across countries, invest overseas, and make global payments.

Example:

- ◇ Exporters and importers use banks to handle foreign payments, trade documents, and currency conversion.
- ◇ Multinational companies rely on banks for international project financing and global cash management.

Without international banks, global business activities would be much more difficult and expensive. Their support helps countries grow through increased trade and investment.

2.1.4 Functions of International Banking

Key functions involve accepting deposits and extending loans in foreign currencies to multinational corporations (MNCs), governments, and individuals; providing foreign exchange services to convert currencies for trade; and issuing letters of credit to guarantee payments in international trade. Banks also offer trade finance, such as export credits, wire transfers for remittances, and treasury management for cash flow optimization.

a. Facilitating International Trade

One of the most important functions of international banking is supporting export and import activities between countries. Banks provide various instruments and services that make global trade safe, smooth, and reliable.

How Banks Support Trade:

- ◇ **Letters of Credit (LC):** A guarantee issued by a bank ensuring the exporter will receive payment once the goods are shipped.
- ◇ **Bills of Exchange:** A document that instructs the importer to pay a specific amount on a specific date.
- ◇ **Export & Import Financing:** Short-term loans provided to exporters and

importers to meet working capital needs.

Example:

An Indian textile exporter sells goods to a buyer in France. The buyer's bank issues an LC guaranteeing payment. The Indian exporter ships the goods confidently because the bank ensures payment.

b. Foreign Exchange Services

International banks buy, sell, and exchange foreign currencies for individuals, businesses, and governments. They also help manage risks caused by changes in exchange rates.

Key Services:

- ◇ Currency conversion (USD to INR, INR to EUR, etc.)
- ◇ Forex accounts
- ◇ Exchange rate quotes
- ◇ Forex advisory services

Example:

A student paying university fees in Australia pays in INR. The bank converts the amount into AUD and transfers it to the university's account.

c. International Remittance Services

International banks help people send and receive money across countries quickly and safely. These remittances are used for family support, education, travel, and business payments.

Common Remittance Channels:

- ◇ SWIFT system
- ◇ Wire transfers
- ◇ Online banking platforms
- ◇ Correspondent banking networks

Example:

A person working in Dubai sends money to their family in India through the SWIFT network, ensuring the amount reaches the correct account within hours or days.

d. Financing International Projects

International banks provide loans in foreign currencies for global projects such as infrastructure, energy, transportation, and large business expansions.

Forms of International Financing:

- ◇ Syndicated loans – loans provided jointly by several banks
- ◇ Foreign currency loans



- ◇ International project finance
- ◇ External Commercial Borrowings (ECBs)

Example:

An Indian company setting up a plant in Singapore may take a USD-denominated loan from an international bank like Standard Chartered or Citi.

e. Risk Management and Hedging Services

Since international business involves currency fluctuations and country risks, banks provide tools to help customers reduce or “hedge” these risks.

Hedging Instruments:

- ◇ Forward contracts – agreement to buy or sell currency at a future date
- ◇ Currency swaps – exchanging currencies for a fixed time
- ◇ Options and futures – rights to buy/sell currency at fixed prices

Example:

An Indian importer who must pay in USD can lock in a specific exchange rate through a forward contract, avoiding loss if the dollar becomes more expensive later.

f. Correspondent Banking Services

International banks form partnerships with foreign banks to provide services in countries where they do not have branches.

Why Correspondent Banking Is Needed?

- ◇ To handle foreign payments
- ◇ To clear international cheques
- ◇ To support trade finance
- ◇ To provide local transactions abroad

Example:

If an Indian bank customer needs to make a payment in Brazil, the Indian bank will use its correspondent bank in Brazil to complete the transaction.

g. Support to Multinational Corporations (MNCs)

International banks help MNCs manage their global financial activities. They assist with:

Major Services for MNCs:

- ◇ Cash management across countries
- ◇ International payroll
- ◇ Raising funds globally
- ◇ Tax and regulatory advisory

- ◇ Overseas investments

Example:

A company like Tata Motors operates in many countries. International banks help them move money between countries, pay employees abroad, and finance new projects.

h. Investment Banking Services

International banks support global capital markets by offering:

Key Activities:

- ◇ Underwriting international bonds and shares
- ◇ Helping companies raise money in foreign stock markets
- ◇ Advising on mergers and acquisitions
- ◇ Managing foreign investments

Example:

When Infosys issues shares in the U.S. market (ADR), an international investment bank manages the process.

i. Custodial and Wealth Management Services

International banks also provide wealth management and secure asset storage for high-net-worth clients.

Services Include:

- ◇ Global investment portfolios
- ◇ International mutual funds
- ◇ Custody of securities
- ◇ Tax planning across countries

Example:

A businessman from India investing in U.S. stocks may use HSBC Global Wealth Management services to manage his investments safely.

j. Promoting Global Economic Stability

International banks work closely with international institutions and governments to support global financial systems.

How They Support Stability:

- ◇ Helping stabilize currency crises
- ◇ Supporting global liquidity
- ◇ Funding international development projects



Example:

During global financial crises, large international banks help stabilize markets by cooperating with the IMF and central banks.

2.1.5 Benefits of International Banking

International banking provides access to diverse funding sources and global markets, lowering borrowing costs for businesses expanding abroad. It simplifies cross-border payments, reduces currency risks through hedging, and boosts trade by offering specialized tools like documentary collections. Individuals benefit from multi-currency accounts for travel or remittances, while economies gain from increased capital mobility and investment inflows; for instance, it supported India's export growth via State Bank of India's international divisions. The benefits of international banking are as follows:

A. Benefits to Individuals

- ◇ Easy money transfers for education, travel, and family support
- ◇ Access to foreign currency accounts
- ◇ International debit and credit cards
- ◇ Investment opportunities abroad

B. Benefits to Businesses

- ◇ Smooth trade transactions
- ◇ Protection against currency fluctuations
- ◇ Access to global capital
- ◇ Better financial planning for overseas operations

C. Benefits to Banks

- ◇ Higher profit from international operations
- ◇ Larger customer base
- ◇ Risk diversification
- ◇ Stronger global presence

D. Benefits to the Economy

- ◇ Growth in international trade
- ◇ Promotion of foreign direct investment
- ◇ Better integration with global markets
- ◇ Overall economic development

2.1.6 Difference Between Domestic Banking and International Banking

Basis	Domestic Banking	International Banking
Area of Operation	Within one country	Across multiple countries
Currency	Single currency	Multiple currencies
Regulations	Domestic laws	International + domestic laws
Risks	Limited	High (currency, political, regulatory)

Other differences are as follows :

1. **Customers served:** Domestic banking serves local individuals and businesses; international banking serves exporters, importers, multinational companies, NRIs, and foreign clients.
2. **Nature of transactions:** Domestic banking handles local deposits, loans, and payments; international banking handles cross-border payments, trade finance, and foreign exchange.
3. **Foreign exchange risk:** Domestic banking has no foreign exchange risk; international banking is exposed to exchange rate fluctuations.
4. **Operational complexity:** Domestic banking operations are simple; international banking operations are complex due to multiple laws and currencies.
5. **Income sources:** Domestic banking earns mainly interest and service charges; international banking earns interest, foreign exchange margins, and international fees.
6. **Risk exposure:** Domestic banking faces limited risk; international banking faces economic, political, and currency risks across countries.
7. **Examples of services:** Domestic banking offers savings accounts and personal loans; international banking offers letters of credit, export finance, and foreign currency accounts.

Recap

- ◇ International banking means Banking activities performed across national borders.
- ◇ Foreign exchange means Conversion of one currency into another for trade or investment.
- ◇ SWIFT means Global network used for international money transfers.
- ◇ Letter of Credit is A document issued by a bank guaranteeing payment to an exporter.
- ◇ Correspondent Banking means Relationship between two banks in different countries for cross-border services.
- ◇ Currency Risk is a Risk arising from changes in exchange rates.
- ◇ Syndicated Loan means Large loan provided jointly by multiple international banks.
- ◇ Foreign Branch means Bank branch established outside the home country.
- ◇ Forex Hedging means Reducing risk from currency fluctuations using financial instruments.
- ◇ Multinational Corporation (MNC) is a company operating in multiple countries.

Objective Questions

1. What is the primary purpose of international banking?
2. Which global network is commonly used for secure international fund transfers?
3. What is the banking instrument used to guarantee payment in international trade?
4. What term refers to banking operations conducted across different countries?
5. Which international organisation sets global banking standards such as Basel norms?
6. What type of risk arises from fluctuations in foreign exchange rates?
7. What banking service is used to protect importers and exporters from currency fluctuations?

Answers

1. To facilitate cross-border financial transactions.
2. SWIFT (Society for Worldwide Interbank Financial Telecommunication).
3. Letter of Credit (LC).
4. Cross-border operations.
5. Basel Committee on Banking Supervision.
6. Currency risk.
7. Hedging services.

Self Assessment Questions

1. Discuss the benefits of International banking.
2. Differentiate domestic banking & International banking.
3. Essay on functions of International banking?
4. Describe the Meaning and features of International banking?

Assignment Questions

1. Explain the functions of international banking with suitable examples.
2. Discuss the major features of international banking in detail.
3. Describe the benefits of international banking to businesses, banks, and the economy.
4. Illustrate how international banks support foreign trade using a case example.

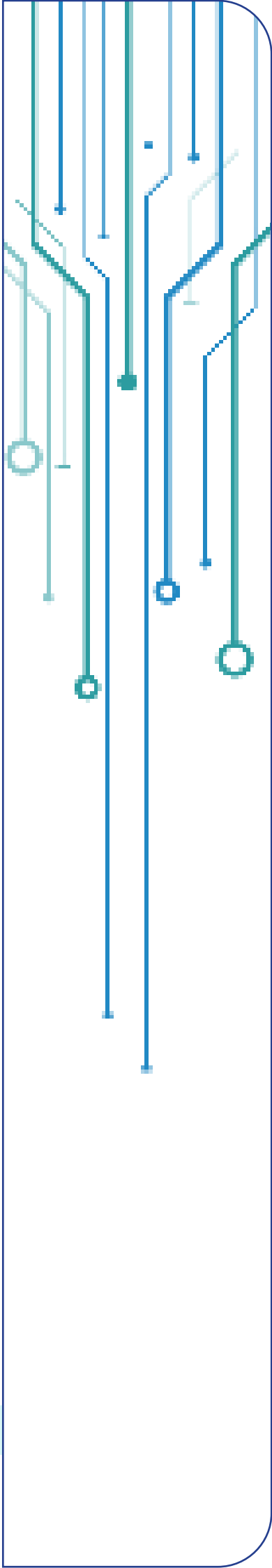


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Unit

Modes of International Banking

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ comprehend the various modes of international banking
- ◇ differentiate between the structural and functional characteristics of correspondent banking, foreign branches, limited branches, and subsidiary banks.
- ◇ describe the roles and responsibilities of correspondent banks in enabling cross-border payments, trade finance, and foreign exchange services.
- ◇ explain the purpose and functions of representative offices

Prerequisite

International banks expand abroad using several structural modes, each with different levels of presence, powers, cost, and regulatory obligations. These modes include correspondent banks, representative offices, foreign branches (full and limited), and subsidiary banks, which together form the basic “toolkit” of international banking operations. This unit explains the different modes of international banking

Keywords

Correspondent Banks, Representative Offices, Foreign Branches, Limited Branches , Subsidiary Banks

Discussion

International banking involves the operations of banks across national borders. To serve customers worldwide-traders, corporates, travelers, migrant workers, and investors-banks adopt different organizational forms in foreign countries.

These modes differ in terms of authority, regulatory compliance, functions, services offered, cost of establishment, and ownership structure. The modes of international banking refer to the various ways through which banks conduct and manage banking operations across national borders. To facilitate international trade, investment, and cross-border financial transactions, banks adopt different institutional and operational arrangements such as correspondent banking, foreign branches, subsidiaries, and offshore banking centers. These modes enable banks to expand their global presence, serve international clients efficiently, and support the smooth flow of funds, credit, and foreign exchange in the global economy.

The major modes are:

1. Correspondent Banks
2. Representative Offices
3. Branches and Offices
4. Limited Branches
5. Subsidiary Banks

2.2.1 Correspondent banks

A correspondent bank is a financial institution in a foreign country that provides services to another bank that has no physical operations in that country.

A correspondent bank is a bank that provides services on behalf of another bank, usually in a foreign country where the other bank has no physical presence. It maintains accounts (nostro/vostro) for the respondent bank and facilitates services such as international wire transfers, cheque clearing, trade finance, foreign exchange, and cash management in local currency. It is used when the home bank wants to reach in a foreign market without opening its own office, reducing cost and regulatory burden. It is crucial for cross-border payments and trade; for example, a small Indian bank can route a customer's payment to Brazil through a large global correspondent bank. Many banks cannot afford to open branches in every country. Correspondent banks solve this problem by acting as a bridge.

Example:

An Indian bank wanting to settle payments in US dollars uses a correspondent relationship with JPMorgan Chase, USA.

2.2.1.1 Features

- ◇ Works through mutual agreement between two banks.
- ◇ No ownership or structural link.
- ◇ Provides access to foreign markets.
- ◇ Settles cross-border payments.
- ◇ Handles transactions through Nostro, Vostro, and Loro accounts.

Important Accounts

1. **Nostro Account** – “Our account with you.”- Used by banks to hold funds in a foreign currency with a correspondent bank.
 - ◇ Help banks to manage foreign exchange and settle international transactions in that currency.
2. **Vostro Account** – “Your account with us.”- means foreign banks account held by the domestic bank.
3. **Loro Account** – “Their account with another bank.”- A third party account used when two banks have a mutual correspondent relationship through a third bank.

Objectives of Correspondent Banks

1. To facilitate international payments and remittances between countries
2. To provide foreign exchange services to domestic banks and their customers
3. To support international trade through services like collection of bills and letters of credit
4. To act as an agent bank for clearing, settlement, and fund transfers abroad
5. To help banks operate internationally without opening foreign branches
6. To provide local market knowledge of the foreign country to the home bank
7. To ensure smooth and speedy cross-border transactions
8. To strengthen international banking relationships and cooperation

2.2.1.2 Functions of Correspondent Banks

The functions of correspondent banks are as follows:

a. International Payment Services

One of the most important functions of international banks-especially correspondent banks-is to facilitate smooth and secure global payments. These banks process wire transfers through systems like SWIFT, which enable money to be sent across countries within a short time. They also manage remittances sent by workers abroad to their families in their home country, ensuring that funds reach safely and quickly. In addition, they handle cross-border business payments, which are essential for import and export transactions. For example, when an exporter in India needs to receive payment from a buyer in Germany, the Indian bank may not have a branch in Germany. In such cases, a bank like Deutsche Bank acts as a correspondent bank and helps complete the payment process on behalf of the Indian bank.



b. Trade Finance

International banks play a major role in trade finance, which supports global business activities. They issue and confirm Letters of Credit (LCs), which guarantee payment to exporters and build trust between trading partners across countries. These banks also collect export and import bills, ensuring that payments are received or made only after all agreed conditions are met. Another important function is verifying shipping documents, such as bills of lading, invoices, and packing lists, to ensure that goods have been shipped correctly. By performing these tasks, banks reduce risk for both importers and exporters and make international trade safer and more efficient.

c. Treasury and Forex Services

Treasury and foreign exchange (forex) services are essential for managing currency-related transactions in international banking. Banks provide foreign currency exchange, enabling customers and businesses to convert one currency into another for trade, travel, investment, or remittances. They also help banks and clients hedge against foreign exchange risk, which arises when currency values fluctuate. Hedging tools such as forward contracts, options, and swaps protect customers from unexpected losses due to changes in exchange rates. Through these services, international banks help maintain stability and reduce financial risk in global transactions.

d. Cash Management and Clearing

International banks ensure efficient movement and settlement of funds across borders through cash management and clearing services. They assist banks in settling cheque clearing in foreign countries, allowing customers to deposit a cheque issued in another country and receive the funds in their local bank account. These banks also support ATM transactions for international cardholders, enabling travellers and expatriates to withdraw money from ATMs worldwide using their home country debit or credit cards. These services offer convenience and accessibility, making global financial operations hassle-free.

e. Custodial and Securities Services

Custodial and securities services are provided by international banks to protect and manage foreign investments. They safeguard the financial assets of clients, such as stocks, bonds, and other securities, by holding them securely in custody accounts. They also ensure proper settlement of securities in foreign markets by coordinating with stock exchanges, clearing houses, and brokers. These services are essential for investors who participate in international markets, as they help reduce risks and ensure that all transactions are completed accurately and on time.

These functions provide several advantages for banks and customers. They enable global operations at a low cost, especially useful for banks that cannot afford to open branches in every country. Correspondent and international banking services reduce the need for physical foreign branches, making global banking more accessible. They also

speed up international trade and payment processes, benefiting exporters, importers, and individuals worldwide. Most importantly, these services are highly valuable for small and medium-sized banks, helping them offer international services without significant investment.

2.2.2 Representative offices

A representative office is a small, non-banking office that a foreign bank sets up in another country to represent its interests, gather information, and support clients, but it generally cannot take deposits or make loans locally. It typically maintains relationships with local correspondent banks, provides marketing and advisory support, and helps clients navigate local regulations and business practices. Representative offices are very low-cost mode of entry; used mainly for market intelligence, customer liaison, and promotional activities rather than revenue generation.

For example, a European bank may open a representative office in Mumbai only to assist its multinational clients and coordinate with Indian correspondent banks, while all actual transactions route through those correspondents. A representative office is a foreign liaison office of a bank that cannot conduct commercial banking activities such as accepting deposits or giving loans.

It mainly focuses on coordination, communication, and market intelligence.

2.2.2.1 Features

- ◇ Very small structure
- ◇ Cannot undertake financial transactions.
- ◇ Acts as a market research and relationship-building center.
- ◇ Serves as the first step before opening a full branch.
- ◇ Representative offices are offices set up by a bank in a foreign country to represent the parent bank.
- ◇ They do not conduct full banking operations like accepting deposits or granting loans.
- ◇ Their main role is to act as a liaison between the parent bank and foreign customers/banks.
- ◇ They help in promoting the bank's services in the host country.
- ◇ They collect market and business information about the foreign country.
- ◇ They assist customers by providing information on trade finance and investment opportunities.
- ◇ They help in developing international business relationships.
- ◇ They operate under restrictions imposed by the host country's regulations.

Objectives of Representative Offices

1. To represent the parent bank in the foreign country
2. To act as a liaison between the parent bank and foreign clients/banks
3. To promote the bank's international business and services
4. To collect and provide market, economic, and regulatory information to the parent bank
5. To assist customers in trade finance, foreign exchange, and investment-related enquiries
6. To develop and strengthen business relationships with overseas institutions
7. To explore new business opportunities in the host country
8. To support the parent bank in expanding its international presence

2.2.2.2 Functions

a. Marketing and Business Promotion

A representative office mainly functions as the marketing arm of a foreign bank. Since it cannot conduct actual banking operations such as accepting deposits or issuing loans, it focuses on promoting the bank's products and services in the host country. This includes creating awareness about the bank's offerings, such as trade finance, NRI services, corporate banking, or investment products. The office builds connections with local businesses, government agencies, exporters, importers, and potential clients to generate business leads for the parent bank. For example, an Indian bank with a representative office in the UAE may conduct seminars, workshops, or business meetings to promote its NRI deposit schemes, home loans, or remittance services.

b. Customer Support and Liaison Activities

Representative offices act as a bridge between customers in the foreign country and the bank's headquarters or branches in other nations. Although they cannot conduct transactions, they guide customers in filling out documents, resolving issues, and obtaining information about the bank's services. They also help with loan enquiries, account opening procedures, documentation for trade finance, and updates on ongoing transactions. Their main role is to provide non-financial assistance, improve communication, and reduce service delays. For instance, if a foreign company wants to open an account or apply for a trade finance facility in the parent bank's home country, the representative office assists them with the required paperwork.

c. Market Research and Information Gathering

One of the most important functions of representative offices is to conduct market research. They collect information about the economic environment, local banking trends, customer expectations, and competitive strategies in the host country. They also study foreign regulations, market risks, and business opportunities that can help the parent bank plan international expansion. This market intelligence helps the bank decide whether to open a full-fledged branch or subsidiary in the future. For example, before entering Singapore with a full branch, a bank may operate a representative office

for several years to study local business practices, legal requirements, and customer behaviour.

d. Facilitating Trade and Investment

Representative offices contribute greatly to promoting international trade and investment by connecting local companies with the parent bank. They identify exporters, importers, multinational companies, and investors who may benefit from the parent bank's services in areas like trade finance, remittances, and foreign exchange. They act as facilitators by arranging meetings, sharing business opportunities, and coordinating communications between both parties. For example, a bank's representative office in London may help Indian exporters find buyers, navigate documentation, or access trade finance services offered by the parent bank in India.

e. Relationship Building and Networking

Building strong relationships is a core function of representative offices. They regularly meet with local businesses, banks, financial institutions, trade bodies, chambers of commerce, and government officials. These interactions help the bank understand local business culture and create a network of reliable partners. Over time, this network helps the parent bank increase its visibility and credibility in the foreign market. Relationship building is particularly important for winning corporate clients, supporting NRIs, and expanding into new sectors.

f. Preparing the Ground for Full Branch or Subsidiary Operations

A representative office often acts as the first step in the bank's long-term international expansion strategy. By studying the local market and building a customer base, it prepares the bank to eventually open a full branch, limited branch, or subsidiary in the foreign country. During this stage, the office assesses the risks, opportunities, regulatory environment, and competitive landscape. Once the parent bank finds the market profitable and stable, it may apply for permission to upgrade the representative office into an operational branch. Thus, representative offices serve as a low-cost, low-risk platform for testing market potential.

2.2.3. Foreign branches and offices

Foreign branches are full-fledged operational branches of a bank, established in another country, offering almost all banking services like deposit-taking, lending, remittances, forex, and trade finance. A foreign branch is an office of a bank that is legally part of the parent bank but located in another country, conducting banking business under the host country's license and regulation. Unlike a representative office, a branch can usually accept deposits, make loans, and offer many normal banking services, though the exact scope depends on host regulations and the type of license granted. Capital and risk are on the parent bank's balance sheet, so branches allow the bank to leverage its full financial strength internationally. Examples include the New York branches of major European and Asian banks, which handle trade finance, corporate lending, and foreign exchange for global clients



2.2.3.1 Features

- ◇ Part of the parent bank legally.
- ◇ Must follow home country and host country regulations.
- ◇ Larger size than representative offices.
- ◇ Can handle retail or wholesale banking depending on license.

2.2.3.2 Functions

a. Deposit Mobilisation

Foreign branches act as full-service banking units in the host country and are permitted to accept various types of deposits from individuals, businesses, and institutions. These deposits may include savings accounts, current accounts, fixed deposits, and corporate deposits. By mobilising deposits locally, the foreign branch builds a stable source of funds to support its lending and investment operations. This also helps the parent bank expand its customer base and strengthen its international presence. For example, the London branch of an Indian bank can accept deposits from NRIs, local residents, and UK-based companies, just like any domestic bank in the UK.

b. Lending Activities

Foreign branches are authorised to grant loans and credit facilities in the host country. They provide different forms of credit-including term loans, working capital loans, overdrafts, buyer's credit, and trade finance-to individuals, small businesses, corporate clients, and multinational companies. These branches also participate in international syndicated loans, project financing, and corporate debt restructuring. By offering lending services, foreign branches help companies grow their global operations and support cross-border business activities. For instance, a branch in Dubai may provide working capital finance to Indian exporters operating in the Middle East.

c. Foreign Exchange and Treasury Operations

One of the core functions of foreign branches is handling foreign exchange (forex) operations. These branches buy and sell foreign currencies, issue forex drafts, process international contracts, and offer hedging tools such as forward contracts, swaps, and currency futures. Through their treasury operations, they help customers manage currency risks arising from fluctuating exchange rates. These services are very important for importers, exporters, travellers, and multinational companies involved in global trade. For example, a foreign branch may help a company hedge its exposure to USD–EUR exchange rate fluctuations.

d. Trade Finance Support

Foreign branches are actively involved in supporting international trade by offering various trade finance instruments. They issue and confirm Letters of Credit (LCs), negotiate export bills, process import documents, and provide guarantees for international transactions. They also handle documentary collections, performance guarantees, and standby letters of credit. These activities help importers and exporters reduce payment risks and comply with international business rules. For instance, the

Singapore branch of an Indian bank may issue LCs to support Indian exporters doing business with Southeast Asian companies.

e. Remittance and Cross-Border Transfer Services

Foreign branches play a major role in facilitating fast and secure remittances between countries. They enable migrant workers, NRIs, travellers, and businesses to send money across borders using SWIFT and other international transfer systems. These branches also offer instant credit services to linked accounts and collaborate with exchange houses for faster remittance delivery. For example, an NRI in Canada can send money directly to India through the Canadian branch of an Indian bank, ensuring quick processing and reduced transfer charges.

f. Investment and Wealth Management Services

Many foreign branches offer specialised investment services to high-net-worth individuals, corporate investors, and institutional clients. These services may include portfolio management, mutual fund distribution, financial advisory, and private banking support. Some branches also help clients access global investment opportunities, such as international bonds, equity markets, and structured products. This function helps the bank strengthen long-term relationships with clients and increase its service offerings in competitive international markets.

g. Digital Banking and Customer Service Support

Foreign branches provide comprehensive customer services, supported by modern digital banking platforms. They offer online account access, mobile banking, international ATM services, debit/credit facilities, and electronic fund transfers. They also assist customers in resolving queries related to loans, accounts, remittances, card services, and trade documentation. These customer support services enhance convenience and ensure that customers experience seamless banking, even when dealing with cross-border transactions.

h. Regulatory Compliance and Reporting

Foreign branches must follow the banking regulations of both the parent country and the host country. They ensure compliance with local laws related to anti-money laundering (AML), know-your-customer (KYC), foreign exchange management, interest rates, and reporting requirements. They also coordinate with regulatory authorities such as central banks, financial intelligence units, and government departments to ensure transparent operations. This helps the parent bank maintain a strong and trustworthy reputation in global markets.

2.2.4. Limited branches

A limited branch is a foreign branch allowed to do restricted functions based on the license provided by the host country. A limited branch (sometimes called a restricted or specialized branch) is a foreign branch whose activities are confined to certain products or customer segments, such as wholesale banking, trade finance, or investment activities, and which is not allowed to offer a full range of retail services. Regulators may restrict



such branches from taking retail deposits or providing certain consumer services to limit systemic and consumer risk. Common pattern: branches permitted to deal only with corporates, financial institutions, or non-resident clients, focusing on trade finance, treasury, or syndicated loans. This structure reduces compliance and consumer protection burdens while still giving the bank a direct presence in key financial centers.

2.2.4.1 Features

- ◇ Not allowed to perform all activities.
- ◇ Usually focus on:
 - ✓ trade finance,
 - ✓ wholesale banking,
 - ✓ foreign currency operations.
- ◇ Cannot accept retail deposits in many countries.

Nature of Limited Branches

1. Limited branches are foreign branches of banks with restricted banking functions.
2. They are not permitted to conduct full-scale banking operations.
3. Their activities are usually confined to specific services such as trade finance or foreign exchange.
4. They do not accept retail deposits from the general public.
5. Lending powers are limited and closely regulated by the host country.
6. They mainly cater to corporate clients, exporters, and importers.
7. They operate under strict supervision of host country regulations.
8. Their main purpose is to support international banking business with limited risk exposure.

