International Financial Management

Meaning of International Financial Management

Foundation Node

Management of international business related financial functions.

Goal

Maximize firm value and thereby maximize shareholder wealth. (This goal is applicable not only to firms that focus on domestic business but also to firms that focus on international business).

Context

Firms expand international business as a means of enhancing their value. Foreign markets can be distinctly different from local markets, creating an opportunity for improving the firm’s cash flows.

Reasons for investing abroad

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1. High returns

If there are hidden opportunities in international trade, a firm is encouraged to take the benefit of it. Raw-materials may be very inexpensive, or labour is very inexpensive, making production cost very low.

Example: BPO in India

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2. Taxation Benefits

Different countries have different taxation laws. Multinational companies face different tax laws. Under developed countries do have low tax rates with a view to attract foreign investments.

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3. Diversification

Spreading your investment risk among foreign companies and markets that are different than the Indian economy is obviously going to reduce your risk.

Reasons for investing abroad

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4. Growth

Companies may take advantage of the potential for growth in some foreign economies, particularly in emerging markets.

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5. Political stability

Sometimes certain countries have unstable government. Companies in such countries prefer to invest in other countries where governmental stability is a benefit.

Basic problems in International Financial Management

1. Foreign Exchange

An additional risk that a finance manager is required to cater to. Refers to the risk related to fluctuating prices of currency that has the potential to convert a profitable deal into a loss-making one.

2. Political Risks

Any change in the business economic environment of the country (Taxation Rules, Contract Act, or unforeseen government action). It pertains to the government that can change the rules of the game anytime, in an unexpected manner.

3. Market Imperfection

Due to market and product integration, the world economy faces differences across countries in transportation cost, taxation systems, etc. Imperfect markets force the finance manager to strive for the best opportunities across international borders.

Basic problems in International Financial Management

4. Enhanced Opportunity Set

By taking the business across national borders, a business expands its chances of reaping fruits of a different taste. Diversifies the overall risk of business to various nations.

5. Financing Facilities

The question of how to raise funds in foreign markets which is most appropriate to business conditions. Can be raised from internal or external sources. Normally companies prefer both the way simultaneously.

6. Banking Regulations

Global financial management must deal with multiple banking institutions that have problems of their own. Multilateral development banks (IMF, World Bank) give conditions to various countries and advise banks to avoid testing waters in riskier markets.

Foreign Currency Management

Foreign Currency Management involves two basic issues.

- Exchange Risk
- Exchange Risk Management

Exchange risk

- In every foreign transaction, a person needs to pay amount in foreign or domestic currency.
- Mostly seller/exporter prefers payment in domestic currency.
- When domestic currency is losing its value continuously, they prefer foreign currency.
- When seller's country's government encourages foreign currency incomes.
- When seller's country also accepts other currency than the home currency.

Foreign Currency Management

(1) Spot Exchange transactions

In these transactions foreign exchange is purchased or sold in spot market.

Example

Indian importer buys Yens in spot market to pay Japanese ball pen company on a date of payment.

(2) Forward Exchange Transactions

Buyer and seller contract with each other to exchange the currency on a particular future date at a present exchange rate.

Benefit

Buyer has to pay the amount at a future date but at the future date, buyer does not have to bear a burden of risk of change in foreign exchange rates.

Exchange risk management

(1) Forward Exchange Contracts: Used to hedge against the adverse movement in exchange rate.

The Scenario (Spot)

Indian importer buys goods of $1,00,000.

Gets 6 months credit period.

Current spot rate is 1 1 $ = ₹ 42.

The Risk

If exchange rate becomes ₹ 45 after 6 months, importer will have to pay more (₹ 3/$).

Total loss: ₹ 3,00,000.

The Solution

Make a contract of purchase in a forward market today.

Save from the risk of change in foreign exchanges.

Exchange risk management

Forward Exchange Contracts (Exporter Example)

The Scenario (Spot)

Exporter to USA exporting shirts.

Cost per shirt: ₹ 38.

Selling price: US $1 (paid after one month).

Exchange rate (spot): 1 US $ = ₹ 40.

He expects a profit of ₹ 2/shirt.

The Risk

When he receives payment after one month, the exchange rate may be ₹ 37/-.

He will suffer a loss of rupee one per shirt.

The Solution

Enter a forward exchange contract to sell dollars to bank after one month at a determined rate (e.g., ₹ 39.50).

He is assured of profit of ₹ 1.50 per shirt irrespective of what happens to payment.

Exchange risk management

(2) Future Contracts: A **contract** to buy or sell on the '**exchange**' a standard **quantity** of foreign **currency** at a **future date** at the price agreed. Standardised contracts traded on organized future markets, mostly cash settled.

(3) Options: Gives the buyer the option right but not the obligation to sell or buy a fixed amount of currency at a fixed price on a fixed future date.

1. Call Option: An option giving the buyer of the option, the right out not the obligation to **BUY** a currency.

2. Put Option: An option giving the buyer of an option, the right but not the obligation to **SELL** a currency.

3. Strike Price: The fixed price, at which, the buyer of option contract can exercise his option to buy/sell the currency.

