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BANKING AND INTERNATIONAL FINANCE

EXAM REVISION NOTES

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MODULE I

INTERNATIONAL BANKING AND FINANCIAL ARCHITECTURE

Nature, Scope, and Structural Drivers of International Banking: International banking may be formally defined as the provision of banking, financing, treasury, and payment services across national borders.

Organizational Structures of International Banking: International banking operations are conducted through diverse institutional vehicles differing in legal independence, capitalization, and operational scope:

Representative Offices

Foreign Branches

Historical Evolution of International Banking in India: The internationalization of the Indian banking sector has evolved through three distinct historical epochs:

Traditional Global Financial Hubs

GIFT City IFSC (Gujarat, India)

The Offshore Eurocurrency Market: The Eurocurrency Market is the foundation of modern wholesale international finance. A Eurocurrency is defined as any bank deposit denominated in a sovereign currency held in a bank located outside the legal borders of the country that issues that currency.

Multilateral International Financial Institutions: The stability, liquidity, and development of the international monetary system are guarded by multilateral institutions established primarily at the historic Bretton Woods Conference (1944) and subsequent international accords.

Non-Resident External (NRE) Account

Foreign Currency Non-Resident - FCNR(B)

Resident Foreign Currency - RFC RFC(D)

Summary Synthesis

- **International Banking:** ; Finances multinational corporate supply chains, syndicated loans, and foreign trade.
- **Eurocurrency Market:** ; Operates free from domestic reserve taxes, providing tight interbank lending spreads.
- **Global Financial Centers:** ; Concentrates international capital mobilization, debt syndication, and foreign exchange trading.
- **Multilateral Institutions:** ; Safeguards global monetary equilibrium, funds infrastructure, and regulates systemic bank risk.

Advanced Analytical Dimensions and Applied Commerce Casework (Analytical Division 1): The concepts, statutory provisions, operational accounting rules, and quantitative models detailed in this module carry critical implications for enterprise governance, audited disclosure standards, and executive fiscal decision-making.

Comparative Regulatory and Practical Implementation Standards: A rigorous examination of corporate commercial practice highlights the indispensable role of standardized accounting principles.

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Empirical Casework: Forensic Analysis, Audit Trail Verification, and Internal Controls: Empirical accounting investigations across modern industrial enterprises illustrate that financial distortion, fraud, and misstatement rarely occur as isolated incidents; rather, they stem from structural vulnerabilities within accounting workflows, segregation-of-duties lapses, or inadequate internal audit scrutiny.

- **Ledger amp; Voucher Integrity:** ; Companies Act (Sec.
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- **Working Capital Governance:** ; Tandon amp; Chore Committee Norms for Bank Working Capital Credit Appraisal.

Executive Synthesis, Governance Policy, and Continuing Professional Mastery: To conclude, mastery of the concepts examined throughout this module empowers students and commerce executives to evaluate complex fiscal data with precision, independence, and analytical clarity.

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MODULE II

FOREIGN EXCHANGE OPERATIONS AND TRADE FINANCE

Foreign Exchange: Meaning, Evolution, and Administrative Hierarchy in India: Under Section 2(n) of the Foreign Exchange Management Act, 1999, Foreign Exchange is defined comprehensively to mean foreign currency and includes: (i) deposits, credits, and balances payable in any foreign currency; (ii) drafts, travelers cheques, letters of credit, or bills of exchange expressed or drawn in Indian currency but payable in any foreign currency; and (iii) drafts, bills of exchange, or letters of credit drawn by banks, institutions, or persons outside India but payable in Indian currency.

Comprehensive Comparative Analysis: FERA 1973 vs. FEMA 1999

- **Core Legislative Philosophy:** ; Facilitating external trade, promoting foreign investment, and managing forex.
- **Legal Nature of Contraventions:** ; Civil contravention punishable by monetary penalties; no arrest for simple breach.
- **Burden of Proof:** Reversed: accused presumed guilty until proven innocent.
- **Compounding of Offenses:** ; Full provision for compounding contraventions by paying monetary penalties to RBI.

The Administrative Machinery Governing Foreign Exchange in India: The regulatory pyramid of foreign exchange in India is structured across three institutional tiers:

Foreign Exchange Dealers' Association of India (FEDAI): Established in 1958 under Section 25 of the Companies Act, 1956, FEDAI is the self-regulatory association of commercial banks licensed to deal in foreign exchange in India.