2.2.4.2 Functions

a. Accepting Certain Types of Deposits

Limited branches are authorised to accept deposits only from corporate clients, institutional investors, and non-resident customers. They usually cannot accept deposits from the general public. This function helps the branch mobilize funds in a controlled manner while reducing regulatory and operational risks. For example, a Japanese bank's limited branch in India may accept deposits only from multinational companies operating in the country.

b. Trade Finance Services

A major function of limited branches is to support international trade by providing trade finance services. They issue and confirm Letters of Credit (LCs), help in the collection of export and import bills, and verify shipping documents. This ensures

that payments and deliveries are executed safely and efficiently. For instance, a U.S. bank's limited branch may assist an Indian exporter in receiving payments from a U.S. importer through an LC.

c. Foreign Exchange Services

Limited branches provide foreign currency exchange services and help corporate clients manage currency risks. They buy and sell foreign currencies and offer hedging tools such as forward contracts and swaps to protect clients from fluctuations in exchange rates. However, these services are typically available only for businesses and not for individual retail customers.

d. Corporate Lending

Limited branches can extend loans and credit facilities, but these are generally restricted to corporate clients. They may offer working capital loans, short-term trade finance, or project financing. They are usually not allowed to provide retail loans like personal, home, or vehicle loans. For example, a German bank's limited branch may provide a working capital loan to a manufacturing company but cannot offer housing loans to local residents.

e. Liaison and Market Intelligence

Limited branches act as a liaison between the parent bank and the local market. They gather information about market trends, regulatory changes, investment opportunities, and customer needs. This helps the parent bank make informed decisions about expanding operations or offering new products in the host country.

f. International Payment Services

These branches facilitate cross-border payments and settlements for corporate clients. They can process SWIFT transfers, remittances, and international fund transfers, enabling businesses to conduct global transactions efficiently. For example, a limited branch may handle bulk salary remittances for seafarers or process trade payments for exporters.

g. Custodial and Advisory Services

Some limited branches provide custody and advisory services in a restricted capacity. They safeguard trade documents, store financial assets, and offer investment guidance to corporate clients. However, these services are generally limited to business clients rather than individual customers.

2.2.5. Subsidiary banks

A subsidiary bank is a separate legal entity incorporated in the host country but owned (wholly or majority) by a foreign parent bank. It operates under host-country company and banking law, is supervised as a domestic bank, and maintains its own capital and balance sheet, even though strategic control rests with the parent. Because the subsidiary is legally distinct, regulators can ring-fence local operations and require local capital and resolution planning, which can reduce cross-border contagion risk.



Many large international groups (for example, global banks operating in the UK or US through locally incorporated subsidiaries) use this model when they want a long-term, full-service presence and when host regulators prefer local incorporation

Example:

HSBC Bank USA is a subsidiary of HSBC Holdings (UK).

2.2.5.1 Features

- ◇ Separate legal entity from the parent bank.
- ◇ Completely governed by host-country rules.
- ◇ Parent bank generally owns more than 50% share.
- ◇ Easier to expand local operations.

2.2.5.2 Functions

a. Full-Scale Retail Banking

Subsidiary banks operate as fully licensed banks in the host country, offering complete retail banking services. They accept deposits from individuals and businesses, provide savings and current accounts, and offer fixed and recurring deposits. Customers can access loans, credit cards, and other personal banking services just like with any domestic bank. For example, HSBC Bank USA, a subsidiary of HSBC Group, provides full retail banking to American residents.

b. Corporate and Commercial Lending

Subsidiary banks provide a wide range of loans and credit facilities to corporate clients. They offer working capital finance, project financing, term loans, and trade-related loans. This function allows them to support both local and international business operations of companies. For instance, SBI Canada Bank, a subsidiary of State Bank of India, provides loans to Canadian corporations involved in trade with India.

c. Trade Finance and International Banking Services

Subsidiary banks actively participate in international trade by offering Letters of Credit (LCs), guarantees, documentary collections, and export-import financing. They also handle foreign exchange transactions for corporates and investors. This enables businesses to trade across borders with reduced risk. For example, a subsidiary bank may issue an LC for an Indian exporter to sell goods in the USA.

d. Foreign Exchange and Treasury Operations

Subsidiary banks provide comprehensive forex and treasury services. They buy and sell foreign currencies, offer hedging tools like forwards and swaps, and manage forex risk for corporate and individual clients. Unlike limited branches, these banks can provide forex services to both businesses and retail customers. For instance, a subsidiary of Standard Chartered in Singapore can offer currency exchange to local residents and multinational firms.

e. Investment and Wealth Management

Many subsidiary banks offer investment advisory, portfolio management, and private banking services to high-net-worth individuals, corporates, and institutional clients. They may also provide mutual fund distribution, insurance products, and access to international investment opportunities. This service helps clients diversify their portfolios and enhances the bank's revenue streams.

f. Digital Banking and Customer Support

Subsidiary banks use modern technology and digital platforms to provide convenient services. Customers can access accounts online, perform mobile banking, transfer funds internationally, and use ATMs worldwide. The banks also provide dedicated customer support for loans, accounts, remittances, and trade services, ensuring smooth operations for both retail and corporate clients.

g. Compliance and Regulatory Functions

Being incorporated locally, subsidiary banks are fully regulated by the host country's central bank and financial authorities. They ensure compliance with local laws on anti-money laundering (AML), know-your-customer (KYC), foreign exchange management, and reporting requirements. This regulatory compliance helps build trust with local customers and maintains the parent bank's reputation in international markets.

h. Strategic Expansion and Market Penetration

Subsidiary banks often serve as a platform for the parent bank's long-term growth in the host country. They allow the parent bank to gain customer trust, expand product offerings, and compete effectively with domestic banks. For example, HSBC's subsidiaries in various countries enable the bank to establish a strong brand presence and offer full-fledged banking services in local markets.

Importance / Significance of Subsidiary Banks

1. Enable banks to establish a permanent presence in a foreign country
2. Operate as separate legal entities, reducing risk to the parent bank
3. Comply fully with host country laws and regulations
4. Facilitate local banking services such as deposits and loans
5. Help in expanding international business and market reach
6. Improve customer confidence by operating under local supervision
7. Allow better adaptation to local market conditions and customer needs
8. Support international trade, investment, and financial integration

Thus subsidiary banks play a significant role in international banking by enabling parent banks to operate effectively in foreign markets through separate legal entities. By complying with host country regulations and adapting to local market conditions, subsidiary banks reduce risk while enhancing operational flexibility and customer trust. They contribute to the expansion of global banking activities, promote international trade and investment, and strengthen the overall stability and integration of the international financial system



Recap

- ◇ Correspondent banks provide international banking services without having a physical presence in a foreign country.
- ◇ Representative offices act as liaison and marketing offices but cannot conduct financial transactions.
- ◇ Foreign branches are full-fledged branches offering deposits, loans, trade finance, and forex services.
- ◇ Limited branches operate in a host country with restricted powers and mainly serve corporate clients.
- ◇ Subsidiary banks are separately incorporated entities in foreign countries, offering full retail and corporate banking.

Objective Questions

1. What is a correspondent bank?
2. Can representative offices accept deposits?
3. Name one major function of foreign branches.
4. Who can deposit funds in a limited branch?
5. What is the key difference between a subsidiary bank and a foreign branch?
6. Give one example of a correspondent bank relationship.
7. What services do representative offices mainly provide?
8. Can limited branches offer retail loans?
9. What is one benefit of a subsidiary bank?
10. Why do banks establish foreign branches or subsidiaries?

Answers

1. A correspondent bank is a foreign bank that provides banking services for another bank without a branch in that country.
2. No, representative offices cannot accept deposits or provide loans.

3. Foreign branches accept deposits, give loans, handle trade finance, and provide forex services.
4. Corporate clients, institutional investors, and non-residents.
5. A subsidiary bank is a separately incorporated entity, while a foreign branch is part of the parent bank.
6. An Indian bank using Deutsche Bank (USA) to settle payments in dollars.
7. Marketing, customer liaison, and market research.
8. No, they mainly provide loans to corporate clients.
9. It can provide full-scale banking services and operate like a domestic bank in the host country.
10. To expand international presence, serve global clients, and participate in trade and investment activities.

Self Assessment Questions

1. Discuss the major modes of International banking
2. Describe the functions of correspondent banks.
3. Essay on functions and features of respective offices.
4. Short note on limited branches.
5. Discuss the functions of foreign branches and offices.

Assignment Questions

1. Explain the concept of correspondent banking and discuss its importance in international trade.
2. Describe the functions and limitations of representative offices in foreign countries.
3. Discuss the roles and services offered by foreign branches of international banks.
4. Explain the concept of limited branches and their functions in serving corporate clients.

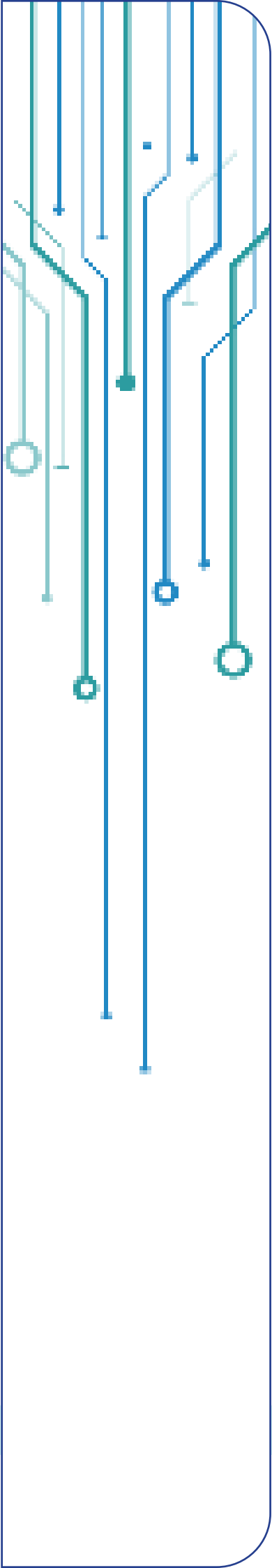
5. Compare subsidiary banks and foreign branches, highlighting their advantages and disadvantages.
6. Discuss the benefits of different modes of international banking for banks and customers.

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Unit

Role of International Banking

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ comprehend the role of international commercial banks in promoting economic growth and development in developing countries.
- ◇ To examine how international banks support trade, investment, and financial stability in developing economies.
- ◇ To distinguish between international banking and multinational banking, including their scope, functions, and objectives.
- ◇ To analyze the impact of global banking practices on the financial systems of developing countries

Prerequisite

International banking plays a crucial role in the global economy, providing financial services that facilitate trade, investment, and capital flow across countries. Developing countries often face challenges such as limited domestic banking infrastructure, inadequate access to credit, and lack of foreign investment. International commercial banks help bridge these gaps by providing capital, expertise, and international connectivity. This unit focuses on the role of these banks in promoting economic growth, supporting trade, and facilitating global financial integration. Additionally, it highlights the distinction between international banking and multinational banking, which is important for understanding the structure, operations, and objectives of banks operating across borders.

Keywords

International Commercial Bank, Developing Countries, Multinational Banking, International Banking, Trade Finance

Discussion

2.3.1 Role of International Commercial Banks in Developing Countries

International commercial banks play a vital role in the economic development of developing countries by providing much-needed capital, credit, and financial expertise. They support international trade by offering services such as letters of credit, export–import finance, and foreign exchange facilities, which help integrate developing economies with global markets. These banks also facilitate foreign direct investment by mobilising international funds and channelling them into productive sectors like infrastructure, industry, and services. In addition, international commercial banks introduce modern banking technology, risk management practices, and managerial skills, thereby strengthening the local financial system. Through their financial support and technical assistance, they promote private sector growth, employment generation, and overall economic development in developing countries.

International commercial banks play a critical role in the economic development of emerging economies by providing capital, financial services, and expertise. Some of their key contributions include:

1. **Providing Capital and Credit:** These banks supply funds for industrial projects, infrastructure development, and business expansion. This is particularly important in developing countries where domestic banks may have limited resources. For example, international banks have financed major infrastructure projects in India, Africa, and Southeast Asia.
2. **Facilitating Trade and Investment:** They provide trade finance services, such as letters of credit, guarantees, and foreign currency transactions, which enable exporters and importers to conduct business securely. For instance, a foreign bank may issue an LC for a textile exporter in Bangladesh selling goods to Europe.
3. **Encouraging Foreign Direct Investment (FDI):** International banks attract and channel foreign investment into developing countries, helping to improve industrial capacity and employment opportunities.
4. **Introducing Advanced Banking Technology and Expertise:** By operating in developing countries, international banks bring modern banking practices, IT systems, risk management strategies, and compliance knowledge that improve

the efficiency and reliability of the local banking sector.

5. **Stabilizing Financial Markets:** International banks help maintain liquidity in financial markets, offer foreign exchange services, and provide risk management tools, contributing to financial stability in developing economies.
6. **Providing Foreign Exchange Services:** They offer foreign exchange facilities, helping developing countries manage currency conversion, international payments, and trade settlements. This service ensures stability in external trade and allows businesses to operate efficiently in global markets.
7. **Mobilizing Foreign Savings:** These banks mobilize foreign savings and investments, directing them toward productive uses in the economy. This flow of funds helps finance development projects that might otherwise remain underfunded due to limited domestic resources.
8. **Supporting Private Sector Growth:** By providing loans, credit, and financial advisory services to private businesses, international commercial banks enable entrepreneurship and business expansion. This support stimulates innovation, productivity, and competitiveness within developing economies.
9. **Generating Employment Opportunities:** Through financing industrial, infrastructure, and business projects, international commercial banks indirectly contribute to employment creation. Jobs generated in these sectors enhance income levels and improve living standards in developing countries.
10. **Promoting Economic Integration:** International banks connect developing countries with the global economy by facilitating trade, investment, and financial flows. This integration allows developing nations to benefit from international markets, technology transfer, and economic cooperation.

2.3.2 Difference Between International Banking and Multi-national Banking

Understanding the distinction between international banking and multinational banking is important for grasping how banks operate globally.



Table 2.3.1 Difference between international banking & multinational banking

Feature	International Banking	Multinational Banking
Definition	Provides banking services across borders without necessarily having full-scale branches; may use correspondent banks or limited branches.	Establishes full-scale banking operations in multiple countries through branches, subsidiaries, or affiliates.
Scope of Operations	Limited to cross-border services such as trade finance, foreign exchange, and international payments.	Offers a complete range of banking services (retail, corporate, investment) in each host country.
Legal Status	Often operates as part of the parent bank; not separately incorporated in the host country.	Typically incorporated as separate legal entities (subsidiaries) in each host country.
Customer Base	Focuses on corporate clients, exporters, importers, and institutional investors.	Serves both individual and corporate customers in multiple countries.
Examples	A correspondent bank helping an Indian bank settle international payments in Europe.	HSBC or Citibank operating subsidiaries in the UK, USA, India, and Singapore.

Other Differences :

1.Regulation:

International banking is governed by domestic and host country regulations, often with limited functions. Multinational banking complies with regulations in all countries of operation and can offer full banking services.

2. Nature of Transactions: International banking is limited to international financial transactions. Multinational banking includes both domestic and international transactions in each country.

3. Risk Exposure: International banking faces mainly foreign exchange and cross-border transaction risks. Multinational banking faces multiple risks, including foreign exchange, political, credit, and operational risks.

4. Objective: The objective of international banking is to facilitate international trade and financial transactions. The objective of multinational banking is to expand global presence and maximize business opportunities internationally.

While international banking mainly focuses on providing cross-border financial services, multinational banking establishes full-scale banking presence in multiple countries, providing comprehensive services similar to domestic banks. International commercial banks are vital for developing countries as they provide capital, expertise, trade support, and risk management, which contribute to economic growth. Understanding the distinction between international and multinational banking helps explain how banks structure their global operations and deliver services to different markets. In developing countries, these banks are not only financial intermediaries but also agents of technology transfer, investment facilitation, and financial stability.

Recap

- ◇ International Commercial Bank means a bank that operates across national borders to provide banking services to corporations, governments, and individuals.
- ◇ Developing Countries are Nations with emerging economies that may need foreign investment and financial support to boost growth.
- ◇ Multinational Banking means Banking operations where banks establish full-scale branches or subsidiaries in multiple countries.
- ◇ International Banking means Banking services provided across borders, often through correspondent banks, foreign branches, or subsidiaries.
- ◇ Trade Finance means Financial instruments and services that facilitate international trade, such as letters of credit, export financing, and guarantees.

Objective Questions

1. What is the role of international commercial banks in developing countries?
2. How do international banks help exporters and importers?
3. Name one way international banks promote foreign direct investment.
4. How do international banks introduce modern banking practices in developing countries?
5. What is trade finance?
6. What is the main difference between international banking and multinational banking?

7. Can international banks operate as subsidiaries in host countries?
8. Give an example of international banking.
9. Give an example of multinational banking.
10. Why are international commercial banks important for financial stability in developing countries?

Answers

1. They provide capital, trade support, and financial services to promote economic growth.
2. By offering letters of credit, guarantees, and foreign exchange services.
3. By channeling foreign investment into developing countries.
4. Through modern technology, risk management, and efficient banking systems.
5. Trade finance refers to financial services that facilitate international trade.
6. International banking provides cross-border services; multinational banking establishes full operations in multiple countries.
7. Yes, as subsidiaries, they can offer full banking services.
8. A correspondent bank helping an Indian bank settle payments in Europe.
9. HSBC operating subsidiaries in India, the USA, and Singapore.
10. They provide liquidity, risk management, and access to international capital, stabilizing financial markets.

Self Assessment Questions

1. Differentiate International banking & Multinational banking.
2. Discuss the role of international commercial banks in developing countries?
3. Give examples of multinational banking?

Assignment Questions

1. Explain the role of international commercial banks in developing countries.
2. Discuss the impact of trade finance services on exporters and importers in emerging economies.
3. Describe how international banks promote foreign direct investment in developing countries.
4. Explain the difference between international banking and multinational banking with examples.
5. Discuss how international commercial banks contribute to financial stability in developing countries.

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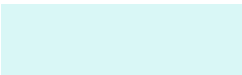
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International Banking Operations



Unit

International Lending

Learning Outcomes

After completing this unit, the learner will be able to:

- ◇ To understand the concept and meaning of international lending.
- ◇ To examine the various forms of international lending used by banks and financial institutions.
- ◇ To identify the risks involved in international lending and how they are managed.
- ◇ To understand the policies and guidelines governing international lending by banks.

Prerequisite

International lending is a critical component of the global financial system. Banks and financial institutions provide loans across national borders to governments, corporations, and financial institutions. This process helps countries finance development projects, businesses to expand internationally, and financial markets to remain liquid. International lending is essential for promoting global trade, economic growth, and investment. However, it also involves several risks due to exchange rate fluctuations, political instability, and differing regulatory frameworks. This unit explores the meaning, forms, risks, and policies of international lending to provide a comprehensive understanding of cross-border credit operations.

Keywords

International Lending, Syndicated Loan, Bilateral Loan, Political Risk, Credit Policy

3.1.1 International Lending

International lending refers to the process by which banks, financial institutions, or governments provide credit to borrowers in foreign countries. It allows countries and businesses to raise capital for trade, investment, infrastructure, and development projects. The borrower can be a foreign government, a multinational corporation, or a financial institution.

It is a crucial aspect of global finance, enabling countries, multinational corporations, and international projects to access funds beyond their domestic markets. International lending helps finance trade, investment, infrastructure development, and economic growth, especially in developing nations.

Through international lending, developing countries can finance infrastructure projects, industrial growth, and balance of payments deficits, while lenders earn profitable returns and strengthen financial ties across nations. This system forms a key component of the global financial network, promoting economic cooperation and stability.

In short International lending is the process of providing loans or credit by banks, financial institutions, governments, or international organizations to borrowers in other countries. It enables countries, businesses, and projects to access funds beyond their domestic resources, supporting trade, investment, and economic development. Through international lending, capital flows from surplus regions to deficit regions, helping finance infrastructure, industries, and other developmental activities while offering returns to lenders.

Example:

The World Bank providing loans to developing countries for infrastructure projects such as highways, dams, and hospitals.

Objectives of International Lending

1. Facilitate economic development in borrowing countries.
2. Promote international trade and investment.
3. Generate profitable returns for lending institutions.
4. Maintain international financial stability.
5. Support infrastructure, energy, and industrial projects in developing nations.

3.1.2. Forms of International Lending

International lending can take several forms depending on the type of borrower, purpose of the loan, and risk-sharing arrangements. One common form is bilateral loans, where a single bank or country provides credit directly to a borrower, such as a government or corporation in another country. For instance, the USA may provide a bilateral loan to India for infrastructure development. Another form is syndicated loans, in which a consortium of banks provides a large loan to spread risk among the lenders. An example would be multiple international banks giving \$500 million to a company in Brazil to build a new factory. Bonds and Eurobonds are also used for international lending, where companies or governments issue bonds in foreign markets to raise capital. Similarly, trade credits allow importers to buy goods on deferred payment terms, often supported by banks. Lastly, loans from multilateral institutions such as the IMF, World Bank, or Asian Development Bank provide funds for development projects in multiple countries.

International lending can take several forms depending on the type of borrower, purpose, and risk-sharing arrangements:

- a. **Bilateral Loans** – Loans provided by one bank or country directly to another bank, corporation, or government.
 - ◇ *Example:* The USA providing a bilateral loan to India for development projects.
- b. **Syndicated Loans** – Large loans provided by a consortium of banks to spread the risk among lenders.
 - ◇ *Example:* A group of international banks providing \$500 million to a multinational company for a new factory in Brazil.
- c. **Bonds and Eurobonds** – Companies or governments raise funds from international investors by issuing bonds.
 - ◇ *Example:* An Indian company issuing Eurobonds in the London market to fund expansion.
- d. **Trade Credits** – Short-term credit extended by exporters or banks to importers to finance imports and exports.
 - ◇ *Example:* A European bank providing trade credit to an African importer of machinery.
- e. **Loans from Multilateral Institutions** – Funds provided by organizations like IMF, World Bank, or ADB for development purposes.
 - ◇ *Example:* World Bank loans for education and healthcare projects in African countries.



Types of International Lending

1. **Sovereign Lending:** Loans extended by banks, international organizations, or governments to foreign governments. These loans often finance large-scale development projects, balance of payments deficits, or economic stabilization programs.
2. **Commercial Lending:** Loans provided by commercial banks to foreign corporations or subsidiaries. This includes trade finance, working capital loans, and project financing.
3. **Institutional or Multilateral Lending:** Loans extended by institutions like the International Monetary Fund (IMF), World Bank, or regional development banks to member countries for development projects, economic reforms, or crisis management.
4. **Private Lending:** Loans from private investors or funds to international borrowers. This often involves higher risk and returns, and can include bonds or syndicated loans

3.1.3. Risks in International Lending

International lending involves a variety of risks that banks and financial institutions must carefully evaluate and manage to protect their funds and ensure successful cross-border operations.

a. Credit Risk

Credit Risk occurs when the borrower may fail to repay the loan, either partially or fully, as per the agreed terms. This is one of the most fundamental risks in international lending because the lender's capital is at stake. For instance, a bank providing a large loan to a foreign company must carefully assess the borrower's financial health, past repayment record, and business prospects to minimize the possibility of default.

b. Political Risk

Political Risk arises from instability in the borrower's country, which can include sudden changes in government, nationalization of assets, expropriation, or unfavorable policies that affect loan repayment. Such risks are particularly significant in developing countries with volatile political environments. For example, an Indian bank lending to a Venezuelan company may face challenges if the government enforces strict currency controls or seizes assets.

c. Currency or Exchange Rate Risk

Currency or Exchange Rate Risk is the possibility that fluctuations in foreign exchange rates will alter the value of loan repayments. Since international loans are often denominated in foreign currencies, any depreciation of the borrower's local currency can make repayment more expensive or difficult. For example, if a Venezuelan company has to repay a loan in US dollars but the local currency weakens, the repayment burden increases significantly.

d. Country Risk

Country Risk is a broader concept that combines economic, social, and political factors in the borrower's country, which may affect the borrower's ability to repay. It includes inflation rates, economic downturns, debt levels, and social unrest. Lenders must evaluate country-specific conditions before granting loans to ensure that external factors do not jeopardize repayment.

e. Operational Risk

Operational Risk involves risks related to the administrative and procedural aspects of lending. These include documentation errors, legal disputes, failure to follow proper procedures, and inefficiencies in loan monitoring. Even if a borrower is creditworthy, operational failures can lead to financial losses or delayed repayments.

Example: Consider an Indian bank lending to a company in Venezuela. The bank faces political risk due to government instability, currency risk because of fluctuating exchange rates, and credit risk if the borrower struggles to repay. By assessing these risks and implementing safeguards, such as political risk insurance or currency hedging, the bank can reduce potential losses and manage international lending effectively.

3.1.4. Policies of International Lending

Banks and financial institutions follow carefully designed policies when engaging in international lending to ensure that loans are granted safely and repayments are secured. Credit assessment policies form the foundation of lending decisions, where the borrower's financial health, repayment history, business performance, and overall risk profile are thoroughly evaluated. By analyzing these factors, banks can decide whether to approve the loan, set appropriate limits, and determine repayment schedules.

a. Risk management policies

Risk management policies are also essential in international lending. These policies include strategies such as currency hedging, political risk insurance, and syndication of large loans to reduce the potential exposure of a single bank. For example, if a bank lends to a company in a politically unstable country, it may require political risk insurance to safeguard against expropriation or nationalization of assets.

b. Regulatory compliance policies

Regulatory compliance policies ensure that banks operate within the legal frameworks of both the home and host countries. This includes adherence to capital adequacy norms, reporting requirements, anti-money laundering (AML) guidelines, and foreign exchange regulations. Compliance policies help banks avoid legal penalties and maintain their credibility in international markets.

c. Interest rate and repayment policies

Interest rate and repayment policies are designed to match the risk profile of the borrower and prevailing market conditions. Banks may charge higher interest rates for riskier borrowers or countries and establish repayment schedules that consider the

borrower's cash flow and economic environment. This ensures that repayments are feasible and timely.

d. Environmental and social policies

Environmental and social policies are increasingly integrated into international lending. Banks are expected to ensure that the loans they provide support sustainable development and adhere to ethical standards. This is particularly relevant for large infrastructure or industrial projects, where environmental impact and social responsibility are considered before loan approval.

Example: A bank lending to a developing country for an energy project may require the borrower to provide political risk insurance, maintain compliance with international banking regulations, and demonstrate that the project meets environmental and social guidelines. By following these policies, the bank minimizes risks and ensures that the loan contributes positively to economic development.

Recap

- ◇ International Lending – Providing loans or credit by banks or financial institutions to borrowers in foreign countries
- ◇ Syndicated Loan – A large loan provided by a group of banks to a single borrower, often for multinational projects
- ◇ Bilateral Loan – A loan agreement between a single lender and a single borrower across countries
- ◇ Political Risk – The risk arising from political instability or government actions in the borrower's country
- ◇ Credit Policy – Guidelines and rules followed by banks to manage lending, repayment, and associated risks

Objective Questions

1. What is international lending?
2. Name two common forms of international lending.
3. What is a syndicated loan?
4. Give an example of a multilateral institution providing international loans.
5. What is credit risk in international lending?
6. How does political risk affect international loans?

7. Explain currency or exchange rate risk with an example.
8. What is operational risk in lending?
9. Name one policy banks follow to manage international lending risks.
10. Why are environmental and social policies important in international lending?

Answers

1. International lending is the provision of loans or credit by banks or financial institutions to borrowers in foreign countries.
2. Bilateral loans and trade credits (also syndicated loans, bonds/Eurobonds, multilateral loans).
3. A syndicated loan is a large loan provided by a group of banks to spread the risk among lenders.
4. The World Bank or Asian Development Bank.
5. Credit risk is the possibility that the borrower may fail to repay the loan on time.
6. Political risk arises from instability, expropriation, nationalization, or sudden policy changes affecting repayment.
7. Currency risk occurs when exchange rate fluctuations increase the repayment burden, e.g., if a Venezuelan company must repay in US dollars while the local currency depreciates.
8. Operational risk involves administrative failures, documentation errors, or legal disputes that may affect repayment.
9. Credit assessment, risk management, regulatory compliance, or repayment policies.
10. Environmental and social policies ensure that loans support sustainable development and adhere to ethical standards.

Self Assessment Questions

1. Explain international lending?
2. Describe the forms of international lending?



3. Write a note on risks in international lending?
4. Explain various policies of international lending?

Assignment Questions

1. Explain the meaning and importance of international lending in the global economy.
2. Describe the different forms of international lending and provide examples for each.
3. Discuss the major risks involved in international lending and how banks manage them.
4. Explain the role of credit assessment and risk management policies in international lending.
5. Discuss the significance of regulatory compliance in cross-border loans.
6. Analyse why environmental and social policies are increasingly important in international lending for developing countries.

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Unit

Other International Banking Operations

Learning Outcomes

After completing this unit, the learner will be able:

- ◇ To understand the various operations performed by international banks beyond standard lending.
- ◇ To examine the role of investments, private banking, and correspondent banking in international finance.
- ◇ To study deposit accounts, borrowings, and the functioning of offshore financial centers.
- ◇ To analyse the characteristics and types of offshore financial centers and their role in global banking.

