COLEGIO MAYOR DE NUESTRA SEÑORA DEL ROSARIO
International Finance

Review No. 2ª

Multiple selection: Select the right answer and give a short explanation of your answer.

1. Which of the following is most accurate regarding derivatives?
   a. Exchange-traded derivatives are created and traded by dealers in a market with no central location.
   b. Derivative values are based on the value of another security, index, or rate.
   c. Derivatives have no default risk.
2. Over-the- counter derivatives:
   a. are customized contracts.
   b. have good liquidity in the over-the-counter (OTC) market.
   c. are backed by the OTC Clearinghouse.
3. Which of the following is NOT an over-the-counter (OTC) derivative?
   a. A futures contract.
   b. A forward contract.
   c. A bond option.
4. Which of the following definitions involving derivatives is least accurate?
   a. An option writer is the seller of an option.
   b. A call option gives the owner the right to sell the underlying good at a specific price for a specified time period.
   c. An arbitrage opportunity is the chance to make a riskless profit with no investment
5. Which of the following is most likely an exchange-traded derivative?
   a. Equity index futures contract.
   b. Bond option.
   c. Currency forward contract.

6. A derivative security:
   a. has a value based on another security or index.
   b. has no default risk.

c. has a value based on stock prices.

7. A financial instrument that has payoffs based on the price of an underlying physical or financial asset is a(n):
   a. option.
   b. future.
   c. derivative security.
8. A derivative security:
   a. is one that is based on the value of another security.
   b. is like a callable bond.
   c. has a value dependent on the shape of the yield curve.
9. Which of the following statements regarding exchange-traded derivatives is NOT correct? Exchange-traded derivatives:
   a. are illiquid.
   b. often trade in a physical location.
   c. are standardized contracts.
10. Which statement does NOT characterize a forward contract?
    a. Valuation can be estimated at any point before maturity.
    b. Action is taken in the future.
    c. Regulation is not an issue.
11. The process of arbitrage does all of the following EXCEPT:
    a. insure that risk-adjusted expected returns are equal.
    b. promote pricing efficiency.
    c. produce riskless profits.

Main concepts from your readings.

1. What are the three main sources of financing for any firm?

2. What is the difference between a centralized and decentralized debt denomination for an MNC?

3. Will an MNC issuing debt in low-interest-rate currencies necessarily lower its cost of funds? Why?

4. Should an MNC borrow primarily short term when short-term interest rates are lower than long-term interest rates? Or should it keep the maturity the same but use a floating-rate loan rather than a fixed rate loan? Explain.

5. What is financial disintermediation?

Finanzas Internacionales.
Review Midterm 2.

I. Multiple choice and explanation.

1. which of the following is most accurate regarding derivatives?
   a. Derivative values are based on the value of another security, index or rate.

   → Derivatives "derive" their value of another asset or security.

2. Over-the-Counter derivatives:
   a. are customized contracts.

   → unlike exchange-traded derivatives (standardized), OTC derivatives are customized to dealers needs so there's no clearing house and have poor liquidity.

3. which of the following is NOT an OTC derivative?
   a. Futures contract

   → These are standardized contracts negotiated at futures exchanges.

4. which of the following definitions involving derivatives is least accurate?
   b. A call option gives the owner the right to sell the underlying good at a specific price for a specified time period.

   → A call option gives the owner the right to buy.

5. which of the following is most likely an exchange-traded derivative?
   a. Equity index futures contract.

   → Bond option and currency forwards are OTC derivatives.

6. A derivative security:
   a. has a value based on another security or index.

   → A derivative security is one that "derives" its value from that of another security.

7. A financial instrument that has payoffs based on the price of an underlying physical or financial asset is a(n):
a. derivative security.

→ Options and futures are examples of derivative securities.

8. A derivative security:
a. is one that is based on the value of another security.

→ Definition of a derivative security

9. Which of the following statements regarding exchange-traded derivatives is NOT correct?
b. are illiquid.

→ Exchange-traded derivatives have good liquidity in most cases.

10. Which statement does NOT characterize a forward contract?
c. Regulation is not an issue

→ This doesn't necessarily apply to forward contracts. Some are regulated, some are not.

11. The process of arbitrage does all of the following EXCEPT:
a. insure that risk-adjusted expected returns are equal.

→ Arbitrage is based on risk-free portfolios and promotes efficient pricing of assets.

II. Main Concepts.

1. What are the 3 main sources of financing for any firm?
- debt financing: bank loans and bonds
- equity financing: selling stocks
- cash internally generated by the firm.

2. What is the difference between a centralized and decentralized debt denomination for an MNC?
a centralized debt denomination means that the debts for both the parent company and its foreign subsidiaries are denominated in dollars.
In a decentralized debt, the service payments are denominated in the currency in which the subsidiary's revenue are received.

3. Will an MNC issuing debt in low-interest-rate currencies necessarily lower its cost of funds? Why?
No necessarily. The final cost of the loan will involve the change in the exchange rate and the interest rate.
If UIRP holds, the expected cost of the loan should equal the cost of a domestic currency loan.
So, if the low-interest-rate currency does not appreciate as predicted by the interest rate differential, the MNC will have Lowered its cost of debt.

