Euro Currency Market

Now a day, there are so many avenues open to companies to procure the funds to meet their financial needs. They can tap not only national market but also international markets to finance their operations. On one hand, international financial markets enable them to raise funds at lower costs of finance; on the other hand, attractive returns on offshore deposits have induced investors to invest their funds abroad to fetch higher returns. Lending and borrowing in foreign currency to finance the international trade and industry has led to the development of Euro currency market. Euro currency market is the largest international debt market. Initially, Euro currency market was originated as dollar denominated Euro deposits and Euro loans, but now Euro market is not confined only to Euro dollar market. So many other currencies have also taken the form of Euro currency. Euro banking involves attracting funds from non-residents and making loans to other non-residents. Initially it was confined only to dollar deposits and loans but now it has taken so many shapes i.e. GDRs, ADRs, FRNs, EMTNs, FRCDs, ECPs, EBs and so many other instruments. Euro market includes both capital market and money market.

“Euro” in common parlance refers to the funds that are intermediate outside the country of the currency in which these funds are denominated. In this way, Euro currency market is a market where Euro banks accept deposits and make loan which are essentially denominated in a currency other than the currency of the country where that Euro banks are located e.g. Euro dollars are dollar denominated deposits in the banks outside the United States. In gross sense, Euro currency market includes all Euro currency liabilities whether it is interbank deposit or transactions between Euro banks and non-bank users. But in its net sense, Euro currency market includes only those deposits and loans which take place between Euro banks and non-bankers. Though so many currencies have entered in Euro market yet Euro dollar market remains the major player in Euro currency market. London is main center of Euro currency.

Features of Euro Market

1. **Whole sale market:** Euro currency market is wholesale market. Size of transactions is large. Transactions are rarely for less than $1 million and sometimes they are for $100 million.
2. **Inter-Bank operations:** The vast bulk of Euro currency market is confined to interbank operations.
3. **Unsecured credits:** No doubt Euro currency borrowers are big corporate who have status and name in the market and thus credit risk is comparatively low. As, Euro currency loans are unsecured credits, special attention is required to judge credit worthiness of borrower before providing any loan.
4. **Concentrated:** Euro currency market is focused upon London who is almost 1/3 of Euro currency market.
5. **Telephone linked:** Euro currency market is linked through Telecommunication which has facilitated Euro currency transaction.
(6) **Commercial banks** :- Commercial banks play dominant role in Euro currency market. They act as both depositors and lenders. They accept primary deposits & enter into inter bank transactions with Euro banks. These features led investors to move their funds more freely. It gives gave lenders and borrowers more options.

(7) **Maturity Transformation** :- Euro banks are also engaged in maturity transformation by borrowing short and lending long.

**Types of Instruments in Euro Market**

1. **Global Depository Receipts** GDR is a negotiable certificate, denominated in US dollars that represents a non US company’s publicly traded local currency security, which can be equity instrument / debt instrument. A company when issues ordinary shares keeps them with custodian / depository banks against which bank issue Drs to the foreign investors. GDRs are listed on the Luxemburg stock exchange. These GDRs are traded freely in the overseas market either on a foreign stock exchange or in over the counter market or among qualified institutional buyers. Holders of GDRs participate in the economic benefits like an ordinary shareholders. But they can not avail voting rights. GDRs are settled through CEDEL and Euro clear international book entry systems. Investors may get GDR cancelled anytime after a cooling off period of 45 days. When any depository bank receives a request from an investor to cancel GDR, it gets corresponding underlying security released in favor of such investor.

**Procedure of issue of GDR:**
1. The investor purchases the shares of any company from the domestic stock market.
2. He delivers those shares to the local custodian bank where these are converted into depository receipts.
3. The local custodian bank instructs the depository bank to issue GDR.

**Pricing of GDR issue:** Pricing of GDR issue depends on so many factors like prospective earnings, market price and price earning ratio. Prospective earnings of the company have direct impact on the investors perception about their future gains. GDR is usually issued at a discount of 10 – 20 % to the current market price of the security.

**Fungibility of GDR issue:** GDR issues can also be replaced by an identical security. Fungibilities are of two types:

a) **One way Fungibility**:- In this case, investor has an option to cancel GDR by withdrawing foreign exchange from the country.

b) **Two way Fungibility**:- In this case, not only investor has an option to cancel GDR but the company also have an option to convert shares into GDRs.