Prerequisite

International banks perform a variety of operations that go beyond traditional lending and deposit-taking. These activities include investments, private banking, correspondent banking, and managing deposit accounts and borrowings. Additionally, many banks operate in offshore financial centers, which serve as hubs for capital flows, investment management, and tax-efficient transactions. Understanding these operations is crucial for comprehending how international banks support global trade, investment, and financial services. This unit provides a comprehensive overview of other international banking activities and highlights the role of offshore centers in facilitating international finance.

Keywords

Investments, Private Banking, Correspondent Banking, Offshore Financial Centers (OFCs), Deposit Accounts

3.2.1 Other International banking activities

a. Investments

International banks actively participate in investments across global financial markets. These investments include government and corporate bonds, equities, mutual funds, and derivatives, which help banks earn returns and manage liquidity. By investing internationally, banks diversify their portfolios, reduce risk, and access new opportunities. For example, an Indian bank may invest in US Treasury bonds or European corporate bonds to earn interest while mitigating domestic market risk. Investment operations also support global capital flow by channeling funds from surplus regions to countries or sectors needing capital.

b. Private Banking

Private banking refers to personalized financial services provided to high-net-worth individuals (HNWIs). These services include wealth management, portfolio management, estate planning, tax advisory, and access to exclusive investment opportunities. International banks cater to clients who require sophisticated financial planning and global investment options. For instance, Citibank or HSBC offer private banking services to clients who invest in foreign markets, diversify assets, and manage family wealth across countries. Private banking also strengthens the bank's revenue through fees and commissions for customized services.

c. Correspondent Banking

Correspondent banking enables a bank in one country to provide financial services on behalf of another bank in a foreign country. This arrangement allows banks to facilitate payments, trade finance, foreign exchange, and remittances without establishing full-fledged branches abroad. For example, a small Indian bank may rely on Deutsche Bank in Germany to process international payments and provide trade-related services. Correspondent banking is particularly important for smaller banks and developing countries, as it provides international connectivity at low cost.

d. Deposit Accounts

Deposit accounts are a fundamental part of international banking operations, allowing banks to gather funds from individuals, corporations, and institutions for various financial activities. International banks maintain different types of deposit accounts, including savings accounts, current accounts, fixed deposits, and foreign currency accounts. These accounts serve multiple purposes: savings and transactional convenience for customers, liquidity management for banks, and as a source of funds for lending and investment. Foreign currency accounts are particularly important in international banking because they allow clients, such as exporters and importers, to hold and transact in multiple currencies, reducing the risks associated with exchange rate fluctuations. For example, an Indian exporter selling goods to the United States may maintain a USD account to receive payments directly in dollars, minimizing currency conversion losses and facilitating faster international trade settlements.

e. Borrowings

Borrowings are essential for international banks to maintain liquidity, fund lending operations, and meet regulatory reserve requirements. Banks may borrow from other commercial banks, central banks, international financial institutions, or money markets. Common forms of borrowings include interbank loans, Eurodollar loans, certificates of deposit, and syndicated borrowings. These mechanisms allow banks to obtain short-term or long-term funds as needed to support their lending and investment operations across countries. For example, a bank in Singapore may borrow from the London interbank market to finance short-term loans for businesses in Asia. Effective borrowing strategies help banks manage interest costs, liquidity gaps, and capital adequacy while ensuring that funds are available for customers and international trade operations..

f. Offshore Financial Centers (OFCs)

Offshore financial centers are jurisdictions that provide financial services to non-residents, often offering tax advantages, confidentiality, and lighter regulatory requirements. OFCs are widely used for investment management, financing, and asset protection. Examples include the Cayman Islands, Luxembourg, and Singapore. The key characteristics of OFCs include low or zero taxation, minimal capital controls, political and economic stability, strong legal frameworks, and professional financial services.

Offshore financial centers can be classified into two main types:

- ◇ Tax Havens – Jurisdictions offering minimal or no taxes to attract foreign capital. For instance, the Cayman Islands attract investment funds due to its zero-tax policy.
- ◇ Financial Hubs – Jurisdictions providing sophisticated banking and financial infrastructure for international trade, investments, and fund management, such as Singapore and Luxembourg.

OFCs play a crucial role in international banking by facilitating capital flows, providing liquidity, and offering investment opportunities that are less constrained by domestic regulations.

3.2.2 Key characteristics of OFCs

a. Orientation to non-residents

- ◇ Majority of business is with foreign individuals, corporations, funds, and banks.
- ◇ Local financial sector size is disproportionately large compared to domestic GDP and domestic credit needs.

b. Tax advantages

- ◇ Low or zero tax on certain income (for example, on offshore company profits, capital gains, interest, or withholding taxes).
- ◇ Extensive tax treaty networks or structures that allow tax planning and deferral for multinational enterprises and high-net-worth individuals.

c. Regulatory and legal flexibility

- ◇ Light or business-friendly regulation compared with major onshore centers.
- ◇ Simple, predictable company and trust laws; quick incorporation; minimal capital or reporting requirements for certain entities.
- ◇ Specialized vehicles such as international business companies (IBCs), exempt companies, special purpose vehicles (SPVs), and protected cell companies.

d. Confidentiality and asset protection

- ◇ Strong bank–client confidentiality and privacy provisions (though increasingly constrained by global transparency standards).
- ◇ Legal structures that protect assets from certain foreign judgments, inheritance claims, or political risks.

e. Open capital and currency regimes

- ◇ Free movement of capital with few exchange controls.
- ◇ Ability to hold and transact in multiple currencies, often centered on major currencies (USD, EUR, GBP).

f. Specialized financial infrastructure

- ◇ Concentration of international banks, law firms, accounting firms, corporate service providers, and fund administrators.
- ◇ Modern payment, clearing, and settlement systems oriented toward cross-border activity.

g. Reputation and scrutiny issues

Used for legitimate purposes such as risk diversification, global investment pooling, and treasury management.

Also criticized in debates on tax avoidance, base erosion, profit shifting, money laundering, and lack of transparency, leading to monitoring by bodies such as the IMF, OECD, FATF, and EU.

3.2.3 Types of OFCs

a. Banking-dominated OFCs

Banking-dominated OFCs are centers in which offshore banking is the core activity, and the balance sheets of local institutions are heavily composed of non-resident deposits and loans, often denominated in major foreign currencies. Their key features include a high concentration of foreign bank branches and subsidiaries, active interbank markets, and friendly prudential and tax regimes that make it attractive for global banks to “book” loans and deposits there. Typical services involve wholesale lending to multinational corporations, interbank placements, foreign exchange dealing, and trade finance rather than retail banking. Classic examples include centers historically used in the Eurocurrency and Eurodollar markets, where international banks locate booking offices to manage cross-border funding and large corporate exposures. These are centers where offshore banking and inter-bank markets are the core business.



1. Features

- ◇ Large presence of foreign bank branches and subsidiaries.
- ◇ Balance sheets dominated by non-resident deposits and loans, often in foreign currencies.
- ◇ Significant role in “booking” loans and deposits for multinational banks (for example, Eurocurrency markets).

2. Typical activities

- ◇ Wholesale banking, trade finance, inter-bank placements, foreign exchange dealing, and balance-sheet management for global banks.

3. Examples

- ◇ Some Caribbean and Asian centers that serve as booking hubs for international banks.

b. Capital-market and fund OFCs

Capital-market and fund-oriented OFCs specialize in hosting investment funds and capital-markets structures rather than primarily focusing on traditional banking. Their main features are flexible company and partnership laws, modern securities regulations, and specialized vehicles for mutual funds, hedge funds, private equity funds, and securitization special purpose vehicles. These jurisdictions make it easy and cost-effective to set up collective investment schemes that invest globally, list securities, and issue structured products. In practice, many hedge funds are legally domiciled in such centers, even though their managers and investors are located elsewhere, because these OFCs allow tax-efficient pooling of capital and provide a predictable, widely accepted legal framework for cross-border investment. These specialize in investment funds, securitization structures, and capital-market SPVs.

1. Features

- ◇ Flexible company, partnership, and fund laws enabling mutual funds, hedge funds, private equity funds, and REITs.
- ◇ Sophisticated legal and professional services industry supporting listing, issuance, and fund administration.

2. Typical activities

- ◇ Domiciling hedge funds and private equity funds investing globally.
- ◇ Establishing SPVs for securitization, structured finance, and project finance.
- ◇ Issuing debt and equity instruments through offshore vehicles.

c. Insurance and reinsurance OFCs

Insurance-focused OFCs are known for captive insurance and reinsurance business, where multinational groups establish their own insurance companies to cover group risks or where global insurers centralize certain risk pools. Their features include specialized insurance legislation, comparatively lighter capital requirements for captives, and regulatory rules tailored to multinational risk management rather than

retail consumer protection. These centers attract corporations that want to self-insure part of their global risks (such as property damage, liability, or employee benefits) in a controlled and tax-efficient way. Reinsurance companies may also base regional or global platforms in such OFCs, writing risks from many countries and taking advantage of the jurisdiction's regulatory framework and treaty network. Some OFCs focus on captive insurance and reinsurance.

1. Features

- ◇ Specialized insurance legislation for captives (wholly owned insurance companies that insure risks of the parent group).
- ◇ Regulatory regimes designed for risk pooling and reinsurance, including lower capital requirements relative to onshore jurisdictions.

2. Typical activities

- ◇ Captive insurance for large corporations to manage global risks.
- ◇ Reinsurance hubs that take on risks originated worldwide.

d. Corporate and holding-company OFCs

Corporate and holding-company OFCs focus on hosting the legal entities that own and finance multinational groups' operating subsidiaries around the world. Their distinguishing features include participation exemptions or low tax on dividends and capital gains from foreign subsidiaries, extensive tax treaty networks lowering withholding tax on cross-border dividends, interest, and royalties, and corporate law that accommodates complex group structures. Multinational enterprises often establish intermediate holding companies, group finance companies, or intellectual-property holding entities in these centers. For example, a global group may route ownership of its Asian or European subsidiaries through a holding company in such a jurisdiction to centralize control, simplify cross-border dividend flows, and optimize tax and legal outcomes. These primarily host holding companies, finance companies, and intellectual-property holding structures.

1. Features

- ◇ Favorable participation exemptions (low or zero tax on dividends and capital gains from subsidiaries).
- ◇ Wide treaty networks reducing withholding taxes on cross-border dividends, interest, and royalties.
- ◇ Flexible rules for thin capitalization, group relief, and intra-group financing.

2. Typical activities

- ◇ Multinationals using holding companies to centralize ownership of subsidiaries in different countries.
- ◇ Use of finance and IP holding companies for intra-group loans and licensing arrangements.



e. Mixed or diversified OFCs

Mixed or diversified OFCs combine several of these roles and have broad, multi-functional financial sectors that include banking, investment funds, insurance, trusts, and corporate services. Their key features are a comprehensive financial infrastructure, a deep pool of international banks and non-bank financial institutions, and a dense network of lawyers, accountants, administrators, and corporate service providers. In these centers, the same jurisdiction might simultaneously be a booking hub for bank loans, a domicile for hedge funds and securitization vehicles, and a base for captive insurers and holding companies. Such OFCs often market themselves as full-service international financial hubs, balancing the attraction of global capital with increasing pressure from international bodies to maintain transparency, robust regulation, and effective anti-money-laundering and tax-compliance standards. Many well-known OFCs are mixed: they host banking, funds, insurance, and corporate vehicles in combination.

Features

- ◇ Broad, diversified financial sector serving multiple offshore segments.
- ◇ Developed professional services ecosystems and infrastructure attracting global clientele.

Activities

- ◇ Combination of functions above: banking, asset management, reinsurance, corporate structuring, trusts and wealth management.

Recap

- ◇ Investments – Allocating funds in securities, bonds, and other financial instruments across international markets.
- ◇ Private Banking – Personalized banking and wealth management services for high-net-worth individuals (HNWIs).
- ◇ Correspondent Banking – Banking relationships where one bank provides services on behalf of another in a foreign country.
- ◇ Offshore Financial Centers (OFCs) – Jurisdictions offering financial services to non-residents, often with tax benefits and confidentiality.
- ◇ Deposit Accounts – Bank accounts maintained for saving, current, or fixed deposits, including foreign currency accounts.
- ◇ Banking-dominated OFCs – Hosting non-resident deposits, loans, and interbank markets in foreign currencies for global banks and corporates.
- ◇ Capital-market and fund OFCs – Domiciling hedge funds, mutual funds, private equity, and securitization SPVs with flexible securities laws.
- ◇ Insurance and reinsurance OFCs – Establishing captive insurers and reinsurance hubs for multinational risk pooling and self-insurance.

- ◇ Corporate and holding-company OFCs – Centralizing group ownership, finance subsidiaries, and IP holdings via tax-efficient treaties and exemptions.
- ◇ Mixed or diversified OFCs – Providing full-spectrum services including banking, funds, insurance, trusts, and corporate structuring.

Objective Questions

1. What are the main other operations of international banks besides lending?
2. Give an example of investment operations by international banks.
3. Who are the clients of private banking services?
4. What services do international banks provide through correspondent banking?
5. Why are foreign currency deposit accounts important for international trade?
6. Name one type of borrowing used by international banks.
7. What are offshore financial centers?
8. Give two characteristics of offshore financial centers.
9. Name one tax haven used in international banking.
10. Why are offshore financial centers important for international banks?

Answers

1. Investments, private banking, correspondent banking, deposit accounts, borrowings, and operations through offshore financial centers.
2. Investing in US Treasury bonds or European corporate bonds.
3. High-net-worth individuals (HNWIs) seeking personalized financial and wealth management.
4. Payments, trade finance, remittances, and foreign exchange services on behalf of other banks.
5. They allow exporters and importers to hold and transact in multiple currencies, reducing currency risk.
6. Interbank loans, Eurodollar loans, or syndicated borrowings.



7. Jurisdictions providing financial services to non-residents, often with tax advantages and confidentiality.
8. Low or zero taxation, political stability, strong legal frameworks, and professional financial services.
9. Cayman Islands.
10. They facilitate capital flows, provide liquidity, offer investment opportunities, and help banks operate efficiently internationally.

Self Assessment Questions

1. What are the key characteristics offshore financial centers?
2. Explain the types of OFC's
3. What is private banking?
4. Describe Deposit accounts?

Assignment Questions

1. Explain the main other operations of international banks and their significance in global finance
2. Discuss how international banks conduct investment operations and manage risk through global markets
3. Explain private banking and its importance for high-net-worth individuals in international banking
4. Describe correspondent banking and its role in facilitating cross-border payments and trade
5. Explain the importance of deposit accounts and borrowings for international banks in managing liquidity
6. Discuss the characteristics of offshore financial centers and how they support international banking operations
7. Analyse the types of offshore financial centers and their role in attracting global investments and capital flows

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Unit

Risks in International Banking

Learning Outcomes

After learning this unit, students will be able to:

- ◇ comprehend the different types of risks faced by banks operating in global markets.
- ◇ explain the nature and causes of credit, market, settlement, liquidity, operational, and legal risks.
- ◇ identify how international transactions increase the complexity of risk management.
- ◇ describe the impact of these risks on financial stability and banking performance.

Prerequisite

International banking has become an essential part of today's globalised economy, where money, investments, and financial services move seamlessly across national borders. As businesses expand internationally, banks support these activities by providing foreign currency loans, trade finance, cross-border payments, and investment services. While these global operations create new opportunities for growth, they also expose banks to several complex risks that are not usually present in domestic banking. These risks arise because international transactions involve different currencies, time zones, political environments, legal systems, and financial markets.

Over the years, the frequency of global financial crises, exchange rate volatility, technological disruptions, and political uncertainties has increased. These factors make international banking more challenging and risk-prone. Therefore, understanding the types of risks-such as credit risk, market risk, settlement risk, liquidity risk, operational

risk, and legal risk-has become critical for students, bankers, policymakers, and financial institutions. A strong grasp of these risks helps banks design better risk-management strategies, protect their financial stability, and ensure smooth functioning of global banking services. This unit sets the foundation for studying how banks identify, evaluate, and manage the diverse risks associated with international banking.

Keywords

Credit Risk, Market Risk, Settlement Risk, Liquidity Risk, Operational Risk, Legal Risk

Discussion

3.3.1 Risk in international banking

Risks in international banking arise because banks operate across borders, currencies, time zones, and legal systems, which multiplies the usual domestic banking risks and introduces new dimensions such as country and currency exposure. In international operations, a single transaction can involve counterparties in multiple jurisdictions, different regulatory regimes, and volatile global markets, so problems in any link of the chain can transmit losses throughout the bank's global network. Effective risk management therefore becomes central to the safety and profitability of international banks, which must measure, monitor, and control credit, market, settlement, liquidity, operational, and legal risks in an integrated way rather than in isolation.

Risks in international banking consists of credit risk, market risk, settlement risk, liquidity risk, operational risk and legal risk.

a. Credit Risk

Credit risk refers to the possibility that a borrower or counterparty will fail to repay the money owed to the bank. In international banking, this risk becomes more complicated because banks must deal with borrowers from different countries, different economic systems, and different levels of financial stability. When a bank lends to a foreign company or government, it depends on the financial health of the borrower and the overall economic condition of that country. If the borrower becomes financially weak or the economy goes into recession, the chances of default increase. Changes in political situations, currency crises, or regulatory shifts can also reduce the ability of foreign borrowers to repay. Therefore, banks must carefully assess creditworthiness before offering international loans.

Credit risk in international banking is the possibility that a counterparty will fail to meet its contractual obligations in full and on time, leading to financial loss for the bank. This risk arises not only in straightforward cross-border loans to foreign borrowers but



also in trade finance (such as letters of credit and guarantees), interbank placements, derivative contracts, and off-balance-sheet exposures. International credit risk is more complex than domestic credit risk because the bank must assess the financial strength of foreign borrowers using different accounting standards, limited information, and unfamiliar business environments, while also considering country risk (e.g., capital controls, political instability, or sovereign default) that may prevent repayment even when the borrower remains solvent. For example, an Indian bank that finances an importer in an emerging African market faces the risk that the importer may default due to local recession, or that sudden foreign-exchange restrictions may stop the importer from obtaining hard currency to pay the bank. To manage international credit risk, banks use rigorous credit appraisal, internal rating systems, country exposure limits, collateral and guarantees, credit derivatives, and diversification across sectors and regions, supported by capital buffers under international standards such as the Basel framework.

Factors / causes increasing credit risk include :

1. Poor financial health of the borrower.
2. Economic instability in the borrower's country.
3. Weak legal enforcement of contracts.

Management: Banks mitigate credit risk through

1. Conduct thorough credit assessment and due diligence.
2. Require collateral, guarantees, or letters of credit.
3. Diversify loans across countries and sectors.
4. Purchase credit risk insurance or use risk-sharing arrangements.

b. Market Risk

Market risk arises from changes in market variables such as interest rates, foreign exchange rates, commodity prices, or stock market movements. In international banking, this risk is particularly high because banks handle multiple currencies and operate in different financial markets across the world. If exchange rates fluctuate, the value of foreign investments or loans can change significantly. For example, if a bank lends in US dollars but the borrower earns income in a weaker currency, the repayment value may drop. Similarly, changes in global interest rates can increase or decrease the cost of borrowing and lending. Banks must constantly monitor market conditions to avoid large financial losses caused by unfavorable movements.

Market risk in international banking is the risk of losses from adverse movements in market prices-primarily interest rates, foreign-exchange (FX) rates, equity prices, and commodity prices-affecting the bank's positions. International banks hold large trading and banking book exposures in multiple currencies and markets, including government and corporate bonds, interest-rate swaps, FX forwards, options, and other derivatives, so changes in global interest rates or exchange rates can quickly alter the value of their assets and liabilities. Currency risk (or FX risk) forms a central part of market risk:

a bank that lends in US dollars to a borrower whose revenues are in a volatile local currency is implicitly exposed to the risk that the local currency depreciates, making it harder for the borrower to service the dollar loan and reducing the bank's effective recovery. Interest-rate risk is equally important: when global benchmark rates such as SOFR or EURIBOR move sharply, the value of fixed-rate securities and the cost of funding change, potentially squeezing net interest margins. For example, a bank holding a large portfolio of long-term US Treasury securities in its overseas branch may incur mark-to-market losses when US interest rates rise. International banks manage market risk through matched positions, hedging with derivatives, value-at-risk (VaR) and sensitivity measures (duration, PVBP, FX delta), trading limits, and active asset-liability management.

c. Settlement Risk

Settlement risk occurs when one party to a financial transaction fails to deliver the required funds or securities at the time of settlement. This risk is especially important in international transactions because settlement times vary across countries due to different time zones, banking holidays, and payment systems. For example, if a bank in India pays for a foreign currency transaction in the morning but the foreign bank fails to deliver the currency later due to system failure or insolvency, the Indian bank faces a loss. This is also known as Herstatt Risk, originating from a famous banking failure. To reduce settlement risk, banks use secure payment systems, clearing houses, and real-time gross settlement (RTGS) mechanisms.

Settlement risk in international banking is the risk that one party to a transaction delivers the asset (such as funds or securities) but does not receive the corresponding asset from the counterparty, either because of default, operational failure, or time-zone differences. This risk is especially acute in foreign-exchange transactions, where payment in one currency may be made in one country's payment system while payment in the counter-currency occurs later in another system, creating a period during which one party is fully exposed—often referred to as “Herstatt risk” after a historical failure that exposed counterparties to such losses. Cross-border securities trades and international trade payments (such as documentary collections) also involve settlement risk when deliveries and payments are not perfectly synchronized. For example, a bank might release documents to an importer's bank under a collection, only to find that the importer fails to pay, leaving the exporter and the bank exposed. To mitigate settlement risk, international banks use payment-versus-payment (PvP) mechanisms like CLS (Continuous Linked Settlement) for major currencies, delivery-versus-payment (DvP) systems in securities markets, netting and set-off agreements, well-defined cut-off times, and careful selection of correspondent and custodian banks, supported by robust operational controls and confirmed SWIFT messaging routines.

d. Liquidity Risk

Liquidity risk refers to the difficulty a bank may face in meeting its short-term financial obligations. In international banking, this risk increases because funds may be locked in long-term loans, foreign assets, or overseas branches. Market disturbances, currency shortages, or political instability may delay the inflow of funds. When a bank



cannot convert its assets into cash quickly, it struggles to meet customer withdrawals, settle debts, or fund its operations. This problem becomes serious in times of global financial crises when international markets freeze and access to foreign money becomes limited. Banks maintain liquidity reserves and follow strict regulations to manage this risk effectively.

Liquidity risk in international banking is the danger that a bank cannot meet its obligations as they fall due-such as depositor withdrawals, margin calls, or maturing wholesale funding-without incurring unacceptable losses. International banks often rely heavily on wholesale markets and foreign-currency funding, which can dry up abruptly during global crises, leaving branches and subsidiaries in different countries scrambling for cash or foreign exchange. Liquidity risk has both funding and market dimensions: funding liquidity risk is the inability to roll over or replace liabilities at reasonable cost, while market liquidity risk is the inability to sell assets quickly at fair prices because markets are thin or distressed. In cross-border operations, liquidity risk is complicated by the fact that liquidity is not perfectly fungible across currencies or jurisdictions: a bank may have ample rupee liquidity in India but still struggle to obtain dollars to meet obligations in New York or London due to FX market stress or regulatory transfer restrictions. The global financial crisis and later episodes showed how quickly international interbank markets can freeze, forcing banks to rely on central-bank swap lines and emergency facilities. To manage liquidity risk, international banks maintain high-quality liquid assets in key currencies, diversify their funding sources and maturities, establish internal transfer-pricing systems for liquidity, and comply with regulatory ratios like the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), alongside detailed contingency funding plans for stress scenarios.

Causes :

1. Large unexpected withdrawals by foreign depositors.
2. Delayed repayments by international borrowers.
3. Market disruptions restricting access to funds.

Examples:

1. A foreign borrower defaults, leaving the bank unable to meet obligations.
2. A crisis in the interbank market restricts cash availability.

Management:

1. Maintain adequate reserves of cash and liquid assets.
2. Access interbank lending markets and standby credit lines.
3. Plan contingency funding strategies.

e. Operational Risk

Operational risk refers to losses arising from internal failures such as human error, fraud, technology breakdowns, cyber-attacks, or failures in internal policies. In international banking, operations are spread across multiple countries, languages, legal systems, and time zones, making the risk more complex. Errors in foreign exchange

transactions, improper documentation, technological failures, or lack of coordination between global branches can create major losses. Cybersecurity issues are also a major concern because cross-border data transfers can expose banks to hacking and data theft. To manage this risk, banks use advanced technology systems, internal controls, compliance audits, and employee training.

Operational risk in international banking is the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, magnified by the complexity of operating across multiple countries and time zones. In practice, this encompasses internal and external fraud, errors in transaction processing, system outages, cyberattacks, failures in model implementation, and breakdowns in controls related to sanctions screening or anti-money-laundering (AML) obligations. International operations introduce additional layers of complexity: different languages and cultures can lead to miscommunication; multiple IT platforms and local adaptations may create reconciliation gaps; and reliance on global service centers or third-party vendors can introduce outsourcing risk. For example, a bank's overseas branch might suffer losses if staff misinterpret local documentation standards for letters of credit, accept incomplete documents, and inadvertently honor discrepant presentations, or if a cyberattack on a regional data center disrupts cross-border payment flows and damages the bank's reputation. Operational risk management in international banking involves strong internal controls, standardized policies, segregation of duties, robust IT and cybersecurity frameworks, disaster recovery and business continuity planning, staff training across jurisdictions, loss-event databases, and scenario analysis, as well as clear governance structures that define responsibilities between head office and foreign units.

Causes :

1. Human error or misconduct.
2. Technology or system failures.
3. Poor internal control systems.
4. Legal or compliance failures.

Examples:

1. Incorrect processing of foreign transactions.
2. Cyberattacks affecting online banking services.
3. Fraudulent activities by employees handling international payments.

Management:

1. Strengthen internal controls and audit procedures.
2. Implement robust IT systems and cybersecurity measures.
3. Train staff and establish compliance protocols.
4. Obtain operational risk insurance.



f. Legal Risk

Legal risk arises when banks face uncertainty due to differences in laws, regulations, and legal procedures across countries. Each country has its own rules regarding taxation, contract enforcement, bankruptcy, foreign exchange control, and dispute resolution. When a bank operates internationally, it must ensure that all its contracts and operations comply with local laws. If the laws change or if a dispute arises in a foreign court, the bank may face heavy penalties or financial losses. For example, a country may impose restrictions on repatriation of profits or may suddenly change banking regulations. To minimize legal risk, banks use legal experts, comply with international norms, and conduct regular legal reviews of their operations.

Legal risk in international banking arises from the possibility of losses due to unenforceable contracts, adverse judgments, regulatory sanctions, or unexpected changes in laws and regulations across the various jurisdictions where the bank operates. International transactions often involve complex documentation-loan agreements, derivatives master agreements, guarantees, netting and collateral arrangements-governed by foreign law, and problems can arise if the bank misunderstands local legal requirements or if courts interpret provisions differently than anticipated. Legal risk also includes non-compliance with host-country banking, securities, tax, AML/CFT, and sanctions rules, which can lead to fines, restrictions on business, or even loss of license. For example, a bank that enters into derivatives with a counterparty in a country where netting or collateral enforcement is not clearly recognized may find that, in the event of default, it cannot enforce its rights as expected, increasing credit and market losses. Similarly, international banks have incurred large penalties for breaching sanctions or failing to implement adequate AML controls in certain branches, illustrating how legal and compliance failures in one jurisdiction can trigger global consequences. To manage legal risk, international banks maintain strong in-house legal and compliance teams with local expertise, obtain legal opinions on enforceability, standardize documentation under frameworks like ISDA where possible, monitor regulatory developments in all key markets, and ensure that head-office policies are adapted to and consistent with local law.

Thus, these categories-credit, market, settlement, liquidity, operational, and legal risk-are interrelated rather than separate silos, particularly in international banking where a problem in one area often amplifies others. A credit default by a foreign borrower may be triggered by currency and interest-rate movements (market risk), worsened by a failure to settle trades (settlement risk), and exacerbated by legal obstacles to enforcing collateral or guarantees (legal risk), while the resulting losses and reputational damage can contribute to funding strain (liquidity risk).

Causes :

1. Non-compliance with foreign banking laws.
2. Changes in taxation, banking rules, or foreign investment regulations.
3. Uncertainty in enforcement of contracts or dispute resolution.

