Management of Fixed Income Securities
Prof. Jitendra Mahakud
Department of Humanities and Social sciences
Indian Institute of Technology Kharagpur

Module No # 07
Lecture No # 35
International bonds

Welcome back. So, in the previous class we discussed about the different debt instruments which are issued by commercial banks. Largely, we have discussed about the certificate of deposits, banker's acceptances, bank notes and all these things and also the different types of loans what the banks provide. Today we will be discussing international bonds. Generally, there are some kinds of bonds that are issued by international agencies or what we call the international bonds.

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So, today we will be discussing largely the different types of international bonds, which are available in the financial system and what are the different types of risks we face, whenever we are investing in these kinds of bonds. Particularly, whenever we have the concept like foreign exchange involved in between, then obviously we are exposed to a certain type of risk and what are those types of risks we generally always face with respect to that? That also will be covering up today's discussion.

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If you look at there are certain keywords we will come across. Let there be different types of bonds, we see in the international market. We have Samurai bonds, we have Yankee bonds, we have Bulldog bonds, we have European currency unity, Cross-border risk, we have Sovereign risk. These are the keywords we will come across while discussing about the international bonds in this particular session.

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So, let us see what are those different types of foreign debt securities which are traded or which are available for the investments. You look at the different types of foreign debt securities. We have a type of foreign debt security particularly, that is called the foreign bond. There is a euro bond, there is some global bond and that is the euro currency deposits. So, these are the different types of foreign debt securities, which are available in the market. So, let us see what are those technical differences between these types of instruments? So, let us see that what exactly the foreign bond is.

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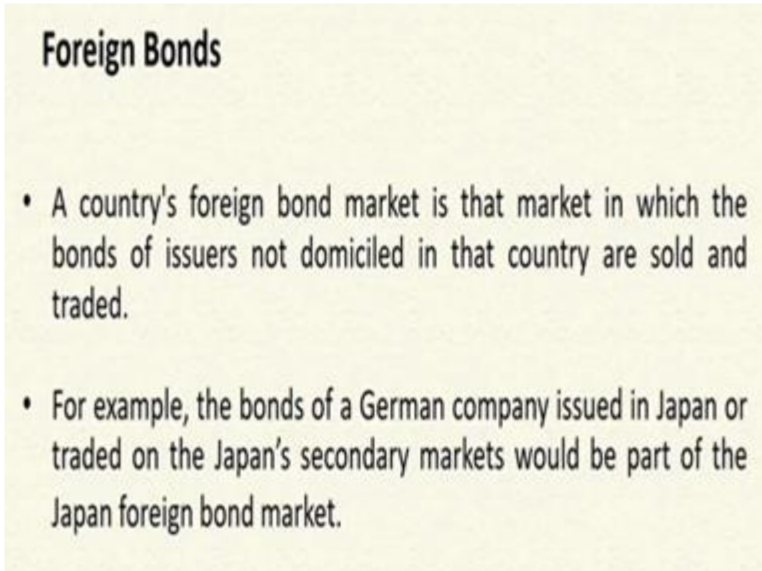

So, whenever you talk about the foreign bond of a country's foreign bond market if you see, it is a market in which the bonds of the issuers are not domiciled in that country, where it is sold and traded. For example, the bonds of German companies issued in Japan or traded in the Japanese secondary market would be a part of the Japanese foreign bond market. The bonds of a German company issued in Japan or traded on Japan's secondary market would be part of the Japanese foreign bond market. So, that particular point we call it is a foreign bond for the Japan.

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So, then in the context of this foreign bond if you look at the different types of features. Typical features you will observe, whenever we categorize a foreign bond market or there is a foreign bond. Foreign bonds are sold in the currency of the local economy. So, if in the Japanese market the German company is issuing the bond, then those things are sold in the Japanese currency. So, that’s why the foreign bonds are sold in the currency of the local economy.

Obviously, they are subject to the regulations which are governed in that particular country or in those particular regulatory bodies which are existing or present in that particular country and what is the objective of the foreign bonds. Foreign bonds basically provide foreign companies’ access to the funds what they want to use to finance their operations in the country where they are selling the bonds or where they are operating.