4. Expiry Date: The last date on which the option may be exercised.

5. European Option: An option which can be exercised only on the specified date.

6. American Option: An option which can be exercised on any date up to expiry date.

Exchange risk management
(4) Currency Swaps

Two parties agree to pay each other's debt obligation denominated in different currencies. Involves exchange of principal amounts and interest payments.

Exchange Rate: 1 GBP = 1.80 US $

The Swap (Action):
An intermediary brings the two companies together and a swap is arranged so they pay each other's specific currency obligations.

US Company

Base: Raises loan of **1 million pounds** (British Bank, 3 years, 12%).

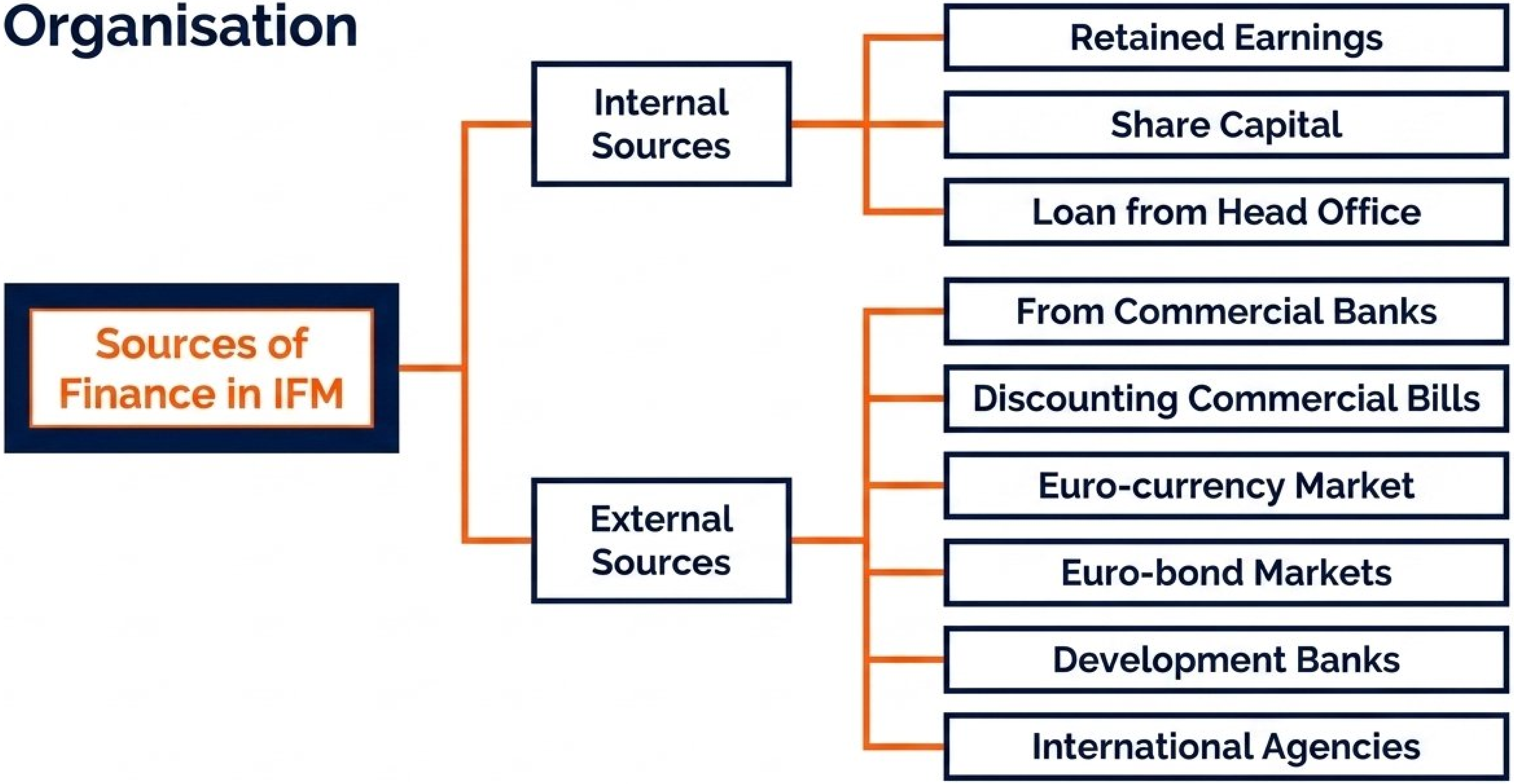
Has to pay **1,20,000 pounds** interest/year.

British Company

Base: Raises loan of **US $ 1.80 million** (US Bank, 3 years, 11%).

Has to pay **US $ 1,98,000** annually.

- **Financing Multinational Organisation**



- **Financing Multinational Organisation (External Sources)**

Commercial banks

Provide finance in domestic market and foreign currency for international business.

Discounting commercial bills

For short term. Traders get bills discounted before maturity period. Banks deduct discount before paying to the customer.