**Benefits**
1. As GDRs are usually quoted in dollars, interest and dividend payments are also in dollars. It can be paid in multiple currencies.
2. GDRs are as liquid as the underlying securities.
3. GDRs are negotiable
(4) In case of GDR no Global custodian / safe keeping charges are required to be paid.
(5) GDRs overcome foreign investment restrictions.
(6) Company can raise debt as well as equity.
(7) Company can increase demand for its securities.

**Disadvantages**

(1) GDR issue dilute earnings on equity shares.
(2) GDRs are expected to be issued at a discount.

2. **American Depository Receipts:**

   ADRs are depository receipts are issued by a company in USA. In this case, a non US company deposits its securities with a custodian bank which in turn informs the depository in US that ADRs can be issued. The holder of such receipts enjoys same ownership rights of underlying securities.

**Types of ADRs**

(1) **Unsponsored ADRs:** Before issuing unsponsored ADRs, there is no formal agreement between issuing company and depository. In this case, cost of disbursement of dividends, lie on the shoulders of investors.

(3) **Sponsored ADRs:**

   In this case, there is a formal agreement between issuing company and depository. Some of the sponsored ADRs are privately placed while some of these ADRs are publicity placed and traded.

(4) **Unrestricted ADRs/ URADRs:**

   These ADRs are issued in US capital market to the general investing public. There are three levels of URADRs. Level I URADRs are exempted from the requirements to conform their financial data to US before going for such issue. That's why these are comparatively cheaper. In case of Level II URADRs, issuing companies have to conform their financial data to US and meet other requirements of security exchange commission. These are listed on one of the US national stock exchanges. Though these are costlier yet they attract potential investors by promising higher visibility. In case of Level III URADRs, issuing companies have to fulfill all the requirements of SEC, GAAP. These are issued to general public.

**Advantages**

(1) Very low information search cost.
(2) It eliminates the problems of unfamiliarity with foreign markets and foreign laws, regulations and foreign trade practices.
(3) There is no such problem of foreign language.
(4) There is no need to locate a borrower or custodian.
(5) In case of ADRs, dividends are paid promptly.
(6) As ADRs are registered in US, it provides assurance to the investors regarding the protection of their ownership rights.
(7) Depository transmits all important information related to the issuing company to the investors, on continuous basis.
(8) ADRs has increased access to US capital markets by lowering the costs of investing in ADRs.
(9) ADRs has increased the liquidity of issuing company’s securities.
(10) ADRs also raise issuing company’s visibility and international familiarity which facilitate issuing co. to raise funds from the market at lower cost.

**Disadvantages**

ADRs act as a disincentive to the development of local capital market. Increasing issue of ADRs can retard development of domestic market.

4. **Eurobonds:** Eurobonds are bonds which are denominated in currencies other than that of the country in which the bonds are sold. In the Eurobond market risk of lending is borne directly by the lender whereas in case of Euro currency market such risk is borne by financial institutions.

5. **Euro convertible bonds:** Euro convertible bond is a debt instrument with an option to convert it into a pre determined number of equity shares of the company. It carries a fixed rate of interest. Euro convertible bonds can be issued with call option and put option. In case of call option, issuer company can any time call bonds for conversion into equity shares prior to the date of maturity. Generally company exercises this option when share prices reach up to 130% to 150% of conversion price/redemption price. In case of put option, holder of bond has a right to sell back bonds to the company. In this case usually, issuer company makes payment in US dollars. Euro convertible bonds are also known as a deferred equity issue.

6. **Euro bonds with equity warrants** In case of these bonds, equity warrants are attached to the bonds. These equity warrant are detachable and can be traded in market. These bonds carry a coupon rate which is determined by the market rates.

**Advantage of Eurobonds**

1. Cost of issue of Eurobonds is low which is around 2.5% of face value of the issue.
2. Eurobond market offer the bonds with maturities that suits to long term funding requirements.
3. There exists a sound institutional framework for underwriting, distribution and placing of securities.
4. Eurobonds are issued in bearer form which enable the investor to evade domestic income tax.
5. Issuers of Eurobonds have an excellent reputation for credit worthiness.