So, they get some kind of funds they raise certain kinds of funds from different economies or different countries where they are operating. So, that’s why we call it they are called foreign bonds, but they are issued in the local currency.

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So, there are certain names if you look at, what are those foreign bonds? Let any, if you took the example of the foreign bonds in Japan are called the Samurai bonds. Foreign bonds in the United Kingdom are called Bulldog bonds. Foreign bonds in the US are called Yankee bonds. Foreign bonds in Spain are called the Matador bonds. So, like those different names you can observe with respect to the different countries, whenever the foreign bonds are issued.

The samurai bonds and the Yankee bonds are quite popular names in the international bond market. So, these are the different types of bonds foreign bonds in the Netherlands, Rembrandt bonds. So, these are the different names has been already established names are there, whenever we try to explain foreign bonds or the international debt market instruments. So, these are some of the examples that have been reported here.

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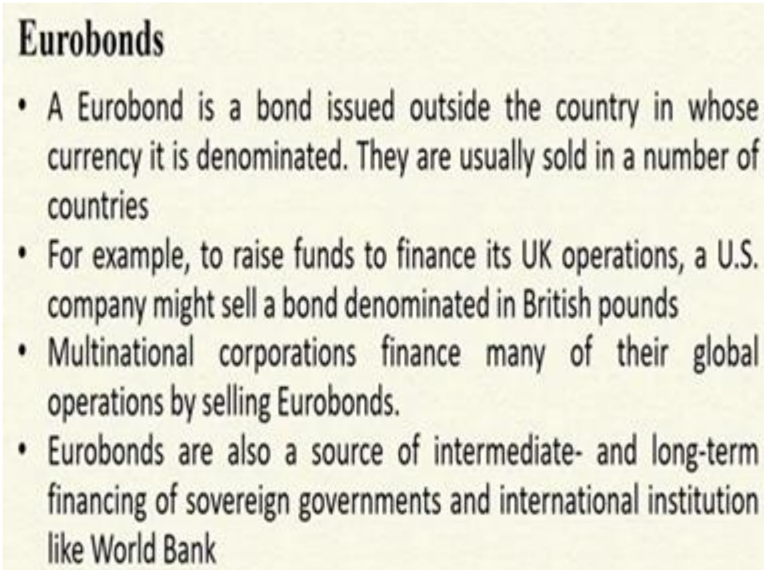

Then we have another major instrument. We look at that as the Eurobonds; it is quite popular across the developed economies. You see whenever you talk about the bond market in India; we have certain kinds of problems with respect to the bond market. Because the bond market is not that developed in that sense we are emerging, but still there are a lot of things that have to be done. It is not that way developed like the stock markets in India.

So, if you look at the international bond market we are not participating in that way, but the other developed countries like US and UK and Germany, Japan, and all the countries. They are the largest contributors of the international bond market. So, Euro bonds if you look at by name, if you look at this it is not like that it is only the bonds which are available in Europe or maybe some European countries like that.

The Euro bond is basically issued outside the country in which the currency is denominated and they are usually sold in a number of countries. For example, to raise the funds or to finance its equal operations a US Company might sell a bond denominated in British pounds that is possible. To finance its UK operations let the US company has an operation in the UK market and there to finance that activity in the UK market. They can sell a bond which is denominated in the British found in the UK market.

Generally, these Eurobonds are issued by Multinationals. The Multinational corporations generally finance many of their global operations by selling Euro bonds because they have the existence of almost more than one country. So, to raise the finance they generally take the help of euro bonds. So, the euro bonds generally are a source of intermediate and long-term financing of the Sovereign governments and international institutions like the World Bank.

So, through this, the financing can be raised. The Euro bonds are a major source or major instrument through which this long-term and intermediate term financing can be always made through the use of the euro bonds.