Euro currency market

Home currency deposited in some foreign country out of control of local banking system.

Example: Rupees deposited in America are called euro rupees.

Euro-bond markets

Used to raise finance from other countries by bonds.

Example: Indian bonds sold in England's market are known as euro bonds.

Development banks

Establish development banks for providing medium term and long term loans.

Example: IFCI, IDBI, ICICI banks, and EXIM bank in India.

International agencies

Provide loans to special projects in developing countries.

Example: World Bank, IMF, Asian Development bank.

• Mode of Payment in International Trade (Part 1)

Highest Risk for Buyer ⟷ Highest Risk for Seller

Cash-in-Advance

Mechanism

Payment is received prior to the transfer of ownership (Wire transfers and credit cards).

Risk Profile

Exporter avoid credit risk. Least attractive option for the buyer (creates cash flow problems, fear goods may not be sent). Exporters may find themselves losing out to competitors.

Open Account

Mechanism

Exporter debits importer's account with every export. Importer pays him time to time.

Risk Profile

Most advantageous option to the importer in cash flow. Highest risk option for an exporter.

- **Mode of Payment in International Trade (Part 2)**

Bank Transfer

An importer deposits the amount in his domestic bank account. That bank pays the amount to an exporter through its foreign branch or it directly pays the amount to the exporter's bank.

Ways money is sent:

(1) Telegraphic transfer

(2) Mail Transfer

(3) Banker's Cheque or Draft

Bills of Exchange

Used in domestic as well as international trade. A kind of check or promissory note without interest. It is a written order by one person to pay another a specific sum on a specific date sometime in the future.

• Meaning of Letter of Credit

The Instrument

The most commonly used form of secure payment. It is a document issued by a financial institution at the buyer's request and instructions.

The Mechanism

It spells out the terms under which the seller will be paid. Acts as an escrow account. Pay the seller a certain amount when it produces documents according to the instructions.

The Context

The preferred method of payment in trade with areas outside of Western Europe, Canada, and the United States.

Offers independent assurance to the both exporter and buyer.

The Origin

Became necessary when trade between countries made it impossible to simply do business by handshake.

Guarantees payment in case of the buyer's default.

- **Types of letter of credit**

Irrevocable vs. Revocable	
Revocable Can be changed or cancelled by the bank that issued it at any time and for any reason.	**Irrevocable** Cannot be changed or cancelled unless everyone involved agrees. Provide more security than revocable ones.
Confirmed vs. Unconfirmed	
Unconfirmed When a buyer arranges a letter of credit they usually do so with their own bank, known as the issuing bank.	**Confirmed** For extra security. A second bank agrees to guarantee payment even if the issuing bank fails to make it.

• Types of letter of credit

Transferable letters of credit

Can be passed from one 'beneficiary' (person receiving payment) to others. Commonly used when intermediaries are involved in a transaction.

Standby letters of credit

An assurance from a bank that a buyer is able to pay a seller. The seller doesn't expect to have to draw on the letter of credit to get paid.

Revolving letters of credit

A single revolving letter of credit can cover several transactions between the same buyer and seller.

Back-to-back letters of credit

May be used when an intermediary is involved but a transferable letter of credit is unsuitable.

• Advantages of a Letter of Credit

For Exporters

Reach out New Customers: Secures order without demanding advance payment from untested buyer.

Increasing Export Coverage: Main payment option for regions like Middle East.

Mitigates Default Risk: Replaces importer's default risk with the issuing bank's undertaking.

Eliminates Political Risks: Achieved by adding confirmation.

Discounting Possibilities: Can discount credit after complying presentation.

For Importers

Proof of Creditworthiness: Proves importer is a financially reputable company.

More Favorable Payment Terms: Can convince exporter to accept deferred payment instead of at-sight payment.

Example: Deferred payment options frequently used are **30 days, 60 days** or **90 days**.

Timely Shipments: Importer can determine shipment period. Late shipment creates discrepancy.

- # Disadvantages of a Letter of Credit

For Exporters

Higher Learning Costs: One of the most complex fields in international trade. Lack of expertise leads to unpleasant consequences.

Higher Bank Fees: Must pay high fees to banks under different names compared to other methods.

Time Consuming Procedures: Making a "complying presentation" (meeting the conditions of the undertaking) is not easy and takes time.

For Importers

Fraud Risks: Not common, but exporters could submit fraudulent documents to reach funds.

Higher Bank Fees: Just like exporters, importers pay high fees to banks.

Risks Associated with Shipment of Low Quality Goods: Hard to stop payment once bank determines a complying presentation, even if goods don't match the sales contract.

FAQ’s in VNSGU Exam

- Mode of payment in International Trade (October - 2024)
- Basic problems in International Financial Management (October - 2023, March - 2023)
- Letter of Credit (October - 2023, April - 2025, 2023)
- Types of Letter of Credit (April - 2025, 2024)
- Foreign Currency Management (April - 2024)
- Financing Multinational Organizations (June - 2023)
- Demerits of Letter of Credit (June - 2023)