6. What is meant by private placement and what are the different modes of private placement.
7. Describe the methods adopted by different countries for private placements.
8. What are the common clauses featuring in Euro-issue.

8.11 FURTHER READINGS

1. *Risk Management Systems in Banks,* Guidelines by Reserve Bank of India, 1999.
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UNIT 9 CAPITAL MARKETS : SOURCES OF EXTERNAL FINANCE

Objectives

The objectives of this unit are to :

- understand different types of capital markets and types of investors globally
- appreciate international bond market and different kinds of bonds and their features
- identify the requirement of capital market
- distinguish the different kinds of bonds.

Structure

9.1 INTRODUCTION

In the developing countries commercial bank loans were the most important source of external finance for corporates. During the year 1980, bank credit provided by commercial banks was amounting to 46% during world debt crisis. A decade later this percentage has come down to 18% and in subsequent years much lower on net basis. The important reasons for falling bank credit are :

i) The losses sustained by international banks on third world debt in the 1980s, and

ii) Imposition of capital adequacy norms which has made it difficult and costly for the banks to lake on additional assets.

The capital market therefore have become more important to the developing world. Developing countries during 1991 raised USD 46 billion from capital market by using instruments as in domestic markets i.e. bond and equity issues. But due to this, some countries became heavily indebted e.g. Mexico, which were unable to serve external bank debt. This took place through debt for equity swap and settlement of bank debt through issue of long term bonds, of face value lower than the principal amount of the loan - so called "**Brady bonds**" These brady bonds are actively traded in secondary market in Brazil, even when Brazilian debt is still to be restructured.

In 1993, flow of funds from international capital markets to the developing countries in the form of portfolio investment had gone up sharply, So much so that it threatened to become a flood.

9.2 THE INTERNATIONAL INVESTORS

There are two categories of international investors: i) Institutional investors, and ii) Individual investors.

i) **The institutional investor** category covers **big** mutual and pension funds. Apart from diversification in different markets and currencies large institutional investors in industrial. countries, faced with stagnant domestic economies which are also attracted by fast growing developing countries. Many institutional investor have a global choice and perspective and have a long term outlook. So their investment is research based. The macro economic conditions that precedes investment decision in India is a result of decades of years study undertaken by various institutional investor for investment in India in portfolio investment.

ii) **The individual investor** was once upon a time mainstay of international bond market in contrast to the institutional investor who makes decision more by perception than analysis. Developing countries are interested for investment in capital market through professionally managed institutional investor.

With this background we shall discuss more about different debt and equity instruments in international capital market.

9.3 THE INTERNATIONAL BOND MARKET

The International bonds are broadly classified under two heads :

1) **Foreign Bonds :** The bonds floated in the domestic markets by non-resident entities. As the control over capital got relaxed, many foreign bonds were issued in the domestic markets of United States, UK, Germany, Japan, Switzerland, etc. Some of the bonds as we have already discussed are Yankee bonds in US domestic market, Bull dog bonds in UK, Samurai bonds in Japan, etc.

2) **Euro Bonds : As** discussed earlier, the term Euro has come to signify a currency outside its home country. Therefore, Euro bonds are the bonds issued **and** sold outside the home country of the currency of the issue, e.g. dollar bonds issued in UK is Euro dollar bonds.

Another way bonds are distinguished by its placements that is private placement **and** public issue.

Different features of the foreign and Euro bonds for various currencies and markets :

Features	**Foreign Bonds**	**Euro Bonds**
1. Issuer	Foreign government or Corporation or international institutions US : SEC - registered currency	Any borrower with good credit rating. Explicit rating, rate local currency, any widely used currency.
2. Amount raised in singlc issue	Typically — USD 50-500 mio	Typically — USD 50-500 mio
3. Type	Bearer, exception Buldog and Yankee market	Bearer
4. Tax	No withholding Tax (except sterling foreign bond market)	No withholding tax
5. Interest payment	As in domestic market	Annual or fixed rate bonds, semi annual or quarterly for FRN
6. Listing	Domestic Stock Exchange	Usually London or Luxembourg.
7. Security	Unsecured	Usually unsecured but often with negative pledge.
8. Issuing House	Largely domestic banks	International syndicate and stock brokers
9. Investor	Domestic and overseas	Wide international profile private individual play major role
10,Structure	Usually bullet	Bullet common, but a wide variety of usual structure.

Features	Foreign Bonds	Euro Bonds
11. Issuing procedure	Placed by domestic syndicate	Placed over a period by a international syndicate
12. Secondary trading	Primarily OTC trading stamp duty charged on transactions by residents in Japanese Yen and Swiss Franc markets	OTC trading organised by issuing banks with settlement by means of book entry transfer system using one of the standard cum market clearing systems.