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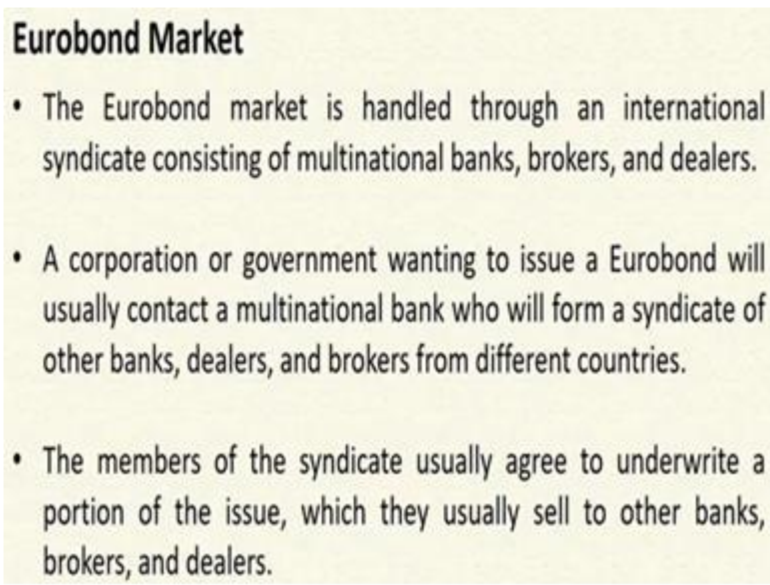

So, that's why there is a euro bond market we have. The Euro bond market if you look at generally it is handled through an international syndicate which consists of multinational banks, brokers and dealers. So, any company or a government if they want to issue a Euro bond will usually contact this Multinational bank and who will basically form a syndicate of other banks, dealers and brokers from different countries.

Through that, this particular bond can be sold to the different economies and to the different investors. So, the members of the syndicate generally agree to underwrite a portion of the issue which they will usually sell to the other banks, brokers and dealers. Underwriting services, you know that they have agreed open to buy certain particular issues if it is not subscribed. But if there is a demand for that particular security, then that is not required.

But if they will underwrite that particular kind of issue, then they have the obligation to invest in that particular security or they can buy a certain kind of type of security from that and finally, they can always sell that particular security to the other banks, brokers and the dealers.

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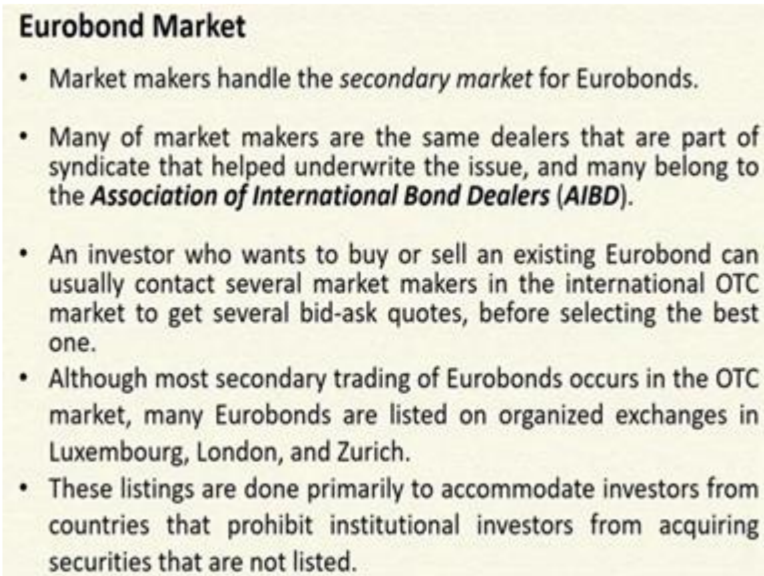

So, in the Eurobond market if you look at the market makers generally handled the secondary market for the euro bonds. Generally, these sophisticated informed investors or informed market participants, they generally call the market makers. So, here the market makers generally handle the secondary market for the euro bonds. So, many of the market makers are the same dealers that are a part of the syndicate that helped underwrite the issue and many belong to the association of international bond dealers.

There is an association they have that is called the association of international bond dealers and who are basically have the major responsibility for the secondary market transactions of the Eurobond? Automatically they are also part of the underwriting services and they also provide these underwriting services for the issuance of this Euro bonds. So, any investor who wants to buy or sell an existing Eurobond can contact several market makers in the international OTC market, that over-the-counter market to get several bid-ask quotes and from that, they can select the best one.