- **Standardizing Market Rules:** Prescribes uniform terms for forward contract delivery, cancellation, extension, and early utilization.
- **Transit and Grace Periods:** Formulates standardized transit days for export and import bills drawn on diverse global regions.
- Crystallization of Overdue Foreign Currency Bills: Establishes mandatory rules governing the date on which an unpaid foreign currency export or import bill must be converted into an Indian Rupee liability to insulate the bank from compounding exchange exposure.
- **Training and Accreditation:** Conducts specialized certification programs in foreign exchange risk management for bank dealers and corporate treasurers.

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Interbank Foreign Exchange Currency Accounts: Nostro, Vostro, and Loro: In international correspondent banking, commercial banks execute cross-border settlements through specialized interbank depository accounts designated in Latin terminology:

Nostro Account ("Ours")

Loro Account ("Theirs")

The Liberalised Remittance Scheme (LRS) of the Reserve Bank of India: Introduced by the RBI in February 2004 with an initial ceiling of USD 25,000, the Liberalised Remittance Scheme (LRS) represents a monumental liberalization milestone in India's capital account regime.

Tax Collection at Source (TCS) Regime under Section 206C(1G): To curb illicit offshore capital flight, the Government of India enforces Tax Collection at Source (TCS) on overseas outward remittances processed under the LRS:

- **Overseas Education Funded via Education Loan:** 5% on remittances exceeding INR 7 Lakh.
- 0% on amounts exceeding INR 7 Lakh.
- **Overseas Tour Packages:** 0% on amounts exceeding INR 7 Lakh.
- 0% TCS on all remittances exceeding the threshold of INR 7 Lakh per financial year.

Advance Remittance

Open Account / Direct Remittance

Documentary Collection (URC 522)

The Letter of Credit (LC) Mechanism: Architecture, Parties, and Workflow: The Letter of Credit (LC), formally known as a Documentary Credit, is the paramount financial instrument in global commerce.

Taxonomy of Specialized Letters of Credit

- **Irrevocable LC:** ; Standard baseline for all international credits under UCP 600 rules.
- **Confirmed LC:** ; Mandatory when exporting to politically unstable nations or weaker foreign banks.
- **Revolving LC:** ; Ideal for recurring, periodic shipments of raw materials between regular partners.
- **Transferable LC:** ; Used by export trading houses and middlemen who source goods from third-party mills.

Summary Synthesis

- **Foreign Exchange Law:** ; Ensures full current account convertibility while managing orderly capital inflows.
- **FEDAI Oversight:** ; Standardizes interbank dealing rules, merchant spreads, and bill crystallization dates.
- **Interbank Accounts:** ; Facilitates global wire clearing; SRVA enables non-dollar trade settlement in Indian Rupees.
- **LRS Framework:** ; Empowers resident citizens to fund foreign education, tourism, and offshore assets.

Empirical Casework: Forensic Analysis, Audit Trail Verification, and Internal Controls: Empirical accounting investigations across modern industrial enterprises illustrate that financial distortion, fraud, and misstatement rarely occur as isolated incidents; rather, they stem from structural vulnerabilities within accounting workflows, segregation-of-duties lapses, or inadequate internal audit scrutiny.

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MODULE III

INTERNATIONAL EXCHANGE SYSTEMS, RUPEE CONVERTIBILITY, AND BALANCE OF PAYMENTS

Exchange Rate Systems: Conceptual Foundation and Taxonomy: An exchange rate is the price of one sovereign currency expressed in terms of another. It serves as the primary price-setting mechanism for cross-border commerce, allocating economic resources between tradable and non-tradable goods sectors, determining national export competitiveness, and establishing the domestic purchasing power of imported capital and consumer items.

Fixed Exchange Rate Reg ×

The Impossible Trinity (Mundell-Fleming Trilemma): A fundamental theorem of open-economy macroeconomics, formulated independently by Robert Mundell and Marcus Fleming, is the Impossible Trinity (Trilemma).

- **1. Free Cross-Border Capital Mobility:** Complete freedom for capital to flow into and out of the country without administrative controls or capital restrictions.
- **2. Fixed Exchange Rate:** An officially pegged and predictable external currency value.
- **3. Independent Monetary Policy:** The sovereign capability of the central bank to set domestic policy interest rates to meet domestic employment and inflation targets.