Restrictions on issuance in the international bond market :

Market	Comments
A. **Free** 1. Euro - dollar 2. Euro - Canadian 3. Euro - ECU	No restrictions on issuance
B. **Modest restrictions/recently full liberalised** 1. Euro - Sterling 2. Deutsche Guilder (foreign) 3. Euro - Deutsche Guilder 4. Swiss Franc (Foreign) 5. DEM (Euro/Foreign) 6. Euro - SEK 7. Euro - Danish Kroner 8. Euro - Australian Dollar	– Selling abolished in 1988. Voluntary information - sharing agreement between security houses introduced subsequently. – Issue of F.1.450 mio or more must be put on Netherland Bank's calendar. – Innovation in new issue must be approved. – Permission required to issue bond beyond SFR 10 mio. – Bonds bank must notify - prior to issue by midnight on trading day. – Liberal approach adopted but innovations not permitted. – Limit DKK - 750 mio – Borrowing permitted after 1991
C. **Significant restrictions** 1. Yankee Bonds 2. Euro Japanese Yen 3. Samurai 4. Euro French Franc 5. Euro Lira	– Public issue must be registered with SEC No. restriction on issuance, – Non Japanese issuer – Must have formal rating 'A' or better, ministry af finance approval required. Eligibility is issuers credit rating, financial strength, previous borrowing history, amount and maturity of issues volume and term limitations were abolished. – Remittance of Euro french market meets 'once in a month and sets issuance calendar for month. – Queue operated by the bank of Italy.
D. Severe Restrictions 1. Belgian Franc (Foreign) 2. Euro-Australian Schilling 3. Poseta (Foreign)	– Only supra national organisations of which Belgium is member are permitted to issue. – Issue generally not permitted – Now issues prohibited, Only international organisadon were permitted to use the market administered by Spanish Ministry of Finance.
E. Prohibition Euro - Swiss Franc	— No Euro bonds denominated in Swiss Franc are permitted

From above comparison it will be observed that Euro bonds in particular are bearer securities that means names of holders are not registered anywhere. Therefore there is very active secondary market in the Euro bonds and two best known clearing and settlement agencies are CEDEL and EUROCLEAR. Euro bond market is existing since past 30 years of number of issues handled per year is approx. USD 200 billion.

It is also observed that most domestic markets have stringent rules for registration, disclosure of interest, credit rating, etc., than in the Euro market. That means lower level of regulatory requirements is basic attraction of Euro market.

Thus, in general regulatory requirement arc less stringent when foreign bond issue are made on private placement basis than public issue basis. Established professional investors in US with whom private placement may be made their list is available under rule 144 **A** of SEC for private placement and they are capable of making risk assessment on their own, therefore stringent regulatory safeguard on the same scale for public is not required for them.

9.4 CAPITAL MARKET REQUIREMENTS

Floating rates

With reference to pre-determined reference rate (usually LIBOR) floating rate interest which resets at regular intervals typically quarterly or half yearly is major innovation in Eurobond market for medium term securities. Bonds are fixed rate instruments. Due to floating rate mechanism interest rate risk is passed from investor to issuer of bonds. Such bonds are called FRN (Floating Rate Note). The distinction between notes and bonds, both debt securities, and real time maturities. For long term maturities term is bond and for shorter term, note. In Euro bond market interest payment on fixed rate at annual interval while on floating rate note at half yearly or quarterly intervals. Euro bonds may be issued with combination of fixed and floating rate, FRN automatically convert into fixed rate, when short term interest rate fall below certain specified level.

Collared/Inverse Floaters

Collared floaters ate FRN but with floor and cap to the interest payable for any half year. These are also called minimax FRNs. Recently a few "inverse coupon floaters" have also been issued, for such issues, applicable rate of interest or particular half year is expressed as given number (say 10%) minus the prevailing LIBOR. Thus for such inverse coupon floaters the applicable interest rate rises where LIBOR falls.

Convertible Bonds

Alongwith straight bonds, which are pure debt issue, convertible bonds, those which allows the holders to convert the bonds into the equity of the issuing or its parent companies equity at the pre-determined price. Bond carrying a warrant allow warrant holder to buy the issuers equity at pre-determined price are also very much in vogue.

Perpetual Bonds

The perpetual bonds had no maturity as the name signifies. There has been no issue in the market since several years because market proved it is short lived.

Dual Currency Bonds

This is another innovation introduced by issuer at the cost of unsophisticated investors. Therefore, it is called dual currency bonds. The characteristic feature of this bond is while bond is issued in one currency, issuer retains the option to repay the principal in another currency, conversion rate fixed at the time of its issue. Since the investor carries the exchange risk, he is compensated by interest rate or coupon. It means investor writes a currency option and the higher coupon is the fee he paid for writing the option. Some issue managers refused to handle such dual currency issues on the basis that unsophisticated investors should not be persuaded to undertake risks they may not fully understand.