Examples:

1. Penalties for violating foreign anti-money laundering laws.
2. Regulatory restrictions on repatriation of profits.

Management:

1. Employ local legal experts and compliance teams.
2. Follow international banking standards and local regulations.
3. Conduct due diligence before entering foreign markets.

Recap

- ◇ Credit Risk – Potential loss from foreign borrowers defaulting on cross-border loans, trade finance, or derivatives due to country instability or weak creditworthiness.
- ◇ Market Risk – Losses from adverse FX rate, interest rate, or equity movements impacting multi-currency trading books and hedging positions.
- ◇ Settlement Risk – Exposure when delivering funds/securities in FX trades or payments before receiving counterparty payment (Herstatt risk).
- ◇ Liquidity Risk – Inability to meet cross-border obligations due to frozen wholesale funding or FX shortages in stress scenarios.
- ◇ Operational Risk – Losses from failed processes, fraud, IT failures, or errors in complex international transaction processing.
- ◇ Legal Risk – Losses from unenforceable contracts, regulatory fines, or adverse judgments across differing jurisdictions.

Objective Questions

1. What is credit risk in international banking?
2. Why is market risk higher in international transactions?
3. What is settlement risk?
4. What is another name for settlement risk arising from time-zone differences?
5. Define liquidity risk.



6. Give one reason why operational risk increases in international banking.
7. What causes legal risk in global banking?
8. Name any two factors that increase credit risk internationally.
9. Why do exchange rate fluctuations create risk?
10. What is a major source of operational risk in cross-border banking?

Answers

1. Credit risk is the risk that a foreign borrower will fail to repay the loan.
2. Because international transactions involve multiple currencies and global market movements.
3. Settlement risk is the risk that one party fails to deliver funds or securities on time.
4. Herstatt Risk.
5. Liquidity risk is the difficulty a bank faces in meeting short-term cash requirements.
6. Because operations span multiple countries, systems, and time zones.
7. Legal risk arises from differences in laws, regulations, and legal systems across nations.
8. Political instability and economic recession in the borrower's country.
9. Because they change the value of foreign currency loans and investments.
10. Technology failures or documentation errors

Self Assessment Questions

1. What is credit risk?
2. Write a note on settlement risk.
3. Explain Legal risk.
4. What is liquidity risk?
5. Define credit risk in the context of international banking

Assignment Questions

1. Explain the concept of credit risk in international banking. Discuss how global economic conditions influence credit risk for banks.
2. Discuss the major components of market risk. Explain how exchange rate movements impact international financial transactions.
3. Describe settlement risk with real-world examples. Why is it considered a major threat in the global payment system?
4. What is liquidity risk? Explain how global financial crises can worsen liquidity problems for international banks.
5. Define operational risk. Discuss how technology and cyber-related threats intensify operational risk in international banking.
6. Explain legal risk in international banking. How do differences in national regulations affect banking operations?
7. Compare and contrast the six major international banking risks and explain how banks manage these risks through policies and risk-management tools.

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SGOU

4

BLOCK

International Finance

Unit

Introduction

Learning Outcomes

After the completion of this unit the learner will be able to;

- ◇ familiarise with the concept of international finance
- ◇ explain the goals of international finance
- ◇ describe the scope of international finance
- ◇ discuss the emerging challenges faced by international finance

Prerequisite

Maya, a young entrepreneur from India, started selling her eco-friendly sunglasses to customers in Japan. Her first big order was worth ¥10 million, and she was excited, until she learned that if the value of the Japanese yen changed, she could lose money. This introduced her to the world of International Finance, which is the study of how money moves between countries. It focuses on areas like foreign exchange rates, international trade, global banking, and investments. For example, when the yen's value fell from ₹0.60 to ₹0.55, the payment she received dropped from ₹6,00,000 to ₹5,50,000, showing how exchange rate changes can affect business profits.

Maya realised that the scope of international finance includes managing currencies, global loans, and financial risks. Its main goals are to earn profits, reduce risks from exchange rate fluctuations, and maintain financial stability. However, she also faced emerging challenges such as cryptocurrency payments, global political tensions, and cybersecurity threats. Maya's experience shows that understanding international finance is essential for anyone who wants to grow and succeed in today's connected global economy.

Keywords

International finance, exchange rate fluctuations, global economy

Discussion

When an Indian company buys machines from Germany, it has to pay in euros instead of Indian rupees. This shows what international finance means — handling money matters that arise from trade between countries. The idea of international trade began long ago during the barter system, when nations exchanged goods to get what they lacked. Over time, this exchange grew into global trade, giving rise to multinational companies and a global culture. As goods, services, people, and money started moving freely across borders, the flow of money between countries also increased. However, every country has its own political, economic, and cultural systems, which makes international transactions more complex. When two countries trade, they must follow each other's rules and financial standards. Differences in currencies, their values, and changing economic conditions make things even more complicated. To make these transactions easier, several international financial organizations, currency exchange systems, and modern banking methods were created to help countries trade and manage money smoothly.

International finance is the study and management of money and financial resources in a global context. It focuses on how businesses and nations conduct trade, exchange different currencies, and generate profits through cross-border activities. As a branch of financial economics, it examines the movement of money and financial transactions between countries. Key areas of international finance include currency exchange rates, global monetary systems, and foreign direct investment (FDI). It is also referred to as multinational finance, international macroeconomics, or international monetary economics.

International finance is the branch of finance that deals with financial interactions between countries, including the flow of money, investment, and trade across national borders. It focuses on topics such as exchange rates, international trade payments, foreign investment, and the functioning of global financial markets. International finance also studies how governments, businesses, and individuals manage risks related to currency fluctuations, economic instability, and political changes. It plays a crucial role in promoting global economic growth by facilitating international trade, investment, and cooperation among countries.

According to Paul R. Krugman, Maurice Obstfeld and Marc J. Melitz, “International finance is the study of monetary interactions that transpire between two or more countries. International finance focuses on areas such as foreign direct investment and currency exchange rates. Increased globalization has magnified the importance of



international finance.”

S.P Gupta defined “International finance is the study of monetary interactions between two or more countries, focusing on foreign exchange rates, international financial markets, and balance of payments.”

4.1.1 Scope of International Finance

The scope of international finance is broad, covering numerous aspects of financial interactions among nations. The main areas include:

1. Foreign Exchange Markets

These markets enable the conversion of one currency into another and are essential for global trade and investment. A solid understanding of how they operate and how exchange rates are set is fundamental to international financial activities.

2. Foreign Direct Investment (FDI)

FDI involves a firm investing directly in business operations in another country—whether by establishing subsidiaries, acquiring foreign enterprises, or forming joint ventures. International finance concepts assist in evaluating the potential risks and returns of such investments.

3. International Trade Finance

This area focuses on funding cross-border trade. Financial tools such as letters of credit and documentary collections are used to reduce risk and ensure prompt payment between exporters and importers.

4. International Portfolio Investment

This pertains to purchasing financial assets like equities and bonds issued by foreign entities. Knowledge of international finance enables investors to make strategic decisions when diversifying into global markets.

5. The International Monetary System

The International Monetary System is a framework that sets the rules and procedures for cross-border financial transactions, including exchange rate systems and the functions of major international institutions such as the International Monetary Fund (IMF) and the World Bank.

6. Global Financial Markets and Institutions

It refers to the systems and networks that enable the flow of money across countries. They include international banks that provide services like foreign currency accounts, trade financing, and cross-border loans; global capital markets where investors and companies buy and sell financial instruments such as stocks, bonds, and derivatives; and financial intermediaries like investment banks, mutual funds, and insurance companies that connect savers with borrowers internationally. Together, these markets and institutions facilitate investment, raise capital, and help manage financial risks, making it possible for businesses, governments, and investors to operate effectively in the global economy.

4.1.2 Goals of International Finance

International finance also referred to as international monetary economics or global finance is a field of financial economics that examines the monetary and financial relationships among nations. It explores how capital moves across borders, how exchange rates are determined, and how international investments and global financial market's function, and through what ways all of which affect economic growth and stability worldwide.

The main objective of international finance is to ensure the smooth flow of funds across countries to support international trade and economic growth. It aims to promote efficient foreign exchange management, facilitate international investment, and maintain balance of payments stability. International finance also seeks to minimize risks arising from exchange rate fluctuations and political uncertainties. Another objective is to encourage global financial cooperation through international institutions like the IMF and World Bank, helping countries achieve economic stability and sustainable development. The following are the important goals of international finance:

1. Efficient Management of Foreign Exchange:

A key objective of international finance is to ensure smooth and cost-effective currency conversion for international trade and investment. Exchange rate fluctuations can significantly affect costs and profitability, so businesses use hedging instruments such as forward contracts, options, and swaps to mitigate these risks. Effective management of foreign exchange enables firms to maintain financial stability and make informed decisions in global markets.

2. Optimal Allocation of Resources:

International finance aims to allocate financial resources efficiently across countries and investment opportunities. By directing funds toward projects or markets with higher returns and acceptable risks, businesses and investors can maximize profitability. Proper allocation ensures that capital is used effectively to support international growth, innovation, and expansion while avoiding overexposure to high-risk ventures.

3. Risk Management:

A central goal of international finance is to identify, evaluate, and manage risks associated with global operations. These risks include currency volatility, political instability, credit defaults, and economic uncertainties. Implementing robust risk management strategies helps businesses safeguard investments, maintain operational continuity, and sustain investor confidence, thereby reducing potential financial losses.

4. Facilitating International Trade and Investment

International finance plays a crucial role in promoting cross-border trade and investment. Financial mechanisms such as letters of credit, trade financing, and foreign loans enable businesses to operate globally without disruptions. By facilitating foreign direct investment (FDI) and international portfolio investment, international finance supports companies in expanding their global presence and accessing new markets.



5. Maximising Shareholder Wealth

One of the fundamental objectives of international finance is to enhance the value of multinational corporations and maximise returns for shareholders. Financial decisions, including foreign investments, cost management, and risk mitigation, are guided by the goal of increasing profitability and long-term corporate value, ensuring that shareholders benefit from the company's global growth.

6. Maintaining Financial Stability

International finance also seeks to maintain stability in international financial operations. This involves ensuring smooth cross-border transactions, complying with global financial regulations, and managing systemic risks that may impact multiple economies. By promoting transparent and stable financial practices, international finance contributes to global economic growth and reduces the likelihood of crises that could disrupt trade and investment.

4.1.3 Importance of International Finance

International finance plays a vital role in promoting global economic growth by facilitating international trade and investment between countries. It helps businesses and governments manage foreign exchange and make cross-border payments smoothly. By encouraging foreign direct investment and portfolio investment, international finance supports industrial development and employment generation. It also helps in maintaining stability in exchange rates and balance of payments. International finance reduces financial risks through hedging and diversification and promotes economic cooperation among nations through institutions like the IMF and World Bank, thereby contributing to global financial stability.

1. Facilitates international trade and smooth foreign payments.
2. Promotes foreign direct investment and capital flow.
3. Helps maintain stability in exchange rates.
4. Supports balance of payments management.
5. Encourages global economic growth and development.
6. Helps manage financial risks such as currency risk.
7. Promotes international financial cooperation.
8. Supports expansion of multinational companies.

4.1.4 Emerging Challenges in International Finance

International finance carries various risks and uncertainties that can affect businesses, investors, and economies. These challenges often arise from currency fluctuations, political instability, and global financial crises. The main challenges in international finance include:

1. Exchange Rate Volatility:

Currency values fluctuate constantly, impacting international trade and investment. Businesses dealing in multiple currencies face financial risks from unpredictable exchange rate movements. Hedging instruments, such as forward contracts and options, are commonly used to manage these risks.

2. Political and Economic Risks:

Changes in government policies, political instability, or trade regulations can disrupt international financial transactions. Sudden policy shifts, sanctions, or conflicts create uncertainty for companies and investors operating in foreign markets.

3. Global Financial Crises:

International financial markets are highly interconnected, so economic crises in one country can quickly spread worldwide. The 2008 global financial crisis exemplifies how financial instability in one region can have far-reaching effects.

4. Credit and Default Risks:

Cross-border lending and borrowing involve higher credit risks. Ensuring timely payments and avoiding defaults can be challenging, especially in countries with weaker financial systems.

5. Cultural and Regulatory Differences:

Different countries have unique financial regulations, laws, and business practices. Companies must navigate these differences carefully to remain compliant and maintain their reputation in global markets.

6. Technological Challenges:

Advances in financial technology (FinTech) are transforming international finance. While these innovations offer opportunities, they also present challenges such as cybersecurity threats and the need for businesses to adopt and adapt to digital financial systems.

Thus International financial markets and institutions play a vital role in regulating and supporting global financial activities. Institutions such as the International Monetary Fund (IMF), World Bank, and World Trade Organization (WTO) help maintain financial stability, provide financial assistance, and promote international cooperation. International finance also focuses on managing risks like exchange rate risk, political risk, and economic risk, using tools such as hedging, forward contracts, and diversification. Overall, international finance is essential for promoting global trade, investment, and economic development while maintaining financial stability across nations.

Recap

1. International finance involves analyzing and managing monetary and financial activities within a global framework
2. International finance focuses on how money and financial resources are utilized, transferred, and regulated across different countries.
3. The scope of international finance encompasses global capital flows, foreign investments, exchange rate management, international monetary systems, and the financial decisions of multinational firms.
4. The goals of international finance are to promote global economic stability, efficient resource allocation, and sustainable growth through balanced trade, stable exchange rates, and risk management.
5. The challenges of international finance often arise from currency fluctuations, political instability, and global financial crises.

Objective Questions

1. What does international finance primarily deal with?
2. Which international financial institution helps maintain global monetary stability?
3. What does FDI stand for?
4. What major challenge arises due to differences in laws and business practices among countries?
5. What is the function of global financial markets?
6. What kind of risk arises when borrowers in foreign countries fail to make payments?
7. Which challenge in international finance is linked to cybersecurity and digital transformation?
8. What is the purpose of risk management in international finance?

Answers

1. Study and management of money and financial resources in a global context.
2. International Monetary Fund (IMF)
3. Foreign Direct Investment
4. Cultural and regulatory differences.
5. To facilitate the flow of money across countries for investment and risk management.
6. Credit and default risk.
7. Technological challenges.
8. To identify, evaluate, and manage risks such as currency volatility and political instability.

Self Assessment Questions

1. Explain in your own words how international finance supports global trade and investment.
2. Define international finance?
3. Discuss why managing exchange rate fluctuations is essential for international businesses.
4. How do political and economic risks affect international financial transactions?
5. Describe the scope of international finance?
6. Briefly explain the challenges of international finance

Assignment Questions

1. Explain the scope and goals of international finance with relevant examples from global business practices.
2. Discuss the relationship between international finance and global trade. How do they influence each other?



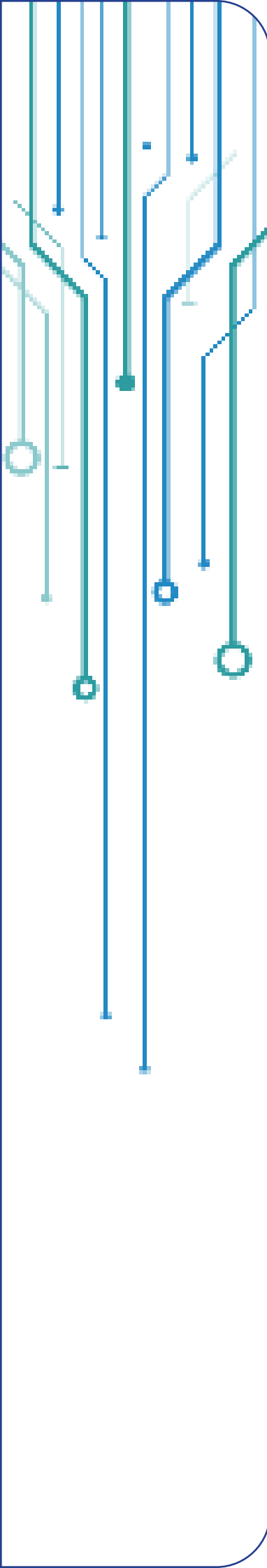
3. Describe the role of foreign exchange markets in facilitating international trade and investment.

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Unit

International Financial Transactions

Learning Outcome

After the completion of this unit, the learner will be able to;

- ◇ familiarise with the concept of Balance of Payment
- ◇ explain the components of the Balance of Payment
- ◇ discuss the concept of disequilibrium in Balance of Payment
- ◇ describe the types of capital flows

Prerequisite

Imagine a small country called Econoland. Just like we keep track of our income and spending, Econoland keeps a record of all the money coming in and going out through trade and investments. This record is called the Balance of Payments (BOP). It has two parts — the Current Account, which shows exports, imports, and money earned or sent abroad, and the Capital Account, which records investments and loans. If Econoland buys more from other countries than it sells, it faces a BOP deficit, meaning more money goes out than comes in.

To fill this gap, Econoland attracts capital inflows such as Foreign Direct Investment (FDI), where overseas companies set up businesses or factories, Foreign Portfolio Investment (FPI), where foreign investors buy shares or bonds, and Foreign Institutional Investment (FII), where large investment firms invest in its markets. These inflows help Econoland balance its payments and strengthen its ties with the global economy.

Keywords

Balance of Payment, BOP deficit, FDI, FPI, FIII

Discussion

Economic transactions between countries have been occurring for centuries, but their frequency and scale have grown significantly in modern times due to globalization. Such economic transactions across countries may be described as international transactions. An international transaction is an exchange of goods, services, or assets between residents of one country and those of another. Residents include businesses, individuals, and government agencies that make the country in question their legal domicile.

The Balance of Payments (BOP) is like a country's financial diary that records all its economic transactions with the rest of the world during a specific period. It has two main parts; the Current Account, which includes trade in goods and services, income, and transfers, and the Capital and Financial Account, which records investments and loans. When a country exports more than it imports, it earns foreign currency, leading to a surplus; but if imports exceed exports, it faces a BOP deficit, meaning more money flows out than in.

To finance this deficit or attract foreign funds, countries rely on capital flows such as Foreign Direct Investment (FDI), when a company invests directly in business operations like factories, Foreign Portfolio Investment (FPI), when individuals or firms buy stocks and bonds, and Foreign Institutional Investment (FII), and when large institutions invest in financial markets. Together, these components and flows reflect a country's economic strength and its financial relationship with the global economy.

4.2.1 Balance of Payment

The Balance of Payments (BOP) of a country is a concise record of various economic transactions that take place over a specific period, typically an accounting year, between the country's residents and the rest of the world. In other words, it provides a summary of a country's international transactions and is intended to reveal the country's balance of international payments, or showing the difference between its foreign receipts and payments of the country.

Balance of Payments (BoP) is a record of all economic transactions between a country and the rest of the world during a specific period (usually one year).

A country has receipts from other countries or residents of other countries on account of the following transactions:

- i. Export of goods
- ii. Service provided to foreigners such as transportation
- iii. Income receivable from investments in other countries
- iv. Gifts received from foreign residents
- v. Aid from foreign Govt or residents
- vi. Borrowings from other countries
- vii. Sale of assets to foreign residents
- viii. Investment in the country by foreign residents.

Likewise, a country has to make payments to other countries or residents of other countries on account of the following transactions:

- i. Import of goods
- ii. Service received from foreign residents
- iii. Income payable on investments made by foreigners in the country.
- iv. Gifts to foreign residents
- v. Aid provided to foreign govt. or residents.
- vi. Lending to foreigners
- vii. Purchase of assets from foreign residents
- viii. Investments made in other countries
- ix. Repayment of earlier borrowings from foreign residents or govts.

Balance of Payment is an account, prepared on the basis of the double entry system of accounting. A transaction that results into a receipt from a foreign country is shown as credit a transaction, and a payment to a foreign country is categorized as debit transaction.

4.2.2 Components of Balance of Payment

The international receipts and payments of a country are grouped into two categories and are shown as sub-accounts in the balance of payment. These sub accounts are the primary components of balance of payment and are known as current account and capital account.

a. The current account

The current account of the BOP records the values of international receipts and payments on account of

- i. Transaction in goods
- ii. Provision of services

iii. Investment income

iv. Unilateral transfers

The BOP statement of the Govt. of India is prepared by the RBI.

Table 4.2.1 structure of India's BOP current account

Current account	Credits	Debits	Net
1. Merchandise (exports and imports of goods by the residents of the country).			
2. Invisibles (a+b+c)			
a) services			
i. travel			
ii. transportation			
iii. insurance			
iv. government not included elsewhere			
v. Miscellaneous			
b) transfers			
i. official			
ii. private			
c) income			
i. investment income			
ii. compensation to employees			
Total Current Account (1+2)			

When all the different items in the current accounts are combined the current account may show a surplus or deficit;

Current Account Surplus indicates excess of receipts over payments in the current a/c transactions of a country during the accounting period.

Current Account Deficit indicates that international payments on account of current account transactions exceed the international receipts.

b) The capital account

Capital account is a sub-account of the Balance of Payments. Capital account records the receipts and payments of capital funds between the country concerned and the rest of the world. It shows the inflows of capital from foreign country as well as the outflows of capital to other foreign countries.

Table 4.2.2 Structure of India's BOP– Capital Account

Capital account	Credits	Debits	Net
1. Foreign investments (a+b)			
a. Foreign Direct investment			
b. Foreign Portfolio investment			
2. Loans (a+b+c)			
a. External assistance			
b. Commercial borrowings			
c. Short-term to india			
3. Banking capital (a+b)			
a. commercial banks			
b. others			
4. Rupee debt service			
5. Other capital			
Total capital account (1+2+3+4+5)			

The Balance of Payment statement has three more items or components, namely;

C. Errors and Omissions

D. Overall Balance (Total of Current and Capital a/c and Errors and Omissions)

E. Monetary movements (a+b)

- a. IMF
- b. Foreign Exchange Reserves (+/-)

4.2.3 Deficit in Balance of Payment

Two key terms often used in relation to the Balance of Payments (BOP) are deficit and surplus. A deficit occurs when the outflow of funds exceeds the inflow, while a surplus occurs when inflows are greater than outflows. A disequilibrium in the balance of payment means its condition of Surplus or deficit. The BOP records various types of transactions, and the inflows and outflows arising from each type are grouped under specific headings and sub-categories. imbalances can occur within these individual sections, resulting in deficits or surpluses for each category. Therefore, the ideas of deficit and surplus apply not to the BOP as a whole but to its specific components.

The main balances that economists analyse for their economic significance and policy implications include:



1. Trade balance: the difference between a nation's exports and imports of goods. If imports exceed exports, the country experiences a trade deficit.
2. Balance of goods and services: the net difference between receipts and payments for both goods and services. This balance may be either positive or negative.
3. Current account balance: the overall difference between all receipts and payments recorded in the current account. A positive value indicates a current account surplus; a negative value indicates a deficit.
4. Basic balance: the result obtained by combining the current account balance with long-term capital transactions in the capital account.
5. Overall balance: the net difference between total inflows and outflows after combining current account transactions, capital account transactions, and the item for errors and omissions. A positive figure reflects an overall surplus, while a negative figure shows an overall deficit.

A deficit has to be adjusted either through borrowings from the IMF (International Monetary Fund) or by utilising the foreign exchange reserves held by the country, resulting in the reduction of foreign exchange reserves. Surplus on the other hand, increases the foreign exchange reserves. Surplus may also be utilised for repaying IMF borrowings.

4.2.3.1 Causes of Disequilibrium in BOP

1. Cyclical Fluctuations

Cyclical fluctuations in an economy such as periods of boom, recession, and recovery, create instability in a country's Balance of Payments. During a boom, incomes rise and people tend to import more consumer goods, raising the import bill. Conversely, during a recession or global slowdown, foreign demand for a country's exports falls sharply, reducing its export earnings. These ups and downs in economic activity disturb the balance between foreign exchange inflows and outflows, leading to periodic BOP disequilibrium.

2. Shortfall in Exports

A decline or slow growth in exports is a major cause of BOP imbalance. When a country's export sector faces problems such as reduced production, higher costs, inferior quality, stiff international competition, or unfavorable global market conditions, export earnings shrink. Since the country still needs to import essential goods like fuel, raw materials, and technology, the gap between falling exports and steady or rising imports causes a deficit in the Balance of Payments.

3. Economic Development

Developing economies typically require large imports of machinery, advanced technology, capital goods, and industrial inputs to build infrastructure and promote growth. However, their export capacity does not increase at the same pace, because industries take time to mature and become competitive internationally. This imbalance where

development-related imports grow rapidly while exports lag behind creates a persistent BOP deficit during the early stages of economic growth.

4. Rapid Increase in Population

A rapidly growing population increases the demand for food, clothing, fuel, medicines, and other essential goods. If domestic production cannot keep up with this rising demand, the country is forced to import more goods to maintain consumption levels. Meanwhile, population growth does not automatically lead to a proportional increase in exports. This widening gap between high imports and slower-growing exports results in a disequilibrium in the Balance of Payments.

5. Structural Changes

Structural changes in an economy such as industrialization, technological shifts, or changes in consumer preferences can also disturb the Balance of Payments. For example, when countries transition from agriculture to industry, they need to import machinery and equipment, increasing import expenditure. Similarly, local industries may become outdated or less competitive compared to foreign industries, leading to reduced exports. These long-term or transitional changes in the economic structure often create temporary or persistent BOP imbalances.

6. Natural Calamities

Natural disasters like floods, earthquakes, droughts, hurricanes, or pandemics disrupt domestic production and reduce export capacity. Agricultural output often suffers the most, forcing the country to import essential food grains and raw materials. At the same time, export-oriented industries may slow down or halt production due to damage to infrastructure or supply chains. This combination of higher imports and lower exports causes a sharp deterioration in the Balance of Payments.

7. International Capital Movements

Movements of capital across countries such as foreign investments, loans, and speculative financial flows can significantly affect the BOP. A sudden outflow of foreign capital, for example when investors withdraw funds due to political instability or interest rate changes, reduces foreign exchange reserves and creates a deficit. Heavy reliance on external borrowing increases future interest and repayment obligations, which also worsen the BOP. Thus, volatile and unbalanced capital movements are an important source of BOP disequilibrium.

4.2.3.2 Measures to correct disequilibrium in BOP

The Balance of Payments (BOP) records all economic transactions between a country and the rest of the world. When the inflow and outflow of foreign exchange do not balance, a disequilibrium occurs, which can lead to economic instability. To restore balance, countries adopt various monetary, fiscal, trade, and structural measures aimed at correcting the deficit or surplus.

1. Monetary Measures

- a. **Monetary Policy:** Monetary policy deals with regulating the supply of money and credit within an economy. The central bank can either increase or decrease money circulation using various tools, which in turn influences the general price level.
- b. **Fiscal Policy:** Fiscal policy refers to the government's decisions regarding revenue and expenditure. The government spends on both developmental and non-developmental activities and raises funds through taxes and other non-tax sources. Depending on the economic situation, the government may choose to raise or reduce its spending.
- c. **Exchange Rate Depreciation:** A country may allow its currency to depreciate as a way to correct BOP imbalances. When the domestic currency loses value relative to foreign currencies, imports become more expensive while exports become cheaper, helping improve the BOP. However, this may also trigger inflation within the country.
- d. **Devaluation:** Devaluation involves officially lowering the value of a country's currency. This makes domestic goods cheaper for foreign buyers and foreign goods costlier for domestic consumers, thereby stimulating exports, reducing imports, and helping lessen a BOP deficit.
- e. **Deflation:** Deflation means contracting the money supply to reduce price levels and incomes. Lower incomes reduce domestic demand for goods, including imports, while the country may increase exports to earn more foreign exchange.
- f. **Exchange Control:** Under exchange control measures, exporters must hand over their foreign exchange earnings to the central monetary authority. The available foreign exchange is then allocated to licensed importers, who may import goods but only up to the limit set by the authority.

2. Non- Monetary measures

- a. **Export Promotion:** The country may adopt measures to stimulate exports like export duties may be reduced to boost exports, cash assistance, subsidies can be given to exporters to increase exports goods meant for exports can be exempted from all types of taxes.
 - b. **Import Substitutes:** Measures can be implemented to promote the domestic production of goods that are normally imported. By replacing imported items with locally produced alternatives, the country can conserve foreign exchange in the short term.
 - c. **Import Control:** Import may be kept in check through the adoption of a wide variety of measures like quotas and tariffs. Under the quota system, the government fixes the maximum quantity of goods and services that can be imported during a particular time period.
1. **Quotas –** Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, the deficit is reduced and the balance of payments position is improved.