The Classical Gold Standard (1870–1914)

The Interwar Period (1914–1944): Instability and Monetary Collapse: The outbreak of World War I in 1914 shattered the Classical Gold Standard. Belligerent governments suspended gold convertibility and financed massive wartime expenditures by printing unbacked paper fiat currency, leading to severe wartime and post-war inflation.

- Hyperinflation and Broken Parities (1919–1925): Central European nations, particularly Weimar Germany in 1923, suffered devastating hyperinflation where paper currency lost virtually all economic value.
- The Great Depression and Gold Standard Abandonment (1929–1933): Following the Wall Street crash of 1929, international liquidity dried up.

- **Fragmentation into Currency Blocs:** The world fractured into isolated currency blocs: the Sterling Area (anchored to the British Pound), the Dollar Area (anchored to the US Dollar), and the Gold Bloc (led by France, Belgium, and Switzerland until its final collapse in 1936).

The Breakdown of Bretton Woods and the Triffin Dilemma: The structural vulnerability of the Bretton Woods system was diagnosed by Belgian-American economist Robert Triffin in 1960, in what became universally known as the Triffin Dilemma.

- As global trade expanded rapidly during the post-war boom, the world economy required an ever-growing supply of international liquidity and reserve assets to settle cross-border commerce.
- Because gold production was physically constrained, this liquidity could only be provided by the United States running continuous, massive Balance of Payments deficits, pumping billions of US dollars into global circulation.
- However, as cumulative US dollar liabilities held by foreign central banks expanded far beyond the physical gold reserves stored at Fort Knox, foreign confidence in the US government's ability to redeem dollars for gold at USD 35 per ounce inexorably eroded.
- If the US eliminated its deficits to maintain confidence, global liquidity would choke and world trade would plunge into depression; if the US maintained its deficits to supply liquidity, the gold convertibility backing would collapse.

Contemporary IMF Exchange Rate Arrangements: Today, the IMF classifies the exchange rate arrangements of its 190 member countries based on their de facto operational policies rather than their de jure official announcements.

- **1. Hard Pegs:** - No separate legal tender (Dollarization / Currency Union) - Currency Board Arrangement (CBA); Complete surrender of monetary autonomy.
- **2. Soft Pegs:** - Conventional Peg - Stabilized Arrangement - Crawling Peg - Crawl-like Arrangement - Pegged within Horizontal Bands; The currency is pegged to a major anchor currency or a basket of currencies.
- **3. Floating Reg ×:** - Floating (Managed Float) - Free Floating (Clean Float); Exchange rates are determined largely by market forces.
- **4. Residual / Other:** - Other Managed Arrangements; Residual category where the exchange rate arrangement does not meet the criteria of hard pegs, soft pegs, or floating mechanisms, often featuring frequent shifts or non-transparent intervention targets.

Relative Inflation Differentials

Current Account Balances

Purchasing Power Parity (PPP) Theory: Formulated systematically by Swedish economist Gustav Cassel in 1918, the Purchasing Power Parity (PPP) theory states that the exchange rate between two currencies should equal the ratio of the price levels in the two respective economies, ensuring that a representative basket of goods costs the exact same amount when converted into a common currency.

Classification of the External Value of Rupee: NEER and REER: A bilateral exchange rate (such as USD/INR or EUR/INR) reflects the value of the Indian Rupee against only a single foreign currency.

Nominal Effective Exchange Rate (NEER)

Convertibility of the Indian Rupee: Evolution and the Tarapore Framework: Currency convertibility refers to the unrestricted legal freedom of residents and non-residents to convert the domestic currency into foreign currencies (and vice versa) at market-clearing exchange rates without administrative approval from the central bank or government.

The Tarapore Committee Recommendations on Capital Account Convertibility: S. Tarapore.

Balance of Payments (BOP): Accounting Architecture and Components: The Balance of Payments (BOP) is a comprehensive, systematic statistical statement that records all economic and financial transactions between the residents of an economy and the rest of the world during a specified accounting timeframe (quarterly or annually).