So, they can collect information about the bid price and tax price from the different kinds of dealers from the different market makers and finally, they can decide that which one they want to choose and which is the best one for them. So, although most secondary trading of the Euro bonds generally occurs in the OTC market, many euro bonds are listed also in the organized stock exchanges like Luxembourg, London and Zurich some of the euro bonds are listed in these stock exchanges.

These listings generally are done to accommodate the investors from the countries that prohibit institutional investors from acquiring securities that are not listed. So, the organized stock exchange where the Euro bonds are basically traded. Those particular stock exchanges are existing, only to facilitate or to accommodate the investors from the countries that prohibit the institutional investors from acquiring securities that are not listed.

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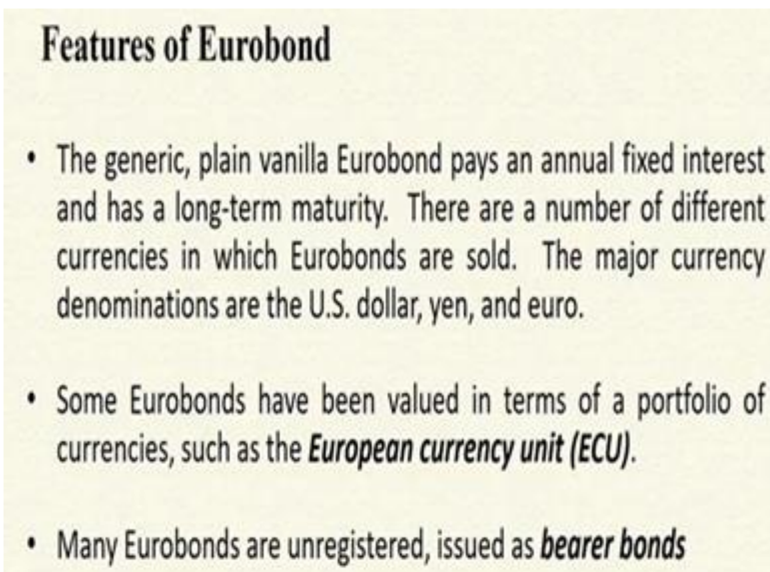

So, what is the feature of a Euro bond? What are the basic features of Eurobond? If you look at a general plain vanilla bond how it looks like? It basically has a face value, it has a coupon, it pays an annual coupon or it is a semiannual coupon. Like that it is a term to maturity and all like that generic plain vanilla euro bond, which also pays an annual fixed interest and has a long-term maturity and there are a number of different currencies in which Euro bonds are sold.

But the major currency denominations if you look at this are the US dollar, Japanese Yen and Euro. So, these are the 3 currencies on which euro bonds are basically dominated. Some of the cases the euro bonds also have been valued in terms of the portfolio of the currencies like European currency units (ECU) and many bonds are unregistered and issued as bearer bonds. Already we discussed what is the difference between the resisted bond and the bearer bond? So, most of the Euro bonds are the unregistered and they are generally issued as the bearer bonds.

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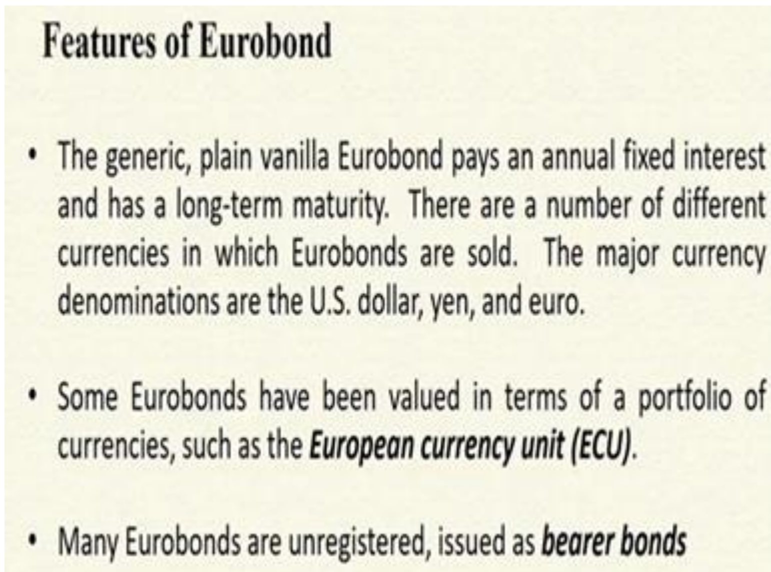