7. **Euro notes:** The traditional function of commercial banks, was to lend money over the medium term. But now, instead of lending money, they can go for securitization where they simply commit their resources, under Euro note issuance facilities, to guaranteeing that it will be available over the medium term. The actual funds are provided by non-bank investors. A borrower can raise money by issuing short term Euro notes, with maturity of 3-6 months. Such Euro notes are negotiable like certificate of deposits. Thus they can be placed with non-bank investors. Before going for Euro notes borrowers have to be sure that they will always be able to find buyers for their notes in the markets. It give rise to so many other ways e.g. NIfs (note issuance facilities), RUFs (revolving underwriting facilities), MOFF’s(multiple option funding
facilities), TRUFs (transferable revolving underwriting facilities), and BONUS (borrower’s option for notes and underwritten stand by) and so on.

8. **Certificate of deposit**: It is a negotiable instrument evidencing a deposit with a bank. Whenever investor requires cash, he can easily dispose it in secondary market. Final holder of Certificate of deposit gets face value along with the interest on maturity. These are issued in large denominations. Interest on Certificate of deposit with maturity exceeding one year, is paid annually rather than semiannually. Floating rate Certificate of deposits are also prevalent now a days, where interest rate is periodically reset.

9. **Euro Commercial Papers**: CP is a corporate short term, unsecured promising note issued on a discount to yield basis. It is redeemable at a face value on maturity. Its maturity generally does not exceed 270 days. Issuers usually roll over the issue and use the proceeds from the new issue to retire the old issue. CP is a cheap and flexible source of funds especially for highly rated borrowers. It is cheaper than banks Loans. But generally these require a backup credit line from a bank ranging from 50% - 100%. Investors in CP consists of money market funds, insurance companies, pension funds, other financial institutions and corporations with short term cash surpluses.

**Disadvantages**
As there exists no apparent control mechanism in Euro market, it may create some adverse effects.

1. **Speculation**: It induces short term speculative activities which results in generation of “hot money”. It makes more difficult for central banks to stabilize their currency exchange rates.

2. **Less effective national monetary policy**: Since the doors are open for offshore market, national monetary authorities lose effective control over monetary policy. It makes national monetary policy less effective.

3. **Inflation Tendencies**: Euro market creates too much of international liquidity which may hamper the balance of world economy. It may result in inflationary tendencies.

4. **Sovereign Risk**: In Case of domestic deposit, there is only risk of intervention by one government. But in case of Euro deposits, there is risk of intervention of both the governments. The government of the country in which Euro bank operates may seize the assets of the bank and block repayment of liabilities or other wise restrict its activities through political action. When host country imposes restrictions on Euro banks’ assets, their offshore operations are at risk. Generally there is a question that who is the “lender of last resort”. When difficulties originate. As in case of domestic banking central banks act as lender of last resort.

**Advantage**
(1) **International capital mobility** :- In Euro market fixed and managed exchange rates provide for perfect capital mobility. It has induced depositors to go for investing their funds abroad and earn higher rate of return. It has also motivated borrowers to borrow from offshore market at lower rate of interest. It has increased the degree of international capital mobility.

(2) **International liquidity** :- Euro currency markets create international liquidity. A company can increase the market of its securities. It can increase the liquidity of securities by making them globally tradable. It enables the companies to attract more buyers for their securities. It can enhance the image of the company in the international market.

(3) **Deficit Financing** :- In case of deficit, any country can easily borrow from Euro market to adjust her balance of payment.

(4) **Efficient allocation of capital worldwide** :- It allows the investors to diversify their portfolio globally.

(5) **Better financial risk management** :- Euro market has enhanced the ability of business to manage their financial risk in much better ways.

(6) **Cheaper Financing** :- In Euro market the company can raise large amount of funds at lower costs. It is very economical source of financing. Moreover as the holders of Euro securities do not get voting rights, it does not cause any harm to the managerial control of the issuer company.

(7) **Closer to market price** :- The companies can issue Euro securities at a price which is closer to the market price of securities at the time of issue.

(8) **Better rates on deposits & loans** :- As Euro markets are not subject to so many regulations, interest rate ceilings or any other pressure to allocate funds for unprofitable purposes as generally imposed by government, they can offer better rates for Euro deposits and Euro loans. Moreover they can keep margins small and overhead costs low. They can also take benefits of low tax locations.

(9) **Freedom and Flexibility** :- Euro market has a freedom and flexibility which is not found in domestic markets.

(10) **Size and depth** :- Euro market has capacity to absorb large and frequent issues due to its size and depth.