Economic Significance of the BOP

Detailed Anatomy of BOP Components (BPM6 Standard)

Autonomous Transactions ("Above-the-Line")

Types and Causes of Balance of Payments Disequilibrium

- **1. Cyclical Disequilibrium:** Arises from international business cycle fluctuations.
- **2. Secular (Long-Run) Disequilibrium:** Stems from structural phases in national economic development.
- **3. Structural Disequilibrium:** Caused by profound structural changes in domestic supply and demand conditions: depletion of domestic mineral reserves, shifts in global consumer tastes, technological displacement of key export items, or sudden terms-of-trade shocks (such as global crude oil price spikes).
- **4. Monetary Disequilibrium:** Caused by domestic monetary overexpansion.

Theoretical Prerequisites for Devaluation: Marshall-Lerner Condition and the J-Curve: Devaluing or depreciating the domestic currency does not automatically guarantee that a trade deficit will improve.

MODULE IV

FOREIGN EXCHANGE MARKETS, CLEARING SYSTEMS, AND INTERBANK TRANSACTIONS

Structure and Distinguishing Features of the Foreign Exchange Market: Unlike centralized equity or commodity exchanges (such as the Bombay Stock Exchange or the New York Stock Exchange), the foreign exchange market possesses no physical trading floor, no centralized order book, and no single sovereign regulatory overseer.

Over-The-Counter (OTC) Architecture

Unprecedented Market Liquidity

Geographic Concentration

Participants in the Foreign Exchange Market: Participants in the global currency market operate with distinct statutory mandates, risk appetites, and commercial motives.

- **1. Commercial Banks (Authorized Dealers):** ; Provide two-way continuous price quotes (bid and ask), execute customer trade orders, manage internal foreign currency asset-liability books, and operate proprietary trading desks within regulatory Net Open Position Limits (NOPL).
- **2. Central Banks:** ; Intervene to suppress excessive currency volatility, manage national foreign exchange reserves, implement domestic monetary policy, defend sovereign creditworthiness, and counter speculative attacks against legal tender.
- **3. Multinational Corporations (MNCs):** ; Convert export billing proceeds, pay import invoices, remit dividend earnings and royalties to parent headquarters, and hedge operational foreign currency cash flows using forward, swap, and option contracts.
- **4. Institutional Investors Funds:** ; Invest in offshore equity and debt securities, rebalance multi-asset international portfolios, hedge foreign asset currency exposures, and execute directional yield arbitrage strategies.

Key Users of Foreign Exchange: Hedgers, Speculators, and Arbitrageurs: Based on their risk posture and economic purpose, users of foreign exchange are categorized into three classic market archetypes: Hedgers, Speculators, and Arbitrageurs.

Speculators (Risk Bearers)

Quantitative Arbitrage Mechanics in Foreign Exchange: Forex arbitrage operates across three primary mathematical methodologies:

Continuous Linked Settlement (CLS) Bank: Established in 2002 by 69 of the world's premier commercial banks, CLS Bank International (based in New York) virtually eliminated Herstatt Risk from the global currency market.

Comparative Architecture of International Messaging and Clearing Systems

- **SWIFT:** ; Operates standardized financial messaging protocols.
- **Fedwire:** ; Settles high-value domestic and international USD transfers individually and instantaneously with immediate, final, and irrevocable legal finality.
- **CHIPS:** ; Primary private clearing house for cross-border US dollar commercial and interbank payments.
- **CHAPS:** ; Provides same-day irrevocable settlement for wholesale financial and corporate sterling transactions, money market operations, and cross-border sterling FX legs with zero settlement risk.

Spot Transactions: A Spot Transaction is a binding contractual agreement to buy or sell foreign currency for immediate settlement and delivery.

Value Tomorrow (TOM)

Value Spot (Standard)

Foreign Exchange Swap (FX Swap) Transactions: A Foreign Exchange Swap is an agreement between two institutional counterparties to simultaneously exchange two currencies on a specific value date (typically spot) and reverse the identical exchange on a specified future date at pre-agreed forward exchange rates.

Non-Deliverable Forwards (NDF) Transactions: A Non-Deliverable Forward (NDF) is a cash-settled, synthetic forward contract traded over-the-counter primarily on currencies that are not fully convertible, have capital controls, or have restricted domestic financial markets (such as the Indian Rupee - INR, Chinese Yuan - CNY, Korean Won - KRW, Brazilian Real - BRL, and Taiwanese Dollar - TWD).

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