So, they have fewer protective covenants, making them an attractive financing instrument for the companies. But, some amount of risk is involved in terms of investment in the Euro bonds. Euro bonds differ in terms of their default risk and are rated in terms of quality ratings. The maturity of the Euro bonds also varies. They have intermediate terms like 2 to 10 years. Generally, they are called the Euro notes and they also have a long-term maturity like 10 to 30 years.

They are called euro bonds. So, whenever the maturity period is varying between 2 to 10 years, we call the Euro notes. Whenever the maturity period is between 10 to 30 years, we call it the Euro bonds. There are some short-term instruments also available in this particular segment. These are called the short-term Euro paper or Euro medium-term notes. So, these are some of the instruments also which are available on the basis of the maturity period.

The name of these particular instruments gets changed and that’s why they like your commercial paper and all which are short-term instruments in the corporate bond market. They can have a short-term Euro paper or the Euro medium-term notes which are also traded in this particular segment.

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So, the dual-currency Euro bonds pay the coupon interest in one currency and principal in another. If there is a Dual currency euro bond, then they will pay the interest in one currency and the principle in another currency. Then the option currency Euro bond offers investors a choice of currency. For example, a sterling or Canadian dollar bond gives the holder the right to receive the interest in principle in either of the currencies.

So, the number of Euro bonds also have some special conversion features like one type of convertible is a dual currency bond which allows the bondholder to convert the bond into stocks or another bond that is denominated in another currency. There is some flexibility involved with respect to some of the typical Eurobonds, which are traded in the market.

So, like you have the Dual currency of the sun, you have the options for getting the interest in one currency and getting principle in another currency and all these things. So, there is a possibility that you can also convert them into stocks and other instruments.

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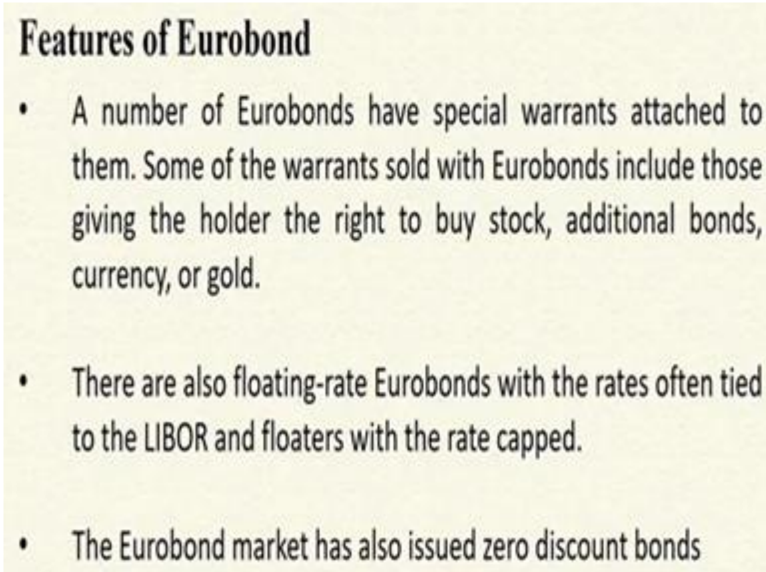

So, some of the warrants sold with Euro bonds include or which basically gives the holder the right to buy back. The warrants feature is like that buyback stock, additional bonds, currency or gold. There are also some floating rate Euro bonds with the rates generally tied with the libor and floaters with the red cap, whatever benchmark they are using that is called the floaters.

The Eurobond market also has issued zero discount bonds. That particular type of Euro bond is also available which is considered a typical characteristic of a zero-coupon bond. That is also available in this Eurobond market.