2. Tariffs – Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of the tariff. The increased prices will reduce the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes.

4.2.4 Types of Capital Flows

Capital flows refer to the movement of money for investment, loans, and other financial transactions between a country and the rest of the world. They are recorded mainly in the Capital Account of the BOP. The major types include:

4.2.4.1 Foreign Direct Investment

Foreign Direct Investment represents a form of capital flow across countries. It is an investment made outside the home country where an investor resident in one country invests in another country in a way that establishes a long interest in and a high degree of influence over an enterprise. Through such investment, the investor owns 10 per cent or more of the voting power and thereby can exercise a high degree of influence in the management and operations of the foreign business.

The International Monetary Fund (IMF) defines FDI as: “A category of international investment that reflects the objective of a resident entity in one economy (direct investor or parent enterprise) obtaining a lasting interest and control in an enterprise resident in another economy (direct investment enterprise)”.

Methods of FDI

i. Greenfield Investment

In a Greenfield investment, a company establishes a completely new operation in a foreign country, such as building factories, offices, or distribution centers from scratch. This method gives the investor full control over the business structure, technology, and operations, allowing them to tailor the venture to their specifications. However, it requires a high initial investment, takes longer to become profitable, and carries higher risks, especially in politically or economically unstable regions.

ii. Mergers and Acquisitions

Mergers and Acquisitions occur when a foreign company purchases or merges with an existing local company. This method provides immediate access to the market, customers, and resources, making it faster than a Greenfield investment. The challenges include potentially high costs if the target company is overvalued, and difficulties in integrating different corporate cultures, management practices, or systems. Despite these challenges, M&A can be an effective way to quickly establish a strong presence in a foreign market.

iii. Joint Ventures

Joint ventures are partnerships between a foreign company and a local firm to create a new business or project. Both parties share investment, management responsibilities,



and risks. This method is particularly useful in countries where foreign firms are required to have local partners by law. Joint ventures allow the foreign investor to benefit from the local partner's market knowledge and government connections, but profits and control are shared, which can sometimes lead to disagreements between partners.

iv. Subsidiary Companies

FDI in subsidiary companies results in establishing a wholly-owned subsidiary in a foreign country. For example, Suzuki Motor Corporation owns a majority stake in Maruti Suzuki India Ltd., a subsidiary that manufactures and sells cars in India.

4.2.4.2 Foreign Portfolio Investors (FPI)

Foreign Portfolio Investment refers to the investment made by foreign investors in a country's financial assets, such as stocks, bonds, government securities, or other marketable instruments, without seeking any control over the companies in which they invest. Unlike Foreign Direct Investment (FDI), FPI is primarily aimed at earning short-term returns through interest, dividends, or capital gains. It is generally more liquid and flexible, as investors can quickly buy or sell securities in response to market conditions or changes in economic policies. In the Balance of Payments, FPI is recorded under the capital account or financial account and is considered a portfolio capital flow, reflecting the movement of funds in and out of financial markets.

4.2.4.3 Foreign Institutional Investment (FII)

Foreign Institutional Investment is a subset of FPI, where investments are made specifically by foreign institutions, such as mutual funds, pension funds, insurance companies, or hedge funds, in the financial markets of another country. FIIs typically invest in equities and bonds and play a significant role in influencing market liquidity and stock prices in emerging economies. Unlike individual portfolio investors, FIIs usually invest larger sums of money and can impact market trends more significantly. The inflow of FII is recorded in the BOP under capital account flows, and it can fluctuate quickly based on global market conditions, risk perception, or regulatory changes in the host country.

4.2.5 Significance of Balance of Payment

The importance of the Balance of Payments (BOP) lies in its ability to provide a clear picture of a country's economic and financial interactions with the rest of the world. The following are some of the significances.

- i. The BOP records all transactions that affect the demand and supply of a country's currency.
- ii. It helps assess the short-term economic and financial health of a nation.
- iii. The BOP reflects trends in a country's international trade and currency exchange rates, and can signal potential changes or reversals in these trends.
- iv. It can provide insights into possible shifts in the policies of the country's

monetary authority, such as the Reserve Bank of India (RBI).

- v. By tracking trade and exchange rate trends, the BOP helps confirm existing patterns and may highlight emerging changes in the economy's international financial position.

The Balance of Payments is an important indicator of a country's economic health and its interactions with the rest of the world. A surplus indicates that a country is earning more from foreign trade and investments than it is spending, while a deficit shows the opposite. Persistent imbalances can affect exchange rates, foreign reserves, and economic stability, making it crucial for governments to monitor and manage their BoP carefully. Overall, it helps in understanding trade performance, financial flows, and the overall economic position of a country globally.

Recap

- ◇ The Balance of Payments (BOP) is like a country's financial diary that records all its economic transactions with the rest of the world during a specific period
- ◇ The major components of balance of payment is the current account and the capital account
- ◇ A disequilibrium in the balance of payment means its condition of Surplus or deficit.
- ◇ Deficit occurs when the outflow of funds exceeds the inflow, while a surplus occurs when inflows are greater than outflows.
- ◇ Capital flows refer to the movement of money for investment, loans, and other financial transactions between a country and the rest of the world.
- ◇ Major capital flows are Foreign Direct Investment, Foreign Portfolio Investment and Foreign Institutional Investment.

Objective Questions

1. The primary components of Balance of Payment include-
2. When the outflow of funds exceeds the inflow in BOP it is called?
3. A disequilibrium in BOP means
4. IMF stands for
5. When the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period, it is known as?



6. Which method of FDI requires high initial investment?
7. Which part of BOP records the receipts and payments of capital funds between the country concerned and the rest of the world.
8. Overall, Balance in BOP include -
9. Which account of the BOP records the values of international receipts and payments?
10. FPI stands for?

Answers

1. The current account and the capital account
2. Deficit in BOP
3. Surplus or deficit.
4. International Monetary Fund
5. Quota system
6. Greenfield investment
7. The capital Account
8. Total of Current and Capital a/c and Errors and Omissions
9. The Current account
10. Foreign Portfolio Investment

Self Assessment Questions

1. Define BOP?
2. Explain the major components of BOP?
3. What is disequilibrium in BOP and explain the causes of disequilibrium?
4. Briefly explain the methods to correct disequilibrium in BOP?
5. Write a short note on FPI and FIIs
6. Describe the methods of FDI
7. what is the significance of BOP?

Assignment Questions

1. Discuss the main components of the Balance of Payments with examples.
2. Suggest practical measures a country can take to correct a BOP deficit, using examples from India or any other country.
3. Differentiate between FDI and FPI using examples of companies investing in India.

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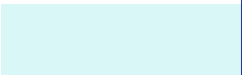
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FOREIGN EXCHANGE MARKET



Unit

Introduction

Learning Outcomes

After completing this unit, learners will be able to:

- ◇ comprehend the meaning, structure, and importance of the global foreign exchange market.
- ◇ identify and describe the key participants involved in foreign exchange transactions.
- ◇ explain how foreign exchange management is regulated in India under FEMA and by the RBI.
- ◇ differentiate between the retail and wholesale segments of the Indian foreign exchange market.

Prerequisite

The foreign exchange market plays a central role in today's globalised economy, where goods, services, capital, and people move freely across national borders. Every international financial transaction-whether it is an export payment, an overseas investment, a student paying university fees abroad, or a tourist buying foreign currency-requires the conversion of one currency into another. This essential process of currency exchange takes place in the foreign exchange (forex) market, which has grown into the largest and most liquid financial market in the world. The increasing integration of global economies has made the forex market vital for maintaining smooth international trade, stable financial systems, and efficient cross-border economic activities.

In India, the importance of the foreign exchange market has expanded significantly after economic liberalisation. With rising international trade, foreign investment, and global business operations, there is a growing need for a well-regulated foreign exchange environment. The Reserve Bank of India, under the Foreign Exchange Management

Act (FEMA) 1999, manages and supervises forex transactions to maintain orderly market conditions. India's forex market consists of both wholesale and retail segments, serving large banks, multinational companies, and individual customers. Understanding how this market functions, who participates, and how it is regulated helps students, researchers, and professionals gain clarity on the financial mechanisms that support India's international economic activities. This unit forms the foundation for studying the structure, role, and significance of the foreign exchange market.

Keywords

Foreign Exchange (Forex), Exchange Rate, Authorised Dealer (AD), Interbank Market, FEMA (1999)

Discussion

5.1.1 Foreign Exchange Market

The Foreign Exchange Market (Forex or FX Market) is a global marketplace where currencies of different countries are bought and sold. It operates 24 hours a day across different time zones, making it the largest and most liquid financial market in the world. The main purpose of the forex market is to facilitate international trade, investment, travel, remittances, and global business activities.

In simple terms, the foreign exchange market enables the conversion of one currency into another—for example, converting Indian Rupees (INR) into US Dollars (USD) for importing goods, paying for foreign education, or receiving money from abroad. The exchange rate between two currencies is determined by supply and demand conditions in the market, along with economic and political factors. The features of foreign exchange market are as follows:

a. Decentralized Structure

The foreign exchange (FX) market operates as a decentralized, over-the-counter (OTC) network without a central exchange or physical location, connecting banks, brokers, corporations, and traders globally through electronic platforms and telephone networks. This structure allows continuous trading across major financial centers like London, New York, Tokyo, and Singapore, enabling seamless execution regardless of geography. For example, a trader in Mumbai can instantly execute a USD/INR trade with a counterparty in London via interbank systems like Reuters or EBS.

b. 24-Hour Operation

The FX market functions 24 hours a day, five days a week, from Monday morning in Sydney to Friday evening in New York, driven by overlapping trading sessions across

time zones. This non-stop availability accommodates global time differences, ensuring liquidity even during regional holidays in one center while others remain active. An importer in Asia, for instance, can hedge currency exposure late at night against European suppliers without waiting for market openings.

c. High Liquidity

With daily turnover exceeding \$7.5 trillion, the FX market is the world's most liquid financial market, allowing large trades with minimal price impact due to deep order books and numerous participants. This liquidity stems from constant participation by central banks, commercial banks, hedge funds, and corporates, reducing bid-ask spreads to near-zero for major pairs like EUR/USD. During high-volume periods, such as post-economic data releases, even billion-dollar trades execute smoothly without slippage.

d. Currency Pair Trading

Currencies trade exclusively in pairs (e.g., base currency against quote currency like GBP/USD), where the exchange rate reflects the relative value of one unit of the base to the quote currency. This pairwise structure underpins all spot, forward, swap, and options transactions, with major pairs dominating 85% of volume due to their stability and liquidity. For example, exporters use USD/JPY pairs to price transactions involving American buyers and Japanese suppliers.

e. Wide Participant Base

The market includes diverse participants: interbank dealers providing liquidity, commercial clients hedging trade flows, speculators betting on rate movements, central banks intervening for policy, and retail traders via brokers. No single entity dominates, fostering competition and efficiency, though banks handle 50%+ of volume. A multinational like Apple participates to convert foreign revenues, while speculators like Soros famously shorted GBP in 1992.

f. Transparency and Accessibility

Real-time pricing and order flow data are widely available through platforms like Bloomberg and Eikon, with electronic trading ensuring fair access for qualified participants via ECNs and multi-bank platforms. High transparency reduces information asymmetry, though full depth-of-market data requires subscriptions. Retail investors now access via apps like MetaTrader, democratizing participation previously limited to institutions.

g. Volatility and Influencing Factors

Exchange rates fluctuate rapidly due to economic data (GDP, inflation), interest rate differentials, geopolitical events, and market sentiment, creating both opportunities and risks. Unlike stock markets, FX derives value from macroeconomic fundamentals rather than company performance. The 2015 Swiss franc unpegging from EUR caused instant 30% moves, illustrating how central bank actions drive extreme volatility.



5.1.2 Participants in the Foreign Exchange Market

The foreign exchange market is made up of various participants, each playing a unique role. These include:

a. Commercial Banks

Commercial banks act as the major players in the forex market. They buy and sell foreign currencies for their customers, such as exporters, importers, travellers, and investors. Banks also trade currencies among themselves to manage their foreign currency positions.

Example

State Bank of India buying USD on behalf of an Indian importer to pay a US supplier.

b. Foreign Exchange Brokers

Brokers act as intermediaries who bring buyers and sellers of foreign currencies together. They do not trade for themselves but help banks and financial institutions get the best exchange rates.

c. Central Banks

Central banks (like the Reserve Bank of India) regulate, monitor, and sometimes intervene in the forex market to stabilise the national currency and control inflation.

d. Corporates

Large companies involved in international business-such as exporters, importers, and multinational companies-participate in the forex market to settle international transactions or hedge foreign exchange risks.

e. Speculators and Investors

Speculators buy and sell currencies to profit from exchange rate fluctuations. Investors such as hedge funds, mutual funds, and financial institutions also trade in forex to diversify their portfolios.

f. Individuals / Retail Customers

Tourists, students going abroad, migrant workers, and online shoppers participate in the forex market through banks and authorised money changers.

5.1.3 Foreign Exchange Management in India

Foreign exchange management in India is primarily governed by the Foreign Exchange Management Act, 1999 (FEMA), together with rules, regulations, and directions issued under it by the Central Government and the Reserve Bank of India (RBI). FEMA replaced the earlier Foreign Exchange Regulation Act (FERA) with the objective of decriminalizing most foreign exchange transactions and shifting the approach from strict control to management and facilitation of external trade and payments. In essence, foreign exchange management in India is about regulating how

foreign currency flows into and out of the country in a way that supports economic growth while safeguarding external stability and preventing misuse.

A central feature of FEMA is its stated objective: to facilitate external trade and payments and to promote the orderly development and maintenance of the foreign exchange market in India. This means the law is designed not only to restrict harmful or risky transactions, but also to create a predictable framework in which exporters, importers, investors, and ordinary residents can access foreign exchange for legitimate purposes. FEMA thus explicitly links foreign exchange management to broader macroeconomic goals-supporting current account transactions like trade and remittances, and carefully regulating capital account flows such as foreign investment or external borrowing.

Under FEMA, the Central Government and the RBI are the key authorities responsible for foreign exchange management. The Central Government lays down the overall policy and issues rules, while the RBI issues detailed regulations, circulars, and directions concerning specific types of transactions, such as foreign direct investment (FDI), external commercial borrowings (ECBs), and remittances by residents. The Enforcement Directorate (ED) is responsible for investigating violations and enforcing penalties, ensuring that the system remains credible and that serious contraventions are deterred.

5.1.3.1 Features of Foreign Exchange Management in India

a. Regulatory Authority – RBI

The Reserve Bank of India (RBI) is responsible for regulating the foreign exchange market. It issues guidelines, monitors forex transactions, and ensures that foreign exchange operations are conducted legally.

b. FEMA – Liberal and Flexible

FEMA replaced the earlier FERA Act and made foreign exchange regulations much more business-friendly. It allows easier foreign investment flows, smoother remittances, and simplified currency exchange rules.

c. Authorised Dealers (ADs)

RBI gives permission to certain banks and financial institutions to deal in foreign exchange. These are known as Authorised Dealers, categorised into AD Category–I, II, and III depending on the type of services they can provide.

d. Exchange Control Measures

RBI monitors:

- ◇ Foreign inflows (FDI, FPI)
- ◇ Foreign outflows (remittances, investments abroad)
- ◇ External borrowings (ECB)
- ◇ NRI accounts
- ◇ Forex reserves



e. Market Development Measures

RBI encourages smooth functioning of the forex market through electronic trading platforms, derivative products, and transparent settlement systems.

5.1.4 Retail and Wholesale Components of the Indian Foreign Exchange Market

The Indian foreign exchange market is broadly divided into retail and wholesale components, both of which play a crucial role in facilitating foreign currency transactions and supporting India's international trade and financial activities. The retail component of the foreign exchange market deals with relatively small-value transactions carried out by individuals and small businesses through authorized dealers such as commercial banks and licensed money changers. This segment primarily serves personal and routine commercial needs such as foreign exchange for travel, education abroad, medical treatment, inward and outward remittances, and small-scale import and export payments. In the retail market, exchange rates are quoted by banks after adding a margin to the prevailing interbank rates, making the cost slightly higher for customers. The retail forex market acts as an important link between the general public and the formal foreign exchange system, ensuring accessibility, convenience, and compliance with RBI regulations. On the other hand, the wholesale component of the Indian foreign exchange market handles large-value transactions and forms the backbone of the forex system. It operates mainly through the interbank market, where commercial banks, foreign banks, authorized dealers, large corporates, institutional investors, and the Reserve Bank of India participate. Transactions in the wholesale market include spot, forward, and swap dealings, settlement of large import-export payments, capital account transactions such as foreign direct investment and portfolio investment, and hedging activities to manage exchange rate risk. Exchange rates in this segment are determined by demand and supply forces with very narrow bid-ask spreads due to high volumes and intense competition. The wholesale market provides liquidity, enables efficient price discovery, and supports large-scale international trade and capital flows, while also allowing the RBI to intervene when necessary to maintain exchange rate stability. Together, the retail and wholesale components ensure the smooth, efficient, and regulated functioning of the Indian foreign exchange market, contributing significantly to the country's external sector stability and economic growth.

The Indian foreign exchange market is broadly divided into two components:

1. Wholesale (Interbank) Forex Market
2. Retail Forex Market

Both segments play important roles but differ in terms of participants, transaction size, purpose, and pricing. Together, they ensure smooth and efficient currency exchange operations in India.

5.1.4.1 Wholesale Foreign Exchange Market (Interbank Market)

The wholesale or interbank forex market is the largest and most active part of India's foreign exchange system. This is where major financial institutions trade large volumes of foreign currency among themselves. The wholesale market sets the benchmark exchange rates that later influence the retail market.

The wholesale or interbank forex market is the largest and most active part of India's foreign exchange system. This is where major financial institutions trade large volumes of foreign currency among themselves. The wholesale market sets the benchmark exchange rates that later influence the retail market.

The Wholesale Foreign Exchange Market, also known as the Interbank Market, is the most important and dominant segment of the Indian foreign exchange market, where large-value foreign currency transactions are conducted primarily among banks and authorized financial institutions. In this market, commercial banks, foreign banks, authorized dealers, financial institutions, large corporates, and occasionally the Reserve Bank of India (RBI) participate in buying and selling foreign currencies among themselves. Transactions are carried out mainly for the purpose of settling large import and export payments, managing foreign exchange exposure, undertaking hedging and arbitrage operations, and facilitating capital account transactions such as foreign direct investment, portfolio investment, and external commercial borrowings. The interbank market is highly organized, competitive, and liquid, with exchange rates determined by the forces of demand and supply and quoted with very narrow bid-ask spreads due to the high volume of transactions. Deals in this market include spot transactions, forward contracts, and swap operations, enabling participants to manage short-term and long-term exchange rate risks efficiently. The RBI plays a crucial role as a regulator and, when required, as a participant by intervening to stabilize excessive volatility and ensure orderly market conditions. The wholesale foreign exchange market thus provides liquidity, ensures efficient price discovery, supports international trade and capital flows, and forms the backbone of India's foreign exchange system.

Key Characteristics of the Wholesale Market

a. Participants

The main participants include:

- ◇ Commercial banks (public, private, foreign banks)
- ◇ Reserve Bank of India (RBI)
- ◇ Large multinational corporations
- ◇ Export-Import (EXIM) institutions
- ◇ Forex dealers and financial institutions

These players transact with each other in high-value deals, often worth millions of dollars.

b. Nature of Transactions

Transactions are large and primarily carried out for:

- ◇ Managing foreign exchange positions
- ◇ Hedging currency risks
- ◇ Settling international trade payments
- ◇ Foreign currency loans and borrowings
- ◇ Treasury operations

These deals are executed using electronic trading platforms such as FX-CLEAR, FX-SWAP, and Reuters Dealing System.

c. Settlement System

The settlement is done through:

- ◇ RBI-approved clearing systems
- ◇ Real-time gross settlement (RTGS)
- ◇ CCIL (Clearing Corporation of India Ltd.)

d. Exchange Rate Determination

Exchange rates in this market are determined by:

- ◇ Supply and demand for different currencies
- ◇ Interest rates
- ◇ Market expectations
- ◇ RBI interventions

The interbank rate becomes the basis for retail forex rates.

e) Example

SBI and ICICI Bank may trade USD 50 million between themselves to adjust their foreign currency positions.

Or

A multinational company may hedge its currency exposure by entering a forward contract with a large bank.

5.1.4.2. Retail Foreign Exchange Market

The Retail Foreign Exchange Market is an important segment of the Indian foreign exchange market that deals with small-value foreign currency transactions undertaken by individuals, tourists, students, non-resident Indians, and small businesses through authorized dealers such as commercial banks and licensed money changers. This market primarily caters to personal and routine commercial needs, including the purchase and sale of foreign currency notes and traveller's cheques, remittances, foreign exchange

for travel, education, medical treatment, and small-scale import and export payments. In the retail forex market, exchange rates are quoted by banks to customers by adding a margin over the prevailing interbank or wholesale market rates, making retail transactions relatively costlier compared to wholesale dealings. The retail market is service-oriented and plays a vital role in providing easy access to foreign exchange while ensuring compliance with the regulations prescribed by the Reserve Bank of India. By connecting individuals and small enterprises to the formal foreign exchange system, the retail foreign exchange market supports international mobility, small trade activities, and remittance flows, thereby contributing to the smooth functioning and inclusiveness of India's foreign exchange framework.

The retail forex market deals with small-value foreign exchange transactions, primarily for individuals, small firms, and service providers. While the wholesale market is dominated by large institutions, the retail market focuses on meeting everyday foreign exchange needs.

Key Characteristics of the Retail Market

a. Participants

Retail transactions are carried out through:

- ◇ Authorised Dealer (AD) Category-I Banks
- ◇ Authorised Money Changers (AMCs/FFMCs)
- ◇ Non-banking financial institutions approved by RBI
- ◇ Travel agencies, airport currency counters

b. Nature of Transactions

These transactions include:

- ◇ Currency purchase for travel abroad
- ◇ Payment of foreign university fees
- ◇ Remittances by individuals (gifts, family expenses, medical treatment)
- ◇ Small export and import transactions
- ◇ NRI remittances
- ◇ Online foreign currency purchases
- ◇ Salary payments for employees working abroad

Amounts involved are much smaller compared to the wholesale market.

c. Pricing

The retail rates differ slightly from interbank rates because:

- ◇ Banks charge service fees
- ◇ Administrative costs are added
- ◇ The spread (difference between buying and selling rates) is higher

d) Regulatory Framework

Retail transactions operate under the Liberalised Remittance Scheme (LRS) and FEMA guidelines. Limits apply-e.g., individuals can remit up to USD 250,000 per financial year under LRS.

e) Example

- ◇ A student exchanges INR for USD to pay for studies in the USA.
- ◇ A tourist buys foreign currency for a holiday in Europe.
- ◇ A small exporter receives payment worth USD 10,000 for goods sold to Singapore.

5.1.4.3 Differences Between Wholesale and Retail Forex Market

Basis	Wholesale Market	Retail Market
Participants	Banks, RBI, large corporates	Individuals, small firms, NRIs
Transaction Size	Very large (millions of USD)	Small (hundreds to thousands USD)
Rates	Interbank rates	Higher than wholesale rates
Purpose	Hedging, trade settlement, treasury operations	Travel, education, small trade, remittances
Market Type	Interbank, institutional	Customer-oriented
Platforms	FX-CLEAR, Reuters, CCIL	Bank counters, money changers

The retail and wholesale components of the Indian foreign exchange market work together to support the country's international financial activities. The wholesale market focuses on large institutional transactions and rate setting, while the retail market serves the needs of individuals and small businesses. The effective functioning of both segments ensures smooth currency conversion, stable exchange rates, and efficient foreign exchange operations across India.

Recap

- ◇ Foreign Exchange Market – A global marketplace where currencies are bought and sold to support international trade, investment, and remittances.
- ◇ Participants – Includes commercial banks, central banks, foreign exchange brokers, multinational companies, exporters, importers, FIIs, and individual customers.
- ◇ Exchange Rate – The price of one currency expressed in terms of another, determined mainly by demand and supply in the forex market.
- ◇ Foreign Exchange Management in India – Regulated by the RBI under FEMA, 1999, to ensure orderly forex transactions, promote foreign trade, and maintain currency stability.
- ◇ Authorised Dealers – Banks and money changers permitted by RBI to conduct foreign exchange operations for customers and businesses.
- ◇ Wholesale Forex Market – Large-value interbank market where banks, RBI, and multinational firms trade currencies for hedging, trade settlement, and treasury operations.
- ◇ Retail Forex Market – Small-value market serving individuals and small firms for travel, education, remittances, NRI services, and minor trade needs.

Objective Questions

1. What is the foreign exchange market?
2. Who regulates the foreign exchange market in India?
3. What is the meaning of an exchange rate?
4. Who are Authorised Dealers?
5. Which law governs foreign exchange management in India?
6. What is the interbank forex market?
7. What is the full form of FEMA?
8. What are the main purposes of the forex market?



Answers

1. A global market where currencies are bought and sold.
2. The Reserve Bank of India (RBI).
3. The value of one currency expressed in terms of another.
4. Banks authorised by RBI to deal in foreign exchange.
5. FEMA, 1999.
6. A wholesale market where banks trade currencies among themselves.
7. Foreign Exchange Management Act.
8. Trade facilitating enabling currency conversion

Self Assessment Questions

1. What is meant by the foreign exchange markets? Explain its main objectives?
2. Describe the structure and key features of the global foreign exchange market.
3. Distinguish between spot transaction and forward transaction in foreign exchange.

Assignment Questions

1. Explain the meaning and importance of the foreign exchange market. Discuss its role in supporting international trade and investment.
2. Describe the key participants in the foreign exchange market. How does each participant contribute to foreign exchange activities?
3. Explain foreign exchange management in India. Discuss the role of RBI and FEMA in regulating forex transactions.
4. Differentiate between the wholesale and retail components of the Indian foreign exchange market with suitable examples.

5. What are Authorised Dealers? Explain their categories and functions in the Indian forex market.
6. Discuss the growth and development of the foreign exchange market in India in the post-liberalisation period.
7. Explain how foreign exchange brokers and central banks influence the functioning of the forex market.

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Unit

Regulatory Framework

Learning Outcomes

After completing this unit, students will be able to:

- ◇ comprehend the regulatory structure of the Indian foreign exchange market.
- ◇ explain the role and functions of FEDAI in maintaining uniformity in forex dealings.
- ◇ describe the objectives and major provisions of FEMA, 1999.
- ◇ identify the role of RBI, SEBI, and other regulators in the forex market.
- ◇ comprehend the structure and functioning of dealing room operations in banks.

Prerequisite

The Indian foreign exchange market has grown significantly over the last few decades due to globalisation, international trade, and cross-border investments. A well-regulated forex market is essential for ensuring smooth financial transactions, stable currency value, and economic growth. The regulatory framework-consisting of RBI, SEBI, FEMA, and FEDAI-plays a major role in maintaining order, transparency, and stability in the market.

FEDAI helps in creating uniform rules for banks dealing in foreign exchange, while FEMA governs all foreign transactions and capital flows. Dealing rooms in banks act as the operational centre where forex transactions are executed, monitored, and settled. Understanding exchange rate systems is also important because the value of a country's currency affects trade, inflation, and economic policies.

This unit therefore provides the foundation for understanding how India's foreign exchange market works, who regulates it, how banks operate internally, and how currency values are determined

Keywords

FEDAI, FEMA, Authorized Dealers (ADs), Dealing Room, Managed Float, Spot Transaction, Forward Contract

Discussion

5.2.1 FEDAI (Foreign Exchange Dealers' Association of India)

FEDAI, or the Foreign Exchange Dealers' Association of India, is a self-regulatory organization established in 1958 by banks dealing in foreign exchange in India, primarily authorized dealers (ADs). Incorporated under Section 25 of the Companies Act, 1956, it serves as a non-profit body to standardize and promote orderly conduct in the interbank foreign exchange market, acting as a bridge between member banks, the Reserve Bank of India (RBI), and other stakeholders.

FEDAI aims to frame rules and guidelines governing interbank forex transactions, ensure compliance with RBI regulations under FEMA, and foster market development through training, accreditation, and dispute resolution. It promotes best practices, transparency, and efficiency in India's forex ecosystem, supporting external trade while mitigating risks in cross-border dealings.