Callable Bonds

Feature of the bond is "call option" in favour of issuer, under which issuer retains the option to pre-pay the bond (call) before maturity but generally after specified period from issue when interest rate falls, issuer exercises his option. These bonds also *carry* coupons higher than what straight bond would to compensate the investor for risk of early redemplion, when interest rate falls.

Equity Index-linked Notes

These are more prevalent in US domestic market but yet to make significant impact in international bond market. These are debt issues carrying a coupon but the principal amount payable on maturity is linked to an equity index. Higher the index, holder will be benefited by principal repayment. This mechanism has various combinations :

- Principal amount unprotected : when index is lower than base level.
- Principal ainount protected i.e. can be higher if the index goes up but will not fall below face value.
- Participative, i.e. only a part of investment is linked to the equity index, instead of whole amount.

Asset Backed Securities

These are the bonds created to securities and sell to investors specified groups of assets of the lender. These bonds being secured by the secured assets which can be :

- . a pool of car loan
- a pool of credit cards receivable or
- a pool of housing loan secured by property mortgage,
- A mortgage backed securities has a very large market in US. Few securitisation has also taken place in India.

Strips

A typical government based bond issued in domestic market will have a stream of cash flow associated with it :

- say 20 interest or coupon payment on 10 years bond and
- one principal payment on maturity.
  Striping involves "interest only (IO)" and "principal only (PO)" instruments and selling them to different investors.

Strips have recently caught on in fresh Government bond market and are expected to be introduced in the UK gilt market.

9.5 STEPS INVOLVED IN BOND ISSUES

Steps to be taken before issing of bonds depends upon whether issue is foreign bond or Euro bond, whether privately placed or to be placed for selling to general public. Following steps are involved in issue of bonds :

- Appointment of group of managers/lead managers of the issue.
- Appointment of under-writers.
- Completion of regulatory requirements.
- Pricing of issue
- The actual issue
- A tombstone i.e. advertisement according to the issue of the bonds.

9.6 THE BENCH MARK RATE

It is the rate of interest fur all fixed interest rate debt, including bonds, i.e. the yield on government securities of corresponding maturities,

The bench mark for fixed interest dollar debt is yield on US government dollar bonds of parallel maturity, similarly for pounds debt it will be yield on 'gilts' of corresponding maturity.

"Corresponding maturity" term explains as under: In general, government bonds have a bullet repayments of principal while most corporate loans have installment repayment so weighted average maturity needs to be calculated and the bench mark is the yield on government bonds with maturity equal to weighted average maturity of the loan. **Fixed** rate borrower pays a premium on this. Premium depends upon borrowers credit standing and market appetite for the bonds.

For FRN most popular bench mark is LIBOR. The actual rate is expressed as a spread over the bench mark and the applicable rate changes every 3-6 months depending upon how LIBOR has moved.

Activity 1

a) What do you mean by minimax FRNS?

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b) List out the major types Equity index-linked bonds.

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c) Some of the assets used as securities in Asset-backed securities are:

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d) Brandy Bonds means:

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9.7 SUMMARY

Capital Markets have become more important to the developing world. There was a series of developments that took place in the capital market since 1991.

International investors are of two types. Institutional investors and individual investors. Due to globalisation of international trade concept of mutual funds, pension funds are cropping up in the international market. Individual investor is lagging behind due to professionally managed institutional investors. It is necessary for every investor to know the bond market, its features, different types of bonds, its availability in the market.

Simultaneously one must know floating rate mechanism and different types of bonds. One should also know the benchmark rate for fixed interest dollar debt as it is on yield on US Government dollar bonds of parallel maturity.

9.8 KEY WORDS

LIBOR : London Interbank Offer Rate - The rate of interest offered on deposit from other banks in Euro currency market.

Collared floaters : Floaters with floor and cap to interest payable for any year.

Inverse floaters : Floaters having rate of interest expressed in given numbers minus the prevailing LIBOR.

Strips : Instrument which allows interest payment to be traded.

Bench mark rate : Rate of interest which determines the yield on government securities.

9.9 SELF ASSESSMENT QUESTIONS

1. Why is capital market considered as a source of external finance?
2. Write short notes on "Brady Bonds"
3. Who is an International Investor? What are the different categories of International Investors? Discuss.
4. What are the different types of bonds floated in the financial market?
5. Explain "bench mark rate"

9.10 FURTHER READINGS

1. ***Risk Management Systems in Banks,*** Guidelines by Reserve Bank of India, 1999.
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