4. Should an MNC borrow primarily short term when short-term interest rates are Lower than Long-term interest rates? or should it keep the maturity the same but use a floating-rate loan rather than a fixed-rate loan? Explain.
It's possible that borrowing at a floating-rate would give the company a natural hedge, if its cash flows were positively correlated with interest rates. The company is likely to experience high interest rate expenses on its floating debt when its revenues are high and viceversa.

5. What is financial disintermediation?
The process whereby corporate borrowing takes the form of a tradable security issued in the public market, rather than a non-tradable loan provided by financial intermediaries.

6. What are the two main segments of the international bond market and what types of regulations apply to them?
- Foreign bond Market → subject to domestic regulations. In the USA, they must go through the SEC's registration process.
- Eurobond Market → not regulated like domestic bonds because the holders are anonymous. There is the International Capital Markets Association, which impose some restrictions and regulations.

7. What is the difference between a foreign bond and an Eurobond?
- A Foreign bond is issued by non-residents in a domestic market and denominated in the domestic currency.
- An Eurobond is issued by Residents or Non-residents in an external market and denominated in a foreign currency.
- A foreign bond is regulated by the domestic authorities, the Eurobond isn't.

8. why might U.S. investors continue to purchase Eurobonds, despite the fact that the U.S. corporate bond market is well developed?
Because the Eurobond market remains untaxed, unregulated and convenient. The SEC disclosure requirements and registration procedure remain time-consuming and burdensome for some U.S and non-U.S. issuers.

9. what is a global bond and what role does it play in the blurring of the distinctions in the international bond market?
It's a bond issued and traded in several countries by a large MNC or a sovereign entity with a high credit rating (such as the World Bank) in different currencies.
Hence, this type of bonds straddle the 2 segments of the international bond market, making distinctions between them more difficult to draw.

10. what are the differences between a straight bond, a floating-rate note and a convertible bond?
A straight bond has a fixed coupon payments, a maturity date and a principal to be repaid at the end.
A floating-rate note (FRN) has coupon payments that varies with a reference interest rate.
A convertible bond is a straight bond that allows the holder to convert it into equity prior to maturity.

11. what is a dual-currency bond?
Is a straight bond issued in one currency, which pays coupons in that same currency, but the final principal payment is denominated in another currency.

12. what kind of activities do international banks engage in?
- Financial services to facilitate the overseas trade of their customers
  ↳ commercial credit, market making, trading in spot and forward currencies, international trade financing and risk management services.
- Eurocurrency market participants
- Members of international loan syndicates lending out large sums of money to MNCs or governments.
- underwriting of Eurobonds and foreign bonds.

1. The following table shows how average share prices jump (in percentage) after the announcement that the stocks will be cross-listed (see Miller, 2000). The price response should be interpreted as corrected for risk and market movements that happened on the same day:

2.	3. All ADR Issues	4. Capital Raising	5. Non-Capital Raising
6. Emerging markets	7. 1.5	8. 0.9	9. 2.8
10. Developed markets	11. 0.9	12. 0.7	13. 0.9
14. Total	15. 1.2	16. 0.8	17. 1.4

Although these numbers appear small, it is important to realize that announcements of equity issues, which are by definition capital raising, in a domestic context lead to an average negative return response of 2% to 3% (see, for instance, Masulis and Korwar, 1986). The main reason is that capital-raising equity issues are viewed as a signal of the managers that the firm may be overvalued in the stock market.

Given what you learned in chapter, answer the following:

a. Why is there a positive price response when a company's shares are cross-listed?

Answer: The positive response likely reflects the reduction of the cost of capital (which increases the valuation of the firm) associated with cross listing. As indicated in Question 7, there are a variety of channels that may lead to a lower cost of capital, such as improved liquidity, a wider shareholder base, improved corporate governance, and effective integration within global capital markets.

b. Why might the response for emerging-market firms be larger than for developed-market firms?

Answer: Because their own stock markets have poorer liquidity and corporate governance, the benefits may be relatively larger for emerging market firms. In particular, while most firms from developed markets are subject to "global pricing," most emerging markets are still "segmented" from global capital markets, and listing in a developed market effectively integrates the firm into global capital markets. The move from segmented to global pricing tends to increase valuations because global discount rates tend to be lower than discount rates in segmented emerging markets.

c. Without knowing that equity issues in a domestic context are associated with negative price responses, is the difference between capital-raising and non-capital-raising ADRs a surprise? Why or why not?

Answer: Ignoring the negative signal of raising capital through the equity market, it is surprising that capital-raising ADRs would lead to a smaller price response than non-capital raising ADRs. That is because the fact that companies raise capital through the international capital market would suggest they have substantial growth opportunities that should raise the value of the firm.

Answer. As we will discuss in Chapter 13, diversifying your portfolio internationally will offer significant benefits. However, since not all international firms have ADRs, the set of firms to invest in may not be large enough to exhaust the benefits of international diversification. In particular, it would tend to be the larger, more internationally oriented firms that will first cross-list, and these firms may be exactly the ones that are more heavily correlated with domestic firms (see Chapter 13 for more discussion on correlation and diversification benefits).