Features of FEDAI (Foreign Exchange Dealers' Association of India)

1. FEDAI is a self-regulatory professional body of authorized foreign exchange dealer banks in India.
2. It functions under the overall supervision and guidance of the Reserve Bank of India (RBI).
3. FEDAI frames and publishes FEDAI Rules to standardize foreign exchange operations and practices.
4. It ensures uniformity in forex transactions such as spot, forward, and interbank dealings.
5. FEDAI issues circulars and operational guidelines to help banks implement RBI's forex regulations effectively.
6. It acts as a link between RBI and authorized dealers, facilitating smooth communication and coordination.
7. FEDAI promotes ethical conduct, discipline, and professionalism among foreign exchange dealers.



8. It provides advisory and consultative support to member banks on foreign exchange matters.
9. FEDAI organizes training programs, workshops, and seminars to improve the skills of forex professionals.
10. It helps in reducing disputes and irregularities by prescribing standard procedures and best practices.

5.2.2 Role of FEDAI (Foreign Exchange Dealers' Association of India)

◇ Standardization of Rules

FEDAI standardizes rules for forex dealings by issuing comprehensive guidelines on exchange margins, charges, documentation requirements, and settlement procedures, ensuring that all member banks follow consistent practices across the country. These rules cover critical aspects like permissible margins on spot and forward rates, uniform documentation standards for trade transactions such as letters of credit and bills, and standardized settlement timelines to minimize discrepancies. By enforcing uniformity, FEDAI reduces operational errors, enhances market efficiency, and builds trust among participants; for example, when processing an export bill under a letter of credit, all banks apply the same FEDAI-prescribed margin and documentation checklist, preventing disputes over negotiation or reimbursement.

◇ Guidelines for Forex Contracts

FEDAI lays down detailed rules governing forward contracts, including cancellation charges, rebooking provisions, and extension policies, which provide clarity and predictability for hedging activities in the interbank market. These guidelines specify maximum extension periods (typically up to 10 years under RBI limits but with FEDAI operational norms), cancellation fees based on remaining tenor, and conditions for rebooking cancelled contracts to prevent abuse. This framework supports exporters and importers in managing currency risks; for instance, an Indian importer booking a 6-month USD forward to hedge machinery payments can extend it per FEDAI rules if shipment delays occur, paying standardized charges without negotiation.

◇ Training and Certification

FEDAI conducts specialized training programs and certification exams for bank employees in treasury and forex departments, elevating professional standards and ensuring competence in complex international transactions. These initiatives include workshops on derivatives, risk management, FEMA compliance, and SWIFT messaging, culminating in certifications like FEDAI Treasury Certification that are recognized industry-wide. By building skilled personnel, FEDAI minimizes errors in high-volume forex operations; banks often mandate this training for dealers, as seen when staff certified under FEDAI handle rupee-dollar swaps accurately during volatile market conditions.

◇ **Dispute Resolution**

FEDAI acts as an arbitrator in disputes between member banks arising from forex transactions, providing a quick, cost-effective mechanism to resolve issues like rate disagreements, failed settlements, or contract breaches without resorting to courts. The process involves submitting details to FEDAI's arbitration committee, which reviews evidence under its rules and issues binding decisions, often within days. This role maintains market harmony; for example, if Bank A claims Bank B delayed a forward contract settlement causing losses, FEDAI mediates based on transaction records and guidelines, averting prolonged litigation.

◇ **Support to RBI**

FEDAI supports the RBI by assisting in framing and implementing forex market regulations, offering technical inputs, market feedback, and recommendations drawn from practical interbank experience. It represents member banks in consultations on policy changes like LRS limits or ECB guidelines, conducts surveys on market liquidity, and proposes reforms for deeper rupee internationalization. This collaboration strengthens oversight; during the 2013 taper tantrum, FEDAI provided RBI with real-time data on USD liquidity strains, helping shape intervention strategies.

◇ **Rule Formulation**

Develops operational guidelines, codes of conduct, and standards for forex business, including transaction protocols and ethical norms.

◇ **Training and Capacity Building**

Organizes workshops, certification courses, and personnel training in foreign exchange operations for member banks.

◇ **Broker Accreditation**

Certifies and regulates forex brokers to maintain professionalism and market integrity.

◇ **Advisory and Dispute Resolution**

Assists members in resolving forex-related issues and interpreting regulations.

◇ **RBI Representation and Rate Announcements**

Represents banks before RBI, announces daily/periodical rates, and liaises for market reforms.

◇ **Market Stabilization**

Collaborates with RBI, FIMMDA, and others to enhance liquidity, depth, and stability in India's forex market.

With over 90 members including public, private, foreign, and cooperative banks, FEDAI plays a pivotal role in aligning India's forex market with global standards while supporting national economic objectives.



Importance of FEDAI (Foreign Exchange Dealers' Association of India)

1. Ensures orderly and smooth functioning of the Indian foreign exchange market.
2. Promotes uniformity and standardization in foreign exchange transactions across banks.
3. Helps in the effective implementation of RBI's foreign exchange regulations.
4. Acts as a coordination link between RBI and authorized dealer banks.
5. Encourages ethical practices and professionalism among forex dealers.
6. Reduces operational errors, disputes, and ambiguities in forex dealings.
7. Enhances efficiency and transparency in the foreign exchange market.
8. Provides expert guidance and advisory support on complex forex matters.
9. Contributes to skill development through training and capacity-building programs.
10. Strengthens stability and confidence in India's foreign exchange system.

Thus, the Foreign Exchange Dealers' Association of India (FEDAI) plays a vital role in strengthening the Indian foreign exchange market by ensuring discipline, uniformity, and professionalism in foreign exchange dealings. By framing standardized rules, facilitating effective implementation of RBI regulations, and promoting ethical practices among authorized dealers, FEDAI enhances transparency, efficiency, and stability in the forex system. Its advisory support and training initiatives further contribute to the development of skilled foreign exchange professionals, thereby supporting smooth international trade and financial transactions. Overall, FEDAI acts as a key institutional pillar that ensures the orderly functioning and sustained confidence in India's foreign exchange market.

5.2.3 FEMA (Foreign Exchange Management Act), 1999

The Foreign Exchange Management Act, 1999 (FEMA) is a pivotal Indian legislation enacted on December 29, 1999, and effective from June 1, 2000, replacing the stringent Foreign Exchange Regulation Act, 1973 (FERA). Its primary objective is to consolidate and amend laws relating to foreign exchange, facilitating external trade and payments while promoting the orderly development and maintenance of the foreign exchange market in India. Unlike FERA's criminal approach, FEMA treats most violations as civil offenses, emphasizing management over rigid control to align with India's liberalization and WTO commitments.

FEMA extends to the whole of India and applies extraterritorially to branches, offices, or agencies outside India owned or controlled by Indian residents, as well as contraventions abroad by applicable persons. "Person resident in India" is defined by stay exceeding 182 days in the preceding financial year, excluding certain exceptions like Indian citizens abroad on employment. It covers foreign exchange, foreign securities, and immovable property dealings.

The Central Government holds overarching powers to restrict payments, forex dealings, and securities transactions, while the Reserve Bank of India (RBI) enforces

through regulations, directions, and permissions. Authorised Persons (mainly banks) handle transactions, and the Enforcement Directorate (ED) investigates violations. Adjudicating Authorities impose penalties, with appeals to the Appellate Tribunal.

Current account transactions (e.g., trade, remittances, travel) are permitted unless prohibited (like lottery payments), often requiring government approval for specific cases. Capital account transactions (e.g., FDI, ECBs, overseas investments) are prohibited unless explicitly allowed by RBI regulations, with routes like automatic (no prior approval) or approval-based. Residents must repatriate export proceeds and cannot freely hold foreign assets without permission.

Objectives of FEMA

FEMA seeks to simplify external transactions, remove payment disparities, and ensure effective utilization of foreign exchange resources for national economic growth. It regulates dealings between residents and non-residents, controls foreign investments in India, and overseas investments by Indians, while enabling a predictable framework for cross-border flows. By distinguishing current account (trade-related) from capital account (investment-related) transactions, it balances openness with stability.

Facilitate external trade and payments.

Promote the orderly development and maintenance of the forex market in India.

Simplify and liberalize foreign exchange rules compared to FERA.

Key Features

a. **FEMA is civil law, not criminal law (unlike FERA).**

Under FEMA, violations are treated as *civil offences*, meaning they do not involve criminal proceedings unless there is deliberate fraud or non-compliance. This is a major difference from the earlier law, FERA (Foreign Exchange Regulation Act), which treated violations as criminal offences, often resulting in strict punishment. FEMA adopts a softer, business-friendly approach that encourages compliance rather than punishment. This shift was essential for India's integration with global markets after liberalisation.

b. **Focuses on management, not control.**

FEMA emphasises the smooth management of foreign exchange transactions, enabling individuals and businesses to conduct international payments more easily. Instead of tightly controlling every transaction, the law creates a transparent framework that supports trade, investment, and global financial activities. The objective is to facilitate foreign exchange flows while maintaining stability in the external sector. The focus on “management” reflects a liberal, supportive approach rather than a restrictive one.

c. **Penalties are monetary, not imprisonment (unless non-payment).**

Under FEMA, penalties for violations primarily involve financial fines, which may vary depending on the severity of the offence. Imprisonment is not the first option and



is applied only when an individual or organisation fails to pay the monetary penalty imposed within the specified time. This makes FEMA less harsh and more aligned with global regulatory practices. It ensures compliance through financial deterrence rather than criminal punishment.

d. RBI is the regulatory authority.

The Reserve Bank of India (RBI) is the primary body responsible for implementing and enforcing FEMA. It issues guidelines, monitors foreign exchange transactions, grants approvals, and ensures that authorised dealers-mainly banks-follow the prescribed rules. RBI plays a central role in maintaining the country's foreign exchange stability and ensuring that all international financial activities support India's economic policies. Through its regulatory oversight, RBI ensures orderly development of the foreign exchange market.

Major Provisions of FEMA

a. Current Account Transactions

Freely allowed unless specifically restricted.

Examples: travel expenses, education, medical bills.

b. Capital Account Transactions

Regulated by RBI.

Includes foreign investment, property purchase outside India, loans, etc.

c. Authorized Dealers (ADs)

Banks and financial institutions appointed by RBI to handle forex.

Must follow RBI and FEDAI rules.

d. Foreign Investment Rules

FDI and FPI regulations are framed under FEMA.

e. Export and Import Regulations

Export proceeds must be realized within a prescribed period.

Import payments must be made through approved channels.

5.2.4 Regulatory Framework of the Indian Forex Market

The regulatory framework of the Indian foreign exchange (forex) market is designed to ensure orderly conduct, stability, transparency, and compliance in all foreign exchange transactions. At the apex of this framework is the Reserve Bank of India (RBI), which regulates, supervises, and controls the forex market under the provisions of the Foreign Exchange Management Act (FEMA), 1999. FEMA provides the legal basis for governing foreign exchange transactions in India, with the objective of facilitating external trade and payments while promoting the orderly development and maintenance of the foreign exchange market. The RBI issues rules, regulations, master directions, and

circulars to authorized dealers, banks, and financial institutions, covering both current account and capital account transactions, exchange controls, reporting requirements, and risk management norms. Authorized Dealer (AD) banks play a key operational role by conducting forex transactions on behalf of customers strictly in accordance with RBI guidelines. Supporting the RBI is the Foreign Exchange Dealers' Association of India (FEDAI), a self-regulatory body that frames operational rules, standardizes market practices, and promotes ethical conduct among forex dealers. In addition, market participants such as banks, money changers, corporates, and institutional investors are required to follow prudential norms, anti-money laundering (AML) guidelines, and know-your-customer (KYC) requirements to ensure transparency and prevent misuse of the forex system. Together, FEMA, RBI, FEDAI, and authorized dealers constitute a comprehensive regulatory framework that safeguards market integrity, manages exchange rate volatility, and supports India's international trade and capital flows in a stable and efficient manner..

The Indian forex market is regulated by a combination of authorities:

A. Reserve Bank of India (RBI)

- ◇ Primary regulator of the forex market.
- ◇ Issues circulars, guidelines, and notifications.
- ◇ Manages exchange rate policy.
- ◇ Maintains foreign exchange reserves.
- ◇ Grants licenses to Authorized Dealers.

B. Ministry of Finance

- ◇ Frames overall foreign exchange policy and economic strategy.
- ◇ Works closely with RBI.

C. Securities and Exchange Board of India (SEBI)

- ◇ Regulates forex derivatives traded on stock exchanges.
- ◇ Oversees FPIs, FIIs, and foreign capital market inflows.

D. FEDAI

- ◇ Sets operational rules for dealers.

E. Enforcement Directorate (ED)

- ◇ Investigates violations of FEMA.

5.2.5 Dealing Room Operations

A Dealing Room, also known as the Treasury or Forex Dealing Room, is a specialised area in a bank where trained dealers buy and sell foreign currencies, manage funds, handle derivatives, and maintain liquidity for the bank. It operates with advanced communication and trading technology, allowing quick execution of transactions in global markets.



Dealing Room Operations refer to the activities carried out in the foreign exchange dealing room of banks and financial institutions where buying and selling of foreign currencies are executed. The dealing room acts as the nerve centre of a bank's foreign exchange operations and functions under strict regulatory and risk management frameworks prescribed by the Reserve Bank of India (RBI) and internal bank policies. It is typically divided into front office, middle office, and back office to ensure efficiency, control, and segregation of duties. The front office consists of dealers who actively quote exchange rates and undertake transactions in the interbank and customer markets for spot, forward, and swap deals. The middle office monitors risk, ensures compliance with exposure limits, assesses market and credit risks, and reports to management. The back office handles confirmation, settlement, accounting, and reconciliation of forex transactions to ensure accuracy and avoid operational risks. Dealing room operations involve continuous monitoring of exchange rate movements, interest rates, and global economic developments to make informed trading decisions. Modern dealing rooms rely heavily on electronic trading platforms, real-time communication systems, and sophisticated risk management tools. Overall, effective dealing room operations ensure liquidity, efficient price discovery, compliance with regulations, and profitability for banks while maintaining stability in the foreign exchange market.

The dealing room connects the bank with:

- ✓ other domestic and international banks
- ✓ foreign exchange markets
- ✓ corporate clients
- ✓ financial institutions
- ✓ RBI (for regulatory compliance)

It functions 24×7 globally, as forex markets operate round the clock across different time zones.

5.2.5.1 Structure of a Dealing Room

1. Front Office

- ◇ Dealers who execute forex transactions.
- ◇ Handle spot, forward, swaps, options, and other instruments.

2. Mid Office

- a. Risk management team.
- b. Monitors:
 - ◇ Market risk
 - ◇ Credit risk
 - ◇ Compliance with RBI rules
 - ◇ Dealer limits

3. Back Office

- ◇ Settlement and confirmation.
- ◇ Accounting, reporting, documentation.

5.2.5.2 Activities in a Dealing Room

1. Currency Trading

- ◇ Spot trades
- ◇ Forward trades
- ◇ Swaps

2. Rate Quoting

- ◇ Dealers quote buying and selling rates to customers and other banks.

3. Hedging

- ◇ Managing currency risk for clients and the bank itself.

4. Arbitrage

- ◇ Taking advantage of rate differences across markets.

5. Market Analysis

- ◇ Tracking economic data, interest rates, global news, and market trends.

6. Compliance

- ◇ Strict adherence to RBI and FEDAI guidelines.

5.2.6 Exchange Rate System

An exchange rate system refers to the method used by a country to determine how its currency will be valued in comparison to other currencies. It provides the rules, policies, and mechanisms through which foreign exchange rates are set in international markets. This system guides how much one currency can be exchanged for another and influences the country's trade, investment flows, foreign reserves, and overall economic stability. Without a structured exchange rate system, international transactions would become unpredictable and risky, making it difficult for countries to engage in global trade or attract foreign investment.

It refers to the method by which a country determines the value of its domestic currency in relation to foreign currencies. It plays a crucial role in international trade, capital flows, balance of payments management, and overall economic stability. Broadly, exchange rate systems can be classified into fixed, floating, and managed systems. Under a fixed exchange rate system, the value of the domestic currency is pegged to another major currency or a basket of currencies, and the central bank intervenes regularly in the foreign exchange market to maintain the fixed rate; this system provides stability and predictability but limits monetary policy independence. In contrast, a floating exchange rate system allows the currency value to be determined freely by market forces of demand and supply in the foreign exchange market, with



minimal or no central bank intervention; while this system offers greater flexibility and monetary autonomy, it may lead to higher exchange rate volatility. Between these two extremes lies the managed floating exchange rate system, also known as a dirty float, where exchange rates are largely market-determined but the central bank intervenes occasionally to prevent excessive volatility or speculative movements. India follows a managed floating exchange rate system, where the Reserve Bank of India intervenes to maintain orderly market conditions without targeting a specific exchange rate level. Overall, the exchange rate system adopted by a country significantly influences its trade competitiveness, inflation, capital flows, and economic growth.

Objectives of Exchange Rate System

The primary objective of an exchange rate system is to maintain stability in the value of the national currency. A stable currency helps exporters, importers, investors, and travelers plan their financial activities without fear of sudden fluctuations. Another major objective is to facilitate smooth international payments by ensuring adequate foreign exchange availability in the economy. The system also aims to enhance global competitiveness, control inflation, support economic growth, and build confidence among foreign investors. A well-designed exchange rate system ensures that a country remains an active and reliable participant in global financial markets.

The following are the important objectives :

1. To maintain stability in the value of the domestic currency in relation to foreign currencies.
2. To facilitate international trade by reducing exchange rate uncertainty.
3. To promote balanced economic growth by supporting exports and regulating imports.
4. To ensure equilibrium in the balance of payments over the long run.
5. To prevent excessive exchange rate volatility and speculative movements.
6. To maintain price stability by controlling imported inflation.
7. To encourage foreign investment by creating confidence in the currency.
8. To support effective monetary policy and overall macroeconomic stability.
9. To protect the external value of the currency and national economic interests.
10. To ensure orderly functioning of the foreign exchange market.

5.2.6.1 Types of exchange rate systems

a. Fixed Exchange Rate System

Under a fixed exchange rate system, the government or central bank officially sets the value of the currency and commits to maintaining it at that level. The central bank continuously intervenes in the foreign exchange market by buying or selling currencies to prevent the rate from moving outside the predetermined range. This system brings stability to the economy and reduces uncertainty in international transactions, which

is especially useful for countries dependent on trade. However, maintaining a fixed rate requires the central bank to hold large amounts of foreign reserves and restricts its ability to use monetary policy freely.

b. Floating (Flexible) Exchange Rate System

A floating exchange rate system allows the currency's value to be determined entirely by market forces such as supply and demand in the foreign exchange market. The central bank does not intervene directly to influence the price. When demand for a currency increases, its value rises; when supply increases, the value falls. This system gives the government greater freedom to use monetary policy to manage inflation, interest rates, and liquidity in the economy. However, floating rates can be highly volatile, making it difficult for traders and investors to predict future currency values.

c. Managed Floating Exchange Rate System (Dirty Float)

The managed floating exchange rate system is a hybrid model in which market forces primarily determine the currency's value, but the central bank intervenes whenever necessary to reduce excessive fluctuations. Unlike fixed systems, the central bank does not aim for a fixed value; instead, it ensures orderly market conditions and prevents extreme volatility that could harm the economy. This system provides both flexibility and stability, making it suitable for developing countries like India, where complete floating could lead to instability while a fixed system would restrict policy freedom.

d. Pegged Exchange Rate System

In a pegged exchange rate system, a country fixes its currency's value to another currency-usually a stable one such as the US Dollar or Euro. The purpose is to provide stability and build confidence in the financial system. Pegging is often used by developing or small economies that find it difficult to manage exchange rate fluctuations on their own. The central bank must actively intervene to maintain the peg, which requires holding sufficient foreign currency reserves. While pegging promotes stability, it can become costly when global market conditions change rapidly.

e. Crawling Peg System

A crawling peg system allows the exchange rate to be adjusted gradually instead of keeping it constant. Countries using this system set a target rate but adjust it periodically-daily, weekly, or monthly-based on inflation, trade performance, or market trends. The objective is to avoid sudden shocks to the economy while maintaining more flexibility than a fixed system. Crawling pegs help countries with persistent inflation to slowly adjust the currency value to maintain competitiveness in global trade.

f. Currency Board System

A currency board system is an extreme form of the fixed exchange rate system in which the country commits to backing every unit of its domestic currency with foreign currency reserves. This eliminates the possibility of printing money without adequate reserves and forces strict financial discipline. Countries with high inflation or unstable monetary policy often adopt this system to gain confidence from global markets. However, it severely restricts the country's ability to respond to domestic economic conditions since monetary policy cannot be independently used.



g. Dual Exchange Rate System

In a dual exchange rate system, the country maintains two separate exchange rates—one for commercial transactions (trade of goods and services) and another for capital transactions (investment flows, loans, securities). This system allows the government to protect essential imports by keeping one rate stable while using another rate to regulate capital inflows and outflows. Dual systems are often adopted during economic crises when governments want to prevent excessive pressure on the currency.

h. Dollarization

Dollarization occurs when a country gives up its own national currency and adopts a foreign currency—most commonly the US Dollar—as its official medium of exchange. This system is usually adopted by countries facing severe inflation, currency collapse, or loss of confidence in the local monetary system. Dollarization instantly stabilizes the economy by eliminating exchange rate risk and restoring public trust. However, it also means the country loses complete control over its monetary policy and becomes dependent on the foreign central bank.

Recap

- ◇ FEDAI – Industry body that standardizes forex rules for banks.
- ◇ FEMA – Law governing foreign exchange transactions in India.
- ◇ Authorized Dealers (ADs) – Banks permitted by RBI to deal in forex.
- ◇ Dealing Room – Treasury unit where forex trading and settlements occur.
- ◇ Managed Float – India's exchange rate system with RBI intervention.
- ◇ Spot Transaction – Immediate purchase/sale of foreign currency.
- ◇ Forward Contract – Agreement to buy/sell foreign currency at a future date.
- ◇ FEDAI – Sets rules, guidelines, and standard rates for foreign exchange dealings among banks.
- ◇ FEMA – Legal framework that governs all foreign exchange transactions in India.
- ◇ Authorized Dealers – Banks permitted by RBI to handle forex transactions.
- ◇ Current Account Transactions – Regular international payments related to travel, education, and remittances.
- ◇ Capital Account Transactions – Transactions that change assets or liabilities such as investments and loans.
- ◇ Dealing Room – The treasury unit where banks conduct and monitor foreign exchange operations.

- ◇ Front Office – Executes forex trades and quotes currency rates to customers.
- ◇ Mid Office – Monitors risks, limits, and compliance in forex operations.
- ◇ Back Office – Handles settlement, documentation, and accounting of forex trades.
- ◇ Managed Floating Exchange Rate – System where market determines the exchange rate with RBI intervention during volatility.

Objective Questions

1. What is the main function of FEDAI?
2. When was FEMA enacted?
3. What is meant by an Authorized Dealer?
4. What is a current account transaction?
5. Who regulates the Indian foreign exchange market?
6. What is the role of the front office in a dealing room?
7. State one difference between FERA and FEMA.
8. What is a managed floating exchange rate system?
9. What is the purpose of a forward contract?
10. Which office in the dealing room handles settlement and accounting?

Answers

1. FEDAI's main function is to set rules, guidelines, and standardized procedures for foreign exchange dealings among banks.
2. FEMA was enacted in 1999 and came into effect on June 1, 2000.
3. Authorized Dealer refers to a bank or financial institution authorized by RBI to handle foreign exchange transactions.
4. Current account transactions are day-to-day foreign exchange transactions such as travel, education, medical treatment, remittances, etc.
5. The Indian foreign exchange market is primarily regulated by the Reserve Bank of India (RBI).
6. The front office executes forex trades, quotes rates, and manages customer transactions.



7. FERA was a criminal law, while FEMA is a civil law focusing on management, not control.
8. A managed floating exchange rate system allows the currency value to be determined by the market, but the central bank intervenes to reduce volatility.
9. A forward contract is used to buy or sell foreign currency at a predetermined rate on a future date.
10. The back office handles settlements, confirmations, documentation, and accounting.

Self Assessment Questions

1. Explain the regulatory framework governing the foreign exchange market in India.
2. Discuss the powers and functions of the Central Bank in foreign exchange, regulation.
3. Explain the provision relating to authorised dealers under FEMA.

Assignment Questions

1. Explain the role and functions of FEDAI in the Indian foreign exchange market. How does it support the operations of Authorized Dealers?
2. Discuss the major provisions of FEMA, 1999. How does FEMA differ from FERA in terms of objectives and approach?
3. Describe the structure and functioning of a dealing room in a bank. Explain the roles of the front office, mid office, and back office in detail.
4. Explain the regulatory framework of the Indian foreign exchange market. What roles do RBI, SEBI, FEDAI, and the Ministry of Finance play?
5. What are the different exchange rate systems? Explain the managed floating exchange rate system followed in India with suitable examples.

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6
BLOCK

GLOBAL FINANCIAL
MARKETS

Unit

International Equity Markets

Learning Outcomes

After the completion of this unit the learner will be able to;

- ◇ familiarise with the concept of international equity markets and its components
- ◇ explain depository receipts
- ◇ describe the mechanism of issue of depository receipts
- ◇ discuss the purpose of IDR.

Prerequisite

Imagine a small Indian company called FreshSip Juices, known for its natural fruit drinks. The company was doing well in India, but it dreamed of expanding to other countries. To grow, FreshSip needed more money, especially from foreign investors. However, investors in countries like the US and UK found it difficult to buy FreshSip's Indian shares directly because of rules, currency issues, and unfamiliar stock markets. To solve this, FreshSip used Depository Receipts. It issued American Depository Receipts (ADRs) so that US investors could buy its shares easily through American stock exchanges, while the real shares stayed safely in India with a custodian bank. Later, FreshSip also issued Global Depository Receipts (GDRs) to attract investors from Europe and Asia. In the same way, a foreign beverage company once entered India by issuing Indian Depository Receipts (IDRs), allowing Indian investors to buy its shares without dealing with foreign markets. This simple example shows how companies use international equity markets and depository receipts like ADRs, GDRs, and IDRs to connect with investors across the world and grow beyond their home country.

Keywords

Depository Receipts, ADR, GDR and IDR

Discussion

The rise of Infosys Technologies offers a clear example of how international equity markets and depository receipts work. In the late 1990s, the company needed global capital but foreign investors found it difficult to buy Indian shares due to regulations and currency issues. To solve this, Infosys became the first Indian company to issue American Depository Receipts (ADRs) and list on NASDAQ in 1999. A U.S. depository bank held its shares in India through a custodian bank and issued ADRs abroad, making it easy for American investors to invest. This success increased Infosys's global visibility and encouraged other Indian companies to raise funds through Global Depository Receipts (GDRs) in international markets. Later, foreign companies such as Standard Chartered Bank issued Indian Depository Receipts (IDRs), helping Indian investors to invest in global firms without dealing with foreign exchanges.

Global financial markets enable the movement of funds across countries. These funds may be in the form of equity (ownership capital) or debt, and can be raised for various durations—short-term, medium-term, or long-term. Different institutions supply these types of funds, and they are accessed through various financial instruments. Global financial market connects financial markets of different countries, allowing money to move freely across borders. Through this market, funds can be raised, invested, borrowed, or traded internationally, helping economies grow and promoting global economic integration.

Depending on the nature of funds being traded, the international financial market or global financial market is divided into segments such as the international bond market, international equity market, international money market, and international credit market.

6.1.1 International equity market

Companies raise equity capital by issuing shares, which are then traded on the stock exchanges of their home country. Multinational companies, however, often prefer to raise equity from multiple countries by issuing shares abroad and listing them on international stock exchanges. They may do this to obtain foreign currency for specific projects, to enhance their global reputation, or because of their domestic market is too small to handle a large share issue.

International equity issues; companies offering shares in foreign markets expanded significantly in the 1980s. Non-US companies began raising equity in the American

market through American Depositary Receipts (ADRs), which are certificates representing multiple shares. These ADRs are bought and sold on U.S. stock exchanges. Similarly, companies raise equity in markets outside the U.S. through Global Depositary Receipts (GDRs), which are traded in the stock exchanges where they are listed.

Many countries now permit non-resident, particularly institutional investors, to trade in their stock markets. Investors increasingly purchase securities from various countries to reduce risk through international diversification. As a result, the stock markets of developed and many developing countries have evolved into international equity markets, where foreign shares may be listed and traded, and where non-resident investors participate freely.

In the 1990s, developing nations opened their equity markets to foreign investors. Investors from developed countries were attracted to East Asian and Latin American markets because of rising share prices. At the same time, companies from these developing countries started raising funds from the capital markets of developed nations. This mutual flow of capital led to the global integration of equity markets.

Indian companies have also gained from this integration. They raise equity capital from international markets by issuing ADRs and GDRs, and many prominent Indian companies have their shares traded on foreign stock exchanges. Foreign Institutional Investors (FIIs) also invest heavily in Indian stocks. Consequently, the Indian equity market has become an integral part of the global equity market.

The international equity market is a global marketplace where companies from one country can issue and trade their shares in other countries, and investors can buy and sell shares of foreign companies. It allows businesses to raise equity capital from international investors and gives investors the opportunity to diversify their investments across different countries. In this market, shares may be listed on multiple foreign stock exchanges, and instruments like ADRs and GDRs are often used to facilitate cross-border trading.

◇ **Components of the International Equity Market**

1. Primary Market

In the primary market, companies raise capital by issuing new shares to international investors. This is done through Initial Public Offerings (IPOs), Follow-on Public Offers (FPOs), and cross-border listings.

2. Secondary Market

The secondary market allows investors to trade existing shares among themselves. Prices are determined by demand and supply, influenced by global economic conditions, company performance, and investor sentiment.

3. Depositary Receipts (DRs)

Companies raise equity internationally through instruments like American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs), which represent shares of foreign companies traded on international exchanges.



◇ **Features of the International Equity Market**

1. Global reach and cross-border capital flow
2. High liquidity in major exchanges
3. Price discovery based on global information
4. Diverse investment opportunities
5. Exposure to foreign exchange risk.

◇ **Participants in the International Equity Market**

1. Individual and institutional investors
2. Mutual funds and pension funds
3. Foreign Institutional Investors (FIIs)
4. Investment banks and brokers
5. Multinational corporations
6. Regulatory authorities

The international equity market plays a vital role in the global financial system by connecting investors and companies across nations. It supports economic growth, encourages global investment, and provides opportunities for diversification. However, investors must carefully manage associated risks such as currency fluctuations and political uncertainty to fully benefit from participation in international equity markets.

6.1.2 Depository Receipts

Depository receipts are negotiable receipts which evidence the deposit of foreign securities. These receipts are easily transferable and are typically traded on stock exchanges. The most common forms are American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs). ADRs are listed on stock exchanges in the United States, while GDRs are generally traded on European exchanges. Each depository receipt corresponds to a certain number of underlying shares held by a custodian in the issuing company's home country.

Advantages to Issuers

Depository receipts have become an important tool for companies looking to expand their presence in global financial markets. By allowing firms to raise capital and gain visibility among international investors without directly listing on foreign exchanges, DRs offer several strategic advantages. For issuers, they provide opportunities to access broader markets, enhance liquidity, and strengthen their global brand—all while maintaining compliance within their home regulatory environment.

1. **Access to International Capital** – By issuing shares in foreign markets through ADRs or GDRs, a company can tap into a much larger pool of funds than what is available domestically. This provides the company with additional capital to fund expansion projects, research and development, or other strategic initiatives without depending solely on the home market.

2. **Diversify Shareholder Base** – Attracting investors from multiple countries spreads ownership across a broader group of shareholders. This reduces dependence on domestic investors, lowers risk concentration, and can provide more stability in the company's stock performance.
3. **Boost Domestic Share Price** – When foreign investors show strong interest in a company's shares, it can create higher demand both internationally and domestically. This increased demand often reflects positively on the company's valuation, helping to raise its share price in the home market.
4. **Improve Liquidity** – Listing shares on multiple international exchanges increases the number of potential buyers and sellers. This larger market makes it easier for investors to trade shares quickly and at fair prices, improving overall liquidity.
5. **Enhance International Visibility** – Being present in global markets raises the company's profile among international investors, partners, and customers. This visibility can strengthen the brand, attract strategic partnerships, and enhance credibility in the global business community.
6. **Support Mergers and Acquisitions** – Depository receipts can be used as a form of acquisition currency in cross-border mergers or takeovers. Companies can use ADRs or GDRs to acquire foreign firms without needing large cash reserves, simplifying international expansion and strategic growth.

Advantages to Investors

Depository receipts (DRs) offer several benefits to investors compared to directly investing in foreign equities:

1. **Simplified Investment Process:** DRs eliminate the complexities associated with purchasing foreign securities directly, which often arise due to delays or inconsistencies in obtaining market information. In international markets, differences in quotation methods and time lags make timely decision-making even more difficult.
2. **Fewer Regulatory Hurdles:** Direct investment in foreign equities is subject to restrictions on buying, selling, and physically transferring stock certificates. DRs help investors avoid these obstacles.
3. **Better Access to Corporate Information:** DR holders receive accurate and timely information about corporate activities such as meetings, dividend declarations, mergers, acquisitions, and other significant decisions. The depository bank ensures that investors stay well-informed about their holdings.
4. **Convenient Currency Management:** DRs spare investors from handling currency conversion. For example, dividends from the underlying shares of ADRs are collected and converted into U.S. dollars by the custodian bank before being paid to the investor. In contrast, direct foreign equity investors must collect dividends themselves and perform the currency conversion.



Overall, depository receipts provide a simpler, safer, and more convenient way to invest in foreign equities, combining ease of access, regulatory compliance, and timely information with efficient handling of foreign currency.

6.1.3 ADRs and GDRs

1. American Depositary Receipts (ADRs)

An American Depositary Receipt (ADR) is a financial instrument that represents a specified number of shares of a company based outside the United States. These receipts are issued to investors by a U.S. depository bank. Once issued, ADRs are listed on U.S. stock exchanges and trade just like any other domestic shares. This system enables foreign companies to attract investment and raise capital in the U.S. market without directly listing their equity on an American exchange, which is typically more costly.

The depository bank holds the actual shares of the foreign company and issues ADRs—denominated in U.S. dollars—to investors. These receipts may be traded on major U.S. exchanges such as the NYSE and NASDAQ, or in the over-the-counter market. American investors who purchase ADRs receive dividends and capital gains in U.S. dollars, though these amounts are subject to foreign exchange fees and applicable taxes.

In short, ADRs are certificates issued by a U.S. bank representing a specified number of shares of a foreign company. They allow U.S. investors to invest in foreign companies without dealing with foreign stock exchanges or currencies.

Characteristics of ADR

- ◇ Traded on U.S. stock exchanges (like NYSE or NASDAQ).
- ◇ Denominated in U.S. dollars.
- ◇ Dividends from underlying shares are collected and converted into dollars by the depository bank.
- ◇ Help foreign companies raise capital from U.S. investors and increase their visibility in the U.S. market.

Example: Infosys issued ADRs in 1999 to raise funds from American investors and list its shares on NASDAQ.

2. Global Depositary Receipts (GDRs)

GDRs are certificates issued by international banks representing shares of a company, allowing it to raise equity in multiple foreign markets simultaneously (except the U.S., which is handled via ADRs). By issuing Global Depositary Receipts (GDRs), a company can access capital from financial markets in multiple countries and have its securities traded on several stock exchanges at the same time. While GDRs function similarly to ADRs, they offer certain additional advantages to the issuing firm. The additional benefits are :

- ◇ Lower Expenses: Raising funds through depositary receipts in the foreign market can lower expenses for the firm than raising funds by issuing equity shares in the primary market of the foreign country directly.
- ◇ Liquidity for Investors: This depositary receipt traded on the stock exchange can provide liquidity to the foreign investor.

Characteristics of GDR:

- i. Traded on European or other international stock exchanges (like London or Luxembourg).
- ii. Denominated in major currencies like USD, EUR, or GBP.
- iii. Provide access to a broad international investor base.
- iv. Useful for raising funds, enhancing global visibility, and diversifying shareholder base.

Example: Indian companies like ICICI Bank, Wipro, and Tata Motors have issued GDRs to attract investors from Europe and Asia.

6.1.4 Mechanism of Issue of Depositary Receipts

The issuance of depositary receipts involves multiple parties, each with a specific role. Understanding these roles is essential before discussing the process.

Key Parties in a DR Issue:

1. Lead Manager: Typically, an investment bank, the lead manager guides the company throughout the DR issuance process. They help structure the issue, coordinate with other parties, and keep investors informed about the company's performance.
2. Depository: This financial institution receives confirmation of share deposits and issues the corresponding Depositary Receipts. Since it serves both the company and the investors, it receives fees from both parties.
3. Custodian Bank: Responsible for holding the underlying shares and related assets, such as dividends. The custodian is appointed by the depository in consultation with the issuing company.
4. Clearing Systems: Systems such as CEDEL (London), EUROCLEAR (Brussels), and Depository Trust Company (DTC, USA) maintain detailed records of DRs and their holders, ensuring accurate and transparent tracking.

DR Issue Process

The process of issuing DRs involves several preparatory and procedural steps:

1. The investor contacts a broker to purchase DRs of a company. If existing DRs are not available, the process for issuing new DRs begins.
2. The investor's broker communicates with a local broker in the company's home market.



3. The company, with the lead manager, decides the issue size and price. At the same time, the depository and custodian bank are appointed, and the company prepares to launch the DR issue.
4. The local broker purchases the ordinary shares on an exchange in the local market.
5. Ordinary shares are deposited with the local custodian.
6. The local custodian then instructs the depository to issue DRs that represent the shares received.
7. The depository issues DRs and delivers them in a physical form or a book entry form through the applicable clearing system to the DR broker.
8. The broker delivers the DRs to the investor thus completing the issuance process.

This structured process ensures that DRs are issued efficiently and that both investors and the issuing company are properly served.

6.1.5 IDR (Indian Depository Receipt)

An Indian Depository Receipt (IDR) is a financial instrument that enables foreign companies to raise funds in India by issuing receipts that represent their equity shares. IDRs allow Indian investors to invest in foreign companies without directly accessing overseas stock markets.

Features of IDR:

1. **Representation of Foreign Shares:** Each IDR corresponds to a certain number of shares of a foreign company held by a custodian outside India.
2. **Traded in India:** IDRs are listed and traded on Indian stock exchanges, just like regular domestic shares.
3. **Transactions in Indian Rupees:** All trading and dividend payments are made in Indian currency, eliminating the need for currency conversion.
4. **Investor Protection:** Indian regulations ensure transparency and safeguard investor interests, similar to domestic equity rules.

Purpose of IDRs:

- ◇ Provide foreign companies with access to Indian capital markets.
- ◇ Offer Indian investors an opportunity to diversify their investments internationally.
- ◇ Help foreign companies raise funds and enhance their global visibility without listing directly on foreign exchanges.

Example: A foreign technology company wants to raise capital in India. It deposits its shares with a custodian abroad, and IDRs representing those shares are issued in India. Indian investors can then buy and trade these IDRs on Indian stock exchanges.

Recap

- ◇ The international equity market is a worldwide platform that allows companies to issue and trade their shares abroad and enables investors to buy and sell stocks of foreign firms.
- ◇ Depository receipts are negotiable receipts which evidence the deposit of foreign securities.
- ◇ An American Depositary Receipt (ADR) is a financial instrument that represents a specified number of shares of a company based outside the United States.
- ◇ A Global Depositary Receipt (GDR) is a financial instrument that represents shares of a foreign company and allows them to be traded simultaneously in multiple international markets.
- ◇ The mechanism of a GDR issue involves a foreign company depositing its shares with an international depository bank, which then issues tradable receipts to global investors on overseas stock exchanges
- ◇ An Indian Depositary Receipt (IDR) is a financial instrument that enables foreign companies to raise funds in India by issuing receipts that represent their equity shares.

Objective Questions

1. A Depository Receipt represents?
2. Which institution issues American Depositary Receipts (ADR)?
3. The Depository Receipts primarily listed on European stock exchanges is known as?
4. The mechanism of issuing DRs involves the foreign company depositing its shares with
5. IDR stands for:
6. Global participation in stock trading is mainly facilitated through?
7. GDRs are generally denominated in?
8. What is the role of a custodian bank?

Answers

1. Ownership of shares held in a foreign company
2. U.S. Depository banks
3. GDR
4. Depository bank
5. Indian Depository Receipt
6. Depository receipts.
7. Euros or U.S. Dollars
8. To hold the underlying shares on behalf of the depository bank.

Self Assessment Questions

1. Explain global financial markets?
2. Write a short note on international equity market.
3. What do you mean by Depository Receipts?
4. Describe ADR?
5. What are the benefits offered by GDR when compared to ADR?
6. Describe the parties involved in issue of Depository Receipts/
7. Explain what is IDR
8. Briefly explain the process of issuing Depository Receipts?

Assignment Questions

1. A foreign company wants to raise funds from Indian investors without directly listing in India. Explain how it can do so.
2. A company is considering issuing a GDR to raise capital in Europe and the U.S. Discuss the potential benefits and challenges it might face.
3. Compare the advantages a company gains by issuing ADRs versus directly listing its shares on a foreign stock exchange.

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Unit

International Bond Market

Learning Outcomes

After the completion of this unit the learner will be able to;

- ◇ comprehend the concept of international bonds
- ◇ describe international bond market
- ◇ differentiate domestic bond and international bond.

Prerequisite

Global Tech Ltd. an Indian technology company, plans to expand its operations internationally and requires substantial capital to fund its growth. Initially, the company considers raising funds through the domestic bond market, where bonds are issued in the home currency and primarily targeted at local investors. While this option is easier to manage and aligns with domestic regulations but it limits the company in terms of the amount of capital it can raise and the diversity of its investor base. To overcome these limitations, Global Tech explores the international bond market, issuing bonds in foreign currencies such as U.S. Dollars or Euros. These bonds can be purchased by investors across the world, providing the company with access to a much larger pool of funds, potentially lower interest rates, and greater financial flexibility. This example demonstrates that while the domestic bond market is suitable for local financing needs, the international bond market allows companies to raise capital on a global scale, diversify their funding sources, and attract international investors.

Keywords

Domestic bond market, International bond, international bond market

Discussion

In January 2025, Tata Capital Ltd., part of a major Indian corporate group, raised US\$ 400 million through its first bond issue in the international market. The bonds were issued in U.S. dollars, had a maturity of 3.5 years, and carried a fixed interest rate of 5.389%. The issue attracted investors from Asia and Europe, and demand was very strong, with orders exceeding four times the amount offered. By issuing bonds internationally, Tata Capital was able to reach a wider range of global investors and likely obtained better borrowing terms than if it had issued bonds only in India. This example shows how companies can use international bond markets to raise funds globally, access diverse investors, and take advantage of currency and cost benefits.

6.2.1 International Bonds

Bonds are long-term debt instruments used to raise funds. When a company raises long-term funds from foreign countries and in foreign currencies, the bonds issued are called international bonds.

International bonds are debt securities issued by governments, corporations, or financial institutions in a country other than the investor's home country or outside the issuer's domestic market. They are a major component of the global debt market and allow issuers to raise capital from international investors while offering investors opportunities to diversify their fixed-income portfolios globally.

◇ Meaning

International bonds are borrowed funds raised in the global capital market, denominated in a foreign currency, and usually traded across borders. Investors receive periodic interest payments (coupons) and principal repayment at maturity.

Types of International Bonds

These mainly include :

- ◇ Foreign bonds,
- ◇ Euro bonds, and
- ◇ Global bonds.



1. **Foreign bonds** are issued in another country and are denominated in that country's currency. For example, If an Indian company issues bonds in Japan in Japanese Yen, these are foreign bonds.
2. **Euro bonds** are also issued in a foreign country, but they are not denominated in that country's currency. For example, If an Indian company issues US dollar bonds in any country other than the USA, they are Euro bonds. Foreign bonds follow the rules of the country where they are issued, while Euro bonds are usually free from such regulations since they use a different currency.
3. **Global bonds** are foreign-currency bonds that are offered at the same time in several countries. They are usually issued in major world currencies like the US dollar, Euro, Yen, or Australian dollar. The World Bank issued the first global bond in 1989. Today, many large companies also issue them.

Specific names also exist for some foreign bonds:

- ◇ Yankee bonds: US-dollar bonds issued in the USA by foreign entities.
- ◇ Samurai bonds: Yen-denominated bonds issued in Japan by foreign entities.

Issuers often add special features to international bonds to attract global investors. Depending on these features, bonds can be straight bonds, floating rate notes, convertible bonds, zero-coupon bonds, callable or puttable bonds, or sinking-fund bonds.

6.2.1.1 Other Types of International Bonds Based on Features

International bonds can also be classified according to special features or options embedded in them. These features make bonds more flexible and attractive to investors, while allowing issuers to manage their financing more efficiently. Some common types include:

1. Straight (Fixed-Rate) Bonds

Straight bonds, also called fixed-rate bonds, carry a fixed interest rate that remains constant throughout the life of the bond. Investors receive regular interest payments (coupons) until maturity, at which point the principal amount is repaid. These bonds are simple and predictable, making them popular among conservative investors.

2. Floating Rate Notes (FRNs)

Floating rate notes have variable interest rates that are linked to market benchmarks, such as LIBOR, EURIBOR, or another reference rate. The interest payments adjust periodically based on changes in these benchmarks. FRNs protect investors against rising interest rates and are often used in volatile interest rate environments.

3. Zero-Coupon Bonds

Zero-coupon bonds are issued at a discount to their face value and do not pay periodic interest. Instead, investors receive the full face value at maturity, earning a return from the difference between the purchase price and the maturity amount. These bonds are attractive to investors who prefer lump-sum returns in the future.

4. Convertible Bonds

Convertible bonds give investors the option to convert the bond into a predetermined number of shares of the issuing company after a specific period. This feature allows investors to benefit from potential equity price appreciation while still receiving fixed interest until conversion.

5. Callable Bonds

Callable bonds give the issuer the right to redeem the bond before its maturity date, usually at a specified call price. This feature is advantageous for issuers if interest rates fall, as they can refinance at a lower cost. However, it introduces reinvestment risk for investors, as they may have to reinvest funds at lower rates.

6. Puttable Bonds

Puttable bonds give the investor the right to sell the bond back to the issuer before maturity, usually at a pre-specified price. This provides protection to investors against interest rate rises or credit deterioration of the issuer, making these bonds less risky for holders.

7. Sinking Fund Bonds

Sinking fund bonds require the issuer to set aside money periodically in a sinking fund to repay the principal at maturity. This reduces default risk for investors and ensures that funds are available to redeem the bond gradually rather than all at once at maturity.

Features of International Bonds

1. Issued in Foreign Markets

International bonds are issued outside the issuer's home country. This allows companies and governments to tap into global financial markets and reach international investors.

2. Denominated in Foreign Currencies

These bonds are usually issued in widely accepted global currencies such as the US dollar, Euro, Japanese Yen, or British Pound. The choice of currency often depends on investor demand and interest rate advantages.

3. Access to a Global Investor Base

International bonds attract investors from different countries, increasing the chances of raising large amounts of capital. This broader investor participation can also reduce borrowing costs.

4. Different Regulatory Environments

Depending on the type of international bond, regulatory requirements vary:

- ◇ Foreign bonds follow the rules of the country where they are issued.
- ◇ Euro bonds have fewer regulations because they are not issued in the currency of that country.

This regulatory flexibility makes some international bonds more attractive.

5. Lower Borrowing Costs

Interest rates differ across countries. By issuing bonds in foreign markets, companies may find lower interest rates, helping them reduce financing costs compared to borrowing domestically.

6. Different bonds with varied features

International bonds come with different structures and features to meet investor preferences. Common types include:

- ◇ Straight (fixed-rate) bonds
- ◇ Floating-rate notes
- ◇ Zero-coupon bonds
- ◇ Convertible bonds
- ◇ Callable and puttable bonds
- ◇ Sinking fund bonds

This variety provides flexibility for both issuers and investors.

7. Exposure to Foreign Exchange Risk

Since these bonds involve foreign currencies, issuers and investors may face foreign exchange risk. Changes in currency value can affect the cost of repayment and investment returns.

8. Active Secondary Market

Many international bonds, especially Euro bonds, are traded in active secondary markets. They are often listed on European exchanges and traded over the counter (OTC), providing liquidity to investors.

9. Large Issue Sizes

International bonds typically involve larger issue sizes because they target global investors. This helps multinational companies and governments raise substantial long-term funds.

10. Used by Both Developed and Developing Countries

Originally dominated by developed nations, the international bond market is now widely used by emerging markets as well. Governments and corporations from developing countries issue these bonds to access cheaper and diversified financing.

6.2.2 International Bond Market

International bond market is the part of the international financial system where international bonds are issued and traded. Companies may choose to raise funds through international bonds instead of domestic bonds for several reasons. One major reason is that interest rates differ across countries. Borrowing in a currency with lower interest rates helps reduce overall financing costs.

Foreign bonds and Euro bonds are the two popular types of international bonds. Foreign bonds began to be issued during the 1950s. Issuers from different countries issued bonds in the US financial markets to raise US dollars which were in much demand at the time. These bonds were known as Yankee bonds. In the 1960s, the US government began to impose restrictions on the issue of Yankee bonds by foreign issuers. These restrictions prompted the issuers to issue dollar denominated bonds in other countries, mostly in Europe. These bonds then came to be known as Euro bonds. The first Euro bond issue was made in 1963 by Autostrade, an Italian company, through an issue of Euro dollar bonds. Euro bonds gradually became quite popular because they were free from statutory obligations. After the 1980s, the volume of business in Euro bonds increased substantially. The Euro bond market is the largest international bond market even though bonds are issued by foreign issuers in different countries. A major portion of Euro bonds is denominated in US dollars, though they can be denominated in other currencies also. As the euro is emerging as a strong currency, Euro bonds denominated in Euros are likely to be issued in large volumes in future. Although traditionally, issuers from the OECD countries have dominated the Euro bond market, governments and corporations from emerging markets of developing countries are also increasingly using the Euro bond market.

A secondary market for Euro bonds has developed as well. Many Euro bonds are listed on European stock exchanges, and underwriters often act as market makers. Over-the-counter trading among dealers and brokers is also common.

In addition to the Euro bond market, European countries allow foreign borrowers to issue bonds in their currencies—such as Sterling bonds in the UK—which are considered foreign bonds.

International bond markets have also grown in Asia and Latin America. Governments and multinational companies in these regions use these markets to lower borrowing costs. Foreign borrowers can access Yen-based bond financing in Japan through public issues known as Samurai bonds and private placements called Shibosai bonds.

Samurai bonds are Yen-denominated bonds issued in Japan by foreign governments, companies, or institutions. They are publicly offered in the Japanese financial market and must follow Japan's strict regulatory and disclosure requirements. Because they are public issues, they are accessible to a wide range of investors in Japan, making them a popular way for foreign borrowers to raise funds in Yen.



Shibosai bonds, on the other hand, are also Yen-denominated bonds issued in Japan by foreign entities but are privately placed. This means they are sold only to selected institutional investors such as banks or large financial firms. Shibosai bonds usually face fewer regulatory requirements and less disclosure compared to Samurai bonds, making them a more flexible option for issuers looking for quicker or more customized financing in Yen.

6.2.3 Concept of Domestic Bond

Domestic bonds are bonds issued within a country by its own government, public sector organizations, financial institutions, or local corporations. These bonds are denominated in the country's own currency and follow the laws, regulations, and disclosure requirements set by the national financial authorities or regulators such as the central bank or securities commission.

Domestic bonds are targeted mainly at local investors—such as banks, pension funds, insurance companies, and individual investors—who are familiar with the country's economic conditions. Because they are issued in the home currency, domestic bonds do not expose investors to foreign exchange risk, making them a safer and more predictable investment compared to international bonds.

Borrowers choose to issue domestic bonds when they want to raise funds within their own financial system, stay under local regulatory protection, and avoid the complexities of international markets. These bonds reflect the country's interest rates and fiscal policies, meaning their yields depend heavily on domestic factors such as inflation, economic growth, and government borrowing levels.

Domestic bond markets are important for the development of a nation's financial system because they provide a stable source of long-term financing for infrastructure, industry, and government projects. They also help deepen the financial markets by encouraging savings, investment, and efficient capital allocation within the economy.

Features of Domestic Bond

1. Issued Within the Home Country

Domestic bonds are issued in the issuer's own country. For example, the Indian government issues bonds in India to raise funds for infrastructure or social projects. These bonds are meant to mobilize local savings and support domestic development.

2. Denominated in Local Currency

Domestic bonds are always in the home currency, such as Indian Rupees (INR), US Dollars (USD), or Japanese Yen (JPY). This protects both investors and issuers from currency risk that arises in international bonds.

3. Regulated by Local Authorities

Domestic bonds must comply with rules of local financial regulators, such as the Securities and Exchange Board of India (SEBI) in India or the U.S. Securities and Exchange Commission (SEC) in the USA. These regulations ensure transparency, investor protection, and orderly market functioning.

4. Targeted at Domestic Investors

Domestic bonds are primarily aimed at local investors, including banks, insurance companies, mutual funds, pension funds, and individual savers. This creates a stable source of long-term financing for government or corporate projects.

5. Fixed or Floating Interest

Domestic bonds may have fixed interest rates (straight bonds) or floating rates that change based on market conditions. For example, a government bond may pay a fixed coupon of 6% per year, whereas a corporate floating-rate bond may pay interest tied to the repo rate or another benchmark.

6. Predictable and Stable Returns

Since domestic bonds are issued in local currency and follow local rules, they provide predictable returns and are generally considered low-risk investments compared to international bonds, which involve currency and geopolitical risks.

7. Mobilization of Local Funds

Domestic bonds are an important instrument for raising funds for national development, such as infrastructure, education, or healthcare projects. Corporations also use domestic bonds to finance expansion or working capital.

8. Liquidity in Local Markets

Government bonds are usually highly liquid and traded in local exchanges or over-the-counter (OTC) markets. Corporate bonds may have lower liquidity, depending on the issuer's reputation and demand.

9. Simplicity and Lower Costs

Issuing domestic bonds is simpler because they do not involve foreign currency transactions, international regulations, or cross-border legal complexities. This reduces issuance costs and administrative effort.

10. Limited Investor Base

The main limitation is that domestic bonds are restricted to local investors, which can limit the size of the funding raised compared to international bonds that tap into global capital markets.



Types of Domestic Bond

1. Government Bonds

Government bonds are issued by the central or state government to raise funds for public expenditure, such as infrastructure development, social programs, or fiscal needs. These bonds are considered very safe because they are backed by the creditworthiness of the government, making the risk of default extremely low.

Features:

- ◇ Fixed or floating interest rates
- ◇ Medium- to long-term maturity
- ◇ Highly liquid, especially central government bonds
- ◇ Often used as benchmarks for other interest rates in the country

Examples:

- ◇ Treasury Bills (T-Bills) – Short-term government securities with maturity less than one year
- ◇ Government Stock or Bonds – Medium- to long-term securities with regular interest payments
- ◇ State Development Loans (SDLs) – Bonds issued by state governments to fund state-specific projects

2. Corporate Bonds

Corporate bonds are issued by companies to raise funds for expansion, working capital, or new projects. These bonds generally carry higher risk than government bonds because repayment depends on the company's financial health, but they also offer higher interest rates to compensate investors for the additional risk.

Features:

- ◇ Can be fixed-rate or floating-rate
- ◇ May include special features such as convertibility into shares
- ◇ Subject to credit rating by rating agencies to indicate risk level
- ◇ Usually less liquid than government bonds, depending on market demand

Examples:

- ◇ Fixed-rate corporate bonds issued by large companies
- ◇ Floating-rate bonds linked to market benchmarks like the repo rate or LIBOR
- ◇ Debentures – Bonds backed by company assets or general credit

3. Special Feature Bonds

These are domestic bonds that include additional features to make them more flexible or attractive to investors. They are usually issued by corporations or sometimes by governments to meet specific funding needs.

Types and Features:

1. **Zero-Coupon Bonds** – Issued at a discount; no periodic interest; investors earn by receiving the full face value at maturity.
2. **Convertible Bonds** – Can be converted into shares of the issuing company after a predetermined period, allowing investors to benefit from equity appreciation.
3. **Callable Bonds** – Issuer can repay the bond before maturity, usually when interest rates fall, allowing them to refinance at a lower rate.
4. **Puttable Bonds** – Investor has the right to demand early repayment, providing protection against rising interest rates or issuer risk.
5. **Tax-Free Bonds** – Interest income is exempt from income tax, often issued by government-backed institutions to fund infrastructure or social projects.
6. **Sinking Fund Bonds** – Issuer sets aside money periodically in a sinking fund to ensure repayment at maturity, reducing default risk.

Purpose of Special Feature Bonds:

- ◇ Attract a wider range of investors
- ◇ Provide flexibility to issuers in managing interest payments and repayments
- ◇ Reduce risk for investors while offering potential higher returns or benefits

In short, domestic bonds can thus be classified into three broad categories:

1. **Government Bonds** – Low risk, backed by the government, stable returns.
2. **Corporate Bonds** – Higher risk and higher returns, issued by companies.
3. **Special Feature Bonds** – Include additional features like zero-coupon, convertible, callable, puttable, tax-free, and sinking fund bonds, offering flexibility to issuers and investors.

Difference Between International Bond and Domestic Bonds

Basis of Difference	International Bonds	Domestic Bonds
Meaning	Bonds issued outside the issuer's home country, often in a foreign currency.	Bonds issued within the issuer's own country and in the domestic currency.
Currency	Usually denominated in foreign currencies (USD, Euro, Yen, etc.).	Always denominated in the home country's currency.
Regulations	Must follow regulations of foreign markets or international markets.	Must follow the laws and regulations of the home country.
Investor Base	Investors from multiple countries; global participation.	Mostly local investors within the home country.
Foreign Exchange Risk	High exposure to currency fluctuations.	No foreign exchange risk, as currency is domestic.
Issuance Complexity	More complex; requires international underwriting and documentation.	Easier to issue; simpler regulatory procedures.
Cost of Borrowing	Potentially lower if foreign interest rates are favorable.	Depends entirely on domestic interest rates; may be higher.
Types	Foreign bonds, Euro bonds, Global bonds (e.g., Samurai, Yankee).	Government bonds, corporate bonds issued domestically.
Market Size	Larger global capital availability.	Limited to the domestic market.
Purpose	Used to access cheaper funds and diversify funding sources.	Used to raise funds locally and avoid currency/market complications.

Recap

- ◇ When a company raises long-term funds from foreign countries and in foreign currencies, the bonds issued are called international bonds.
- ◇ International bond market is the part of the international financial system where international bonds are issued and traded.
- ◇ Samurai bonds are Yen-denominated bonds issued in Japan by foreign governments, companies, or institutions.
- ◇ Shibosai bonds are also Yen-denominated bonds issued in Japan by foreign entities but are privately placed.
- ◇ Domestic bonds are bonds issued within a country by its own government, public sector organizations, financial institutions, or local corporations.
- ◇ Domestic bonds are classified into three broad categories; Government Bonds , Corporate Bonds and Special Feature Bonds.

Objective Questions

1. The International Bond Market refers to:
2. The type of bond in which issuer sets aside money periodically in a sinking fund to ensure repayment at maturity, reducing default risk?
3. Samurai Bonds are issued in which market?
4. The Domestic Bond Market includes
5. bond that can be converted into equity shares is known as
6. The bonds that are meant to mobilize local savings and support domestic development.
7. Investors in domestic bond are protected from
8. Privately placed Samurai Bonds in Japan is known as?

Answers

1. Trading of bonds outside the issuer's home country.
2. Sinking Fund Bond
3. Japanese Market
4. Bonds issued and traded within the home country
5. Convertible bond.
6. Domestic bond
7. The currency risk
8. Shibosai bond

Self Assessment Questions

1. Explain international bonds?
2. Briefly explain international bond market
3. Differentiate between international bond and domestic bond?
4. What is domestic bond?
5. What are the features of international bond?
6. Explain the features of domestic bond?

Assignment Questions

1. A government wants to raise funds from within its own country in local currency. Which type of bond should it issue? Explain your answer?
2. Discuss why do developing countries prefer issuing bonds in international markets rather than domestic markets?
3. Examine how political risk and regulatory differences affect international bond market operations?
4. "The international bond market is a double-edged sword for emerging economies"- Critically analyze this statement

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Unit

Foreign Bonds

Learning Outcomes

After the completion of this unit the learner will be able to;

- ◇ familiarise with the concept of foreign bond
- ◇ distinguish between FCCBs and FCEBs
- ◇ explain the parties involved in issue of FCEBs
- ◇ assess the merits and demerits of participatory notes

Prerequisite

TechNova, a fast-growing Indian technology startup, has developed a revolutionary software platform and now plans to expand into the U.S., Europe, and Japan. To fund this expansion, the company needs to raise a large amount of capital and is exploring ways to attract foreign investors alongside domestic ones. While considering its options, TechNova looks at issuing bonds in foreign countries, offering bonds that could later be converted into shares, or enabling investors to participate indirectly through special financial instruments. As the company weighs these possibilities, it begins to explore the various ways international financial markets can support its growth, opening the door to concepts such as foreign bonds, convertible and exchangeable bonds, and participatory notes

Keywords

Foreign currency convertible bonds, Foreign currency exchangeable bonds, participatory notes.

Discussion

A significant aspect of running any large organization—whether a private corporation or a government—is the ability to secure adequate capital to fund operations, invest in growth, and meet strategic objectives. While domestic capital markets provide one avenue, entities often look beyond their borders to access deeper or more cost-effective pools of global liquidity. One major route for raising such cross-border capital is through foreign securities, which take several forms, including foreign bonds, foreign currency convertible bonds (FCCBs), foreign currency exchangeable bonds (FCEBs), and participatory notes (P-notes).

6.3.1 Foreign Bonds

A foreign bond can be defined as a bond that has been issued by a company or government agency that has operations in one country but is offered to investors located in foreign countries. These bonds are made available to these investors in the currencies that prevail in their countries. Take, for instance, a company that is located in India issues bonds and offers them to investors located in Canada in Canadian Dollars.

Foreign bonds are debt securities issued by a foreign entity in the domestic market of another country and are denominated in the currency of that country. They are a way for foreign borrowers to raise capital in a specific country's market, allowing investors to lend in their local currency without taking currency risk.

6.3.1.1 Types of Foreign Bonds

1. Yankee Bonds

These foreign bonds are U.S. dollar-denominated bonds that are issued by foreign borrowers within the American bond markets. Yankee bonds are typically issued by foreign governments, supranational institutions (beyond any one nation or created by several countries collectively), or highly rated corporate borrowers. These bonds must comply with the regulatory requirements of the U.S. Securities and Exchange Commission (SEC), which ensures that international bond issues are properly regulated and fully disclosed. Issuers of Yankee bonds must follow U.S. accounting standards and obtain credit ratings from American credit rating agencies rather than foreign ones. The bonds are sponsored by a U.S. underwriting syndicate, which must be registered with the SEC before the bonds can be offered for sale in the American market. Among Indian companies, Reliance Industries Ltd. has been a successful and pioneering issuer of Yankee bonds.

2. Samurai Bonds

These foreign bonds are issued in domestic Japanese markets by borrowers who aren't Japanese. Borrowers are required to have at least a minimum investment grade rating (i.e., A) and are supranational. The time frame for the maturity of these bonds ranges between 3 to 20 years. While supranational and their entities are given priority,



sovereigns along with quality private corporations may also be permitted to issue Samurai bonds. If they happen to have Japanese trade links, they are likely to be given more priority as well. The settlement and administrative procedures associated with these registered bonds are expensive.

3. Bulldog Bonds

These foreign bonds are available in the UK domestic securities market and are sterling (currency of U K) denominated. The time frame needed for maturity ranges from 5 years to 25 years or greater.

4. Matador Bonds (Spain)

Matador bonds are issued in the Spanish domestic market by foreign entities seeking to raise capital from Spanish investors. These bonds are denominated in euros and are subject to Spain's financial regulations. Foreign borrowers choose Matador bonds when they want to diversify their investor base within the eurozone or take advantage of favorable interest rate conditions in Spain. They allow issuers to access a stable European market while offering investors exposure to international credits without currency risk.

5. Rembrandt Bonds (Netherlands)

Rembrandt bonds are issued in the Netherlands by non-Dutch borrowers who want to tap into the Dutch capital market. These bonds are typically denominated in euros and comply with Dutch financial and legal standards. Issuers often choose Rembrandt bonds to reach Dutch institutional investors, who are known for their strong demand for high-quality international fixed-income securities. This market provides an attractive option for borrowers seeking efficient funding within the broader eurozone.

6. Maple Bonds (Canada)

Maple bonds are issued in the Canadian financial market by foreign organizations and are denominated in Canadian dollars. They offer international issuers the opportunity to raise funds from Canadian investors, who benefit from gaining exposure to foreign credits without taking on currency risk. Maple bonds gained popularity as Canada's capital markets matured, offering competitive interest rates and strong investor demand. They are commonly used by global corporations, financial institutions, and even sovereign issuers.

7. Kangaroo Bonds (Australia)

Kangaroo bonds are issued by foreign entities in Australia and are denominated in Australian dollars (AUD). These instruments allow overseas borrowers to diversify their funding sources and access Australia's well-developed bond market, known for its robust regulatory framework. Investors benefit from exposure to international issuers while remaining invested in AUD-denominated assets. Issuers may also choose Kangaroo bonds to take advantage of favorable currency or interest rate conditions in Australia.

8. Kiwi Bonds (New Zealand)

Kiwi bonds are foreign-issued bonds sold in New Zealand and denominated in New Zealand dollars (NZD). They provide international borrowers with access to New Zealand's investor base, which includes pension funds, insurance companies, and retail investors. For local investors, Kiwi bonds offer a chance to invest in foreign credits without currency exchange concerns. These bonds are attractive when New Zealand's interest rate environment is favorable or when issuers seek diversification across Asia-Pacific markets.

9. Dim Sum Bonds (China—Offshore Market)

Dim Sum bonds are issued outside mainland China, primarily in Hong Kong by either Chinese or foreign entities, but always denominated in offshore Chinese yuan (CNH). They allow issuers to raise funds in yuan without dealing with mainland China's stricter capital controls. These bonds are popular among investors seeking RMB exposure. Issuers use Dim Sum bonds to access a global pool of investors interested in China's currency and economic growth while avoiding onshore regulatory restrictions.

10. Panda Bonds (China—Onshore Market)

Panda bonds are renminbi-denominated bonds issued *inside* mainland China by non-Chinese issuers. These bonds are regulated by Chinese authorities and give foreign entities access to China's large and rapidly growing domestic capital market. Panda bonds are attractive for issuers looking to establish a financial presence in China or finance operations related to Chinese markets. Investors benefit from gaining exposure to international issuers while staying within the regulated Chinese bond environment.

11. Shogun Bonds (Japan—Foreign Currency)

Shogun bonds are issued in Japan by foreign borrowers but denominated in a currency other than the Japanese yen. This distinguishes them from Samurai bonds (which are yen-denominated). Issuers choose Shogun bonds when they want access to Japanese investors but prefer to avoid yen exposure. Investors may be attracted to these bonds if they want foreign-currency instruments but prefer those issued under Japan's high-quality regulatory and market infrastructure.

6.3.2 Foreign Currency Convertible Bonds (FCCBs)

Foreign Currency Convertible Bonds (FCCBs) are unsecured, optionally convertible bonds issued in a currency other than the Indian rupee. They combine features of both debt and equity: they pay regular interest and principal like a standard bond, but also give holders the option to convert them into a predetermined number of the issuing company's equity shares at maturity. Both interest and the redemption amount (if not converted) are paid in foreign currency. FCCBs may be issued in any freely convertible currency, but the use of the proceeds must comply with External Commercial Borrowing (ECB) end-use regulations.

In addition to complying with ECB policies, the issuance of FCCBs must follow FEMA regulations and the provisions of the Issue of Foreign Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993.

Foreign investors favor FCCBs because they are serviced in dollars, offer a conversion option, and provide arbitrage opportunities when converted into equity at a discount to the prevailing Indian market price. Moreover, up to 25% of the funds raised through FCCBs may be used for general corporate restructuring.

Advantages to the Issuer Company

- ◇ As a Hybrid instrument, the coupon rate on FCCB is particularly lower than pure debt instrument there by reducing the debt financing cost.
- ◇ FCCBs are book value accretive on conversion. It saves risks of immediate equity dilution as in the case of public shares. Unlike debt, FCCB does not require any rating nor any covenant like securities, cover etc.
- ◇ It can be arranged within a month while pure debt takes a longer period to raise. Because the coupon is low and usually payable at the time of redeeming the instrument, the cost of withholding tax is also lower for FCCBs compared with other ECB instruments.

Advantages to the Investor

- ◇ It has the benefits of both equity and debt.
- ◇ It lets investors enjoy equity-like gains while the debt part protects them from big losses.
- ◇ Assured return on bond in the form of fixed coupon rate payments.
- ◇ Ability to take advantage of price appreciation in the stock by means of warrants attached to the bonds, which are activated when price of a stock reaches a certain point.
- ◇ Significant Yield to maturity (YTM) is guaranteed at maturity.
- ◇ Lower tax liability as compared to pure debt instruments due to lower coupon rate.

However, FCCBs also have notable disadvantages; the issuing company cannot be certain that bondholders will opt for conversion, making it difficult to plan its capital structure. Additionally, it is challenging to project the cash outflow required at maturity.

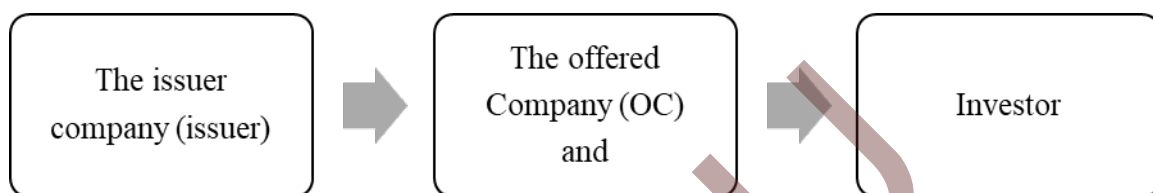
6.3.3 Foreign Currency Exchangeable Bonds (FCEBs)

The Foreign Currency Exchangeable Bonds Scheme, introduced in February 2008, offers Indian promoters a flexible way to raise funds overseas. It allows them to unlock value in their group companies without immediately diluting voting rights or control. The scheme became operational through A.P. (DIR Series) Circular No. 17, issued by the Reserve Bank of India on September 23, 2008, to enable the issuance of such bonds.

FCEB has been defined in the Scheme as 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”.

6.3.3.1 Parties of Foreign Currency Exchangeable bonds

The main parties in an FCEB are the issuer company, the offered company, and the investor. The issuer raises money by issuing FCEBs in foreign currency. Investors buy these bonds, and later they have the option to exchange them for shares of another company in the same promoter group, called the offered company.



As per the Scheme, the term “Issuing Company” has been defined to mean an Indian Company incorporated under the Companies Act, 1956. The term “Offered Company” has been defined to mean an Indian Company whose shares shall be offered in exchange of the FCEB. As per the Scheme both the Issuing Company and the Offered Company are required to be part of the same “Promoter Group”.

The offered company is the company whose shares can be received by investors if they choose to convert the FCEBs. It is usually a sister or group company of the issuer company, part of the same promoter group.

So in an FCEB:

- ◇ Issuer Company → Issues the bond to raise funds.
- ◇ Investor → Buys the bond and may later exchange it for shares.
- ◇ Offered Company → Provides the shares if the investor chooses to convert the bond.

6.3.3.2 Advantages of FCEBs

Advantages of the FCEB Scheme are the following:

1. Provides an additional way for Indian companies to raise funds from overseas.
2. Offers flexibility to promoters to raise money by leveraging their holdings in other promoter group companies.
3. No equity dilution occurs when raising funds through FCEBs.
4. No significant tax disadvantages are perceived under the scheme.

6.3.3.3 Disadvantages of FCEBs

1. Limited eligibility – Only listed companies in certain sectors where FDI is permitted can offer FCEBs, and only to the extent ECBs and FCCBs are allowed.
2. Restrictions on terms – Minimum maturity period, all-in-cost ceiling, and other conditions limit the scheme's benefits.
3. Limited use of proceeds – Funds can only be used for direct investments abroad or in promoter group companies.
4. Prior RBI approval required – Mandatory approval in all cases slows down the process, unlike certain ECBs under the automatic route.
5. No smooth implementation – Lack of exemptions for compliant FCEBs creates regulatory hurdles.
6. Weak bankruptcy protection – FCEB holders are unsecured creditors if the issuing company goes bankrupt before conversion; underlying shares are not automatically pledged.

6.3.4 Difference between FCCBs and FCEBs

The main difference between FCCBs and FCEBs lies in the shares they convert into. In FCCBs, the bonds convert into shares of the issuer company itself. In FCEBs, the bonds convert into shares of another company, called the offered company, which belongs to the same promoter group as the issuer.

Additionally, for FCCBs, when investors convert their bonds, the issuer company issues new shares for them. In contrast, for FCEBs, no new shares are issued. Instead, the issuer company transfers the shares it already holds in the offered company to the bondholder in exchange for the bonds.

The following are some of the differences:

1. **Nature of Bond:** FCCB is a bond that can be converted into the issuer's own shares, while FCEB is a bond that can be exchanged for shares of another company.
2. **Equity Dilution:** FCCB results in dilution of the issuer's equity, while FCEB results in dilution of the other company's equity, not the issuer.
3. **Purpose of Issuance:** FCCB is issued to raise foreign capital and offer investors potential equity upside, while FCEB is issued to monetize holdings in a subsidiary or associate company.
4. **Investor Benefit:** FCCB allows investors to benefit from the appreciation of the issuer's shares, while FCEB allows investors to benefit from the appreciation of another company's shares.

5. **Issuer Type:** FCCB is issued by a company directly seeking funds, while FCEB is issued by a company holding shares in another company.
6. **Use in Financing Strategy:** FCCB is used to finance growth, expansion, or debt restructuring, while FCEB is used to raise funds by selling holdings in another company.
7. **Conversion/Exchange Mechanism:** FCCB converts debt into the issuer's equity, while FCEB exchanges debt into equity of a different company.

6.3.5 Participatory Notes

Participatory Notes ("P-Notes") are a form of Offshore Derivative Instruments ("ODIs") that are issued by Foreign Institutional Investors ("FIIs") to entities that do not directly invest in the Indian public markets by registering themselves under the FII Regulations.

Participatory notes are used for making investments in the stock markets. However, they are not used within the country. They are used outside India for making investments in shares listed in the Indian stock market. That is why they are also called offshore derivative instruments.

In India, Foreign Institutional Investors (FIIs) and their sub-accounts commonly use Participatory Notes to enable their overseas clients to invest in Indian securities. These clients typically prefer not to participate directly in the Indian stock market, so P-Notes provide a convenient way for them to gain exposure without undergoing the formal registration process.

Access to the Indian capital market is restricted to SEBI-registered Foreign Institutional Investors (FIIs), so a pass-through system using Participatory Notes (P-Notes) has developed. These instruments allow high-net-worth individuals, hedge funds, and other foreign investors to invest in Indian markets without undergoing SEBI's registration process. This saves investors time, money, and regulatory scrutiny, while still allowing them to receive any dividends or capital gains from the underlying securities. However, Indian regulators remain cautious about P-Notes, fearing that hedge funds operating through them could increase volatility in the country's financial markets.

6.3.5.1 Flow of Participatory Notes or How Participatory Notes Function

1. **Issuance** – Participatory Notes are created and issued by Foreign Institutional Investors (FIIs) or brokers who are registered with SEBI. These registered entities provide P-Notes to foreign investors who want exposure to Indian markets but do not want to go through the registration process themselves.
2. **Investment Objective** – Foreign investors use P-Notes as a simpler route to invest in Indian shares. Since registering directly with SEBI can be time-



consuming and involves detailed compliance, P-Notes offer an easy alternative for investors seeking quick market access.

3. **Trading** – Investors purchase P-Notes, which function as offshore derivative instruments. These P-Notes derive their value from underlying Indian securities such as stocks, meaning the price of the P-Note reflects the performance of the Indian shares it is linked to.
4. **Investment Execution** – Once the investor buys the P-Note, the issuing FII or broker purchases the corresponding Indian securities in the local market. The investor gets economic benefits (like gains or losses) of the Indian shares without actually holding them directly.
5. **Reporting** – To ensure some level of monitoring, FIIs and brokers must submit monthly reports to SEBI detailing the P-Notes they have issued, including the total value and changes during the month. This helps maintain transparency in the use of P-Notes in Indian markets.

Advantages of Participatory Notes

- i. Participatory Notes can be easily traded in foreign countries via endorsement and delivery.
- ii. Participatory Notes are well known as investors, and hedge funds can enter Indian markets anonymously and go about their operations.
- iii. Some individuals and entities are investing through PNs so that they can benefit from tax laws in particular countries.
- iv. The investors do not require to register with SEBI but the FII need to register with it. P notes can enable the huge amount of investment without disclosing the identity of the investors.

Disadvantages of P- Notes

- i. P-Notes lack transparency because the identity of the final investor is not always revealed.
- ii. They can be misused for money laundering or round-tripping due to their anonymity.
- iii. Large inflows or outflows through P-Notes can create sudden volatility in the stock market.
- iv. Regulators face difficulty monitoring P-Notes since they rely on foreign intermediaries for information.
- v. India has limited control over P-Notes because they are issued outside the country.
- vi. Heavy reliance on P-Notes can hurt India's reputation for maintaining clean and transparent financial markets.
- vii. P-Notes may facilitate tax avoidance by routing investments through tax-friendly jurisdictions.

Recap

- ◇ A foreign bond is a bond issued by a company or government based in one country but sold to investors in another country.
- ◇ A Foreign Currency Convertible Bond (FCCB) is a bond issued in a foreign currency that gives investors the option to convert it into equity shares of the issuing company.
- ◇ A Foreign Currency Exchangeable Bond (FCEB) is a bond issued in a foreign currency that can be exchanged for equity shares of a group company of the issuer.
- ◇ A Participatory Note (P-Note) is a derivative instrument that allows foreign investors to invest in Indian securities without registering directly with Indian regulators.
- ◇ Foreign bonds are bonds issued by a foreign entity in another country's domestic market and currency, and common types include Yankee (U.S.), Samurai (Japan), Bulldog (U.K.), Matador (Spain), Rembrandt (Netherlands), Maple (Canada), Kangaroo (Australia), Kiwi (New Zealand), Dim Sum (offshore China), Panda (onshore China), and Shogun (Japan, foreign-currency) bonds.

Objective Questions

1. Yankee bonds are issued by foreign entities in which market?
2. Samurai bonds means?
3. The foreign bond issued in the U.K. market is known as
4. FCCBs allow investors to
5. FCCBs are issued in?
6. FCEBs differ from FCCBs because they are exchangeable into
7. Participatory Notes (P-Notes) allow foreign investors to invest in India without registering with which regulatory authority
8. Which entities issue Participatory Notes (P-Notes)?

Answers

1. U.S Market
2. Foreign bonds issued in Japan and denominated in yen
3. Bulldog bond
4. Convert the bond into equity of the issuing company
5. Foreign currency
6. Shares of a group company of the issuer
7. SEBI
8. SEBI-registered Foreign Institutional Investors (FIIs).

Self Assessment Questions

1. What is a foreign bond?
2. Explain the types of foreign bond?
3. Briefly explain Foreign Currency Exchangeable Bonds?
4. Explain the Parties in Foreign Currency Exchangeable bonds.
5. Write a short note on Foreign Currency Convertible Bond
6. What is one major difference between FCCBs and FCEBs?
7. Describe participatory Notes.
8. What is the primary purpose of P-Notes in Indian markets?

Assignment Questions

1. Discuss why companies choose to issue foreign bonds in overseas markets.
2. Identify an Indian company that has issued Foreign Currency Convertible Bonds (FCCBs) and explain the purpose of the issuance, its outcome, and the response from investors.
3. Discuss the regulatory issues associated with P-Notes and how SEBI addresses them.

4. Explain the concept of Foreign Currency Exchangeable Bonds (FCEBs) and how they differ from Foreign Currency Convertible Bonds (FCCBs). Illustrate your answer with an example.

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Suggested Readings

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FIRST SEMESTER, BACHELOR OF COMMERCE (B. COM) EXAMINATION
DISCIPLINE SPECIFIC ELECTIVE COURSES(DE)- B21CM02DE -
International Banking and Finance
2024-25 - Admission Onwards-Set-1

Time: 3 Hours

Max Marks: 70

Section A

Answer any ten of the following questions in one or two sentences

(10×1=10)

1. Define banking?
2. What do you mean by foreign banks?
3. What are the primary functions of commercial banks?
4. What is retail banking?
5. What are the objectives of a central bank?
6. List out the important Milestones in RBI's History?
7. What is SLR?
8. How international banks support international trade?
9. What is representative offices?
10. What is international lending?
11. What is meant by balance of payments?
12. What is FPI?
13. What do you mean by international bonds?
14. What is a samurai bond?
15. What is FEMA?

Section B

Answer any five of the following questions in two or three sentences.

(5×2=10)

16. Explain any two features of non-scheduled banks?
17. State the secondary functions of banks?
18. What are the merits of core banking?

19. List out the factors affecting credit creation?
20. State the objectives of the central bank?
21. What is Corporate and holding company OFCs?
22. State the importance of international finance.
23. Who are the participants in Foreign Exchange Market?
24. List out the benefits offered by depository receipts to investors?
25. What are the types of international bonds?

Section C

Answer any six of the following questions in one paragraph.

(6×5=30)

26. Short note on Quantitative credit control methods followed by RBI?
27. Briefly explain the modes of international banking?
28. State the difference Between International Banking and Multinational Banking?
29. Elaborate on the risks involved in international lending.
30. “The scope of international finance is broad, covering numerous aspects of financial interactions among nations”- Justify .
31. Explain the key features of FEMA.
32. Explain IDR and its features.
33. What are the merits of core banking?

Section D

Answer any two of the following questions in 300 words.

(2×15 = 30)

34. Describe retail banking products and services.
35. “The Reserve Bank of India (RBI) acts as the heart of Indian economy, pumping and regulating the flow of money to keep the entire economy healthy, stable, and growing”. Justify the statement by explaining the functions of RBI?
36. Explain Retail and Wholesale Components of the Indian Foreign Exchange Market.
37. Explain Foreign Currency Exchangeable Bond and how it differs from Foreign Currency Convertible Bond.



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**FIRST SEMESTER, BACHELOR OF COMMERCE (B. COM) EXAMINATION
DISCIPLINE SPECIFIC ELECTIVE COURSES(DE)- B21CM02DE -
International Banking and Finance**

2024-25 - Admission Onwards-Set-2

Time: 3 Hours

Max Marks: 70

Section A

Answer any ten of the following questions in one word or sentence.

(10×1= 10)

1. What is banking?
2. Define CORE banking?
3. What is CRR?
4. What are the features of core banking?
5. What is a Central Bank?
6. What is Repo and reverse Repo rate ?
7. What is international banking?
8. Differentiate international banking and domestic banking ?
9. What is correspondent banks?
10. What is credit risk in international banking?
11. What do you mean by OFCs?
12. What are the components of BOP?
13. What is FII?
14. What is Crawling Peg System?
15. What is GDR?

Section B

Answer any five of the following questions in one or two sentences.

(5×2=10)

16. State the objectives of banking?
17. List out the features of core banking?
18. State any two functions of the Reserve Bank of India.
19. Explain the classification of banks based on ownership?
20. Differentiate between debit card and credit card?

21. What are the benefits of international banking to individuals as well as to business?
22. Write a short note on types of international lending?
23. What is market risk in International banking?
24. Write a note on 'deficit in BOP'?
25. How FEDAI extends support to RBI?

Section C

Answer any four of the following questions in one paragraph.

(4×5=20)

26. Describe the functions of correspondent banks?
27. "International commercial banks play a critical role in the economic development of emerging economies"-Justify
28. Differentiate between International Bond and Domestic Bonds?
29. Explain the components of International equity market?
30. What are the methods of FDI?
31. Explain the features of foreign exchange market?
32. Discuss the benefits of international banking?
33. Describe the characteristics of a central bank?

Section D

Answer any two of the following questions in 300 words.

(2×15 = 30)

34. Explain the functions of banks?
35. Describe the modes of international banking?
36. Explain the risks involved in international lending along with the causes that increases each risk and how to manage them?
37. Describe exchange rate systems?



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