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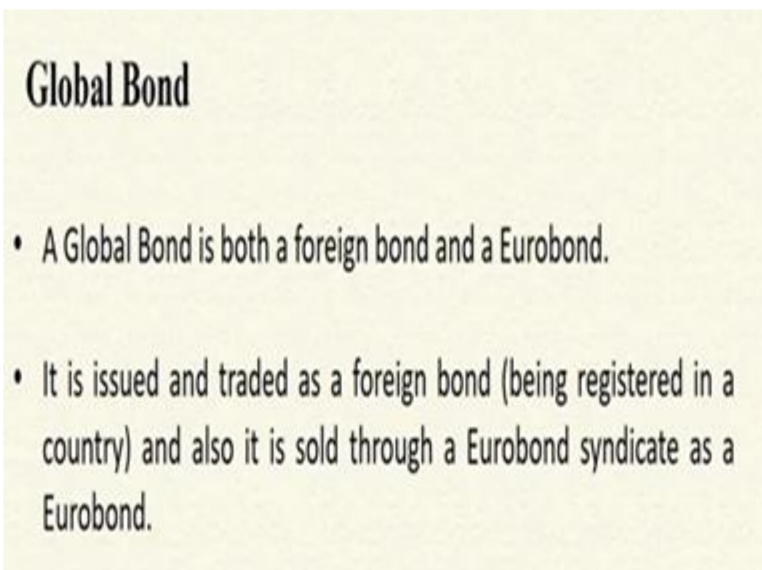

So, then another type of bond we have is called the Global bond. What is the Global bond? The global bond is a bond it is both a foreign bond and a Euro bond. Both the characteristics have to be satisfied to consider one bond as a Global bond. That means it is issued and traded as a foreign bond and also it is sold through a Euro bond syndicate as a Euro bond. It is issued and traded in a foreign bond which means being registered in a particular country and also it is sold through a Euro bond syndicate as a Euro bond. If both these things have been satisfied then we call it a Global bond.

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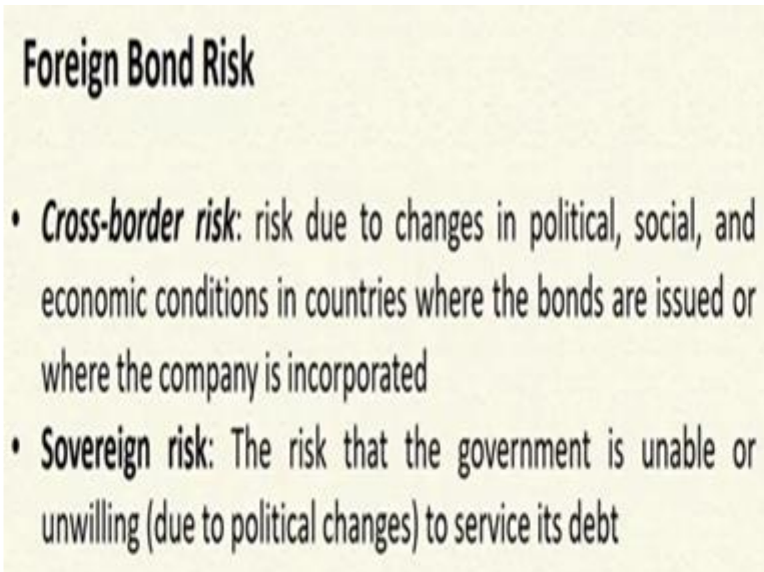

Then whenever we are talking about either this foreign bond or Euro bond or the Global bond whatever it may be. Generally, we are exposed to some degree of risk. What are those basic risks we face? Mostly we face the risk we call the cross-border risk and the sovereign risk. What do you mean by the cross-border risk? This risk basically comes due to either any kind of political changes in that particular country, where the bond is traded or some social and economic conditions have been changed.

So, if the bonds are issued in that particular country and obviously the country's dynamics can change with respect to other external factors, then obviously the performance of those particular bonds also gets affected. So, the risk which is arising due to the political, social and economic conditions in the countries where the bonds are issued and where the company is incorporated.

So, in that case, we are exposed to a certain amount of risk and that risk in the aggregate sense we call the cross-border risk and another type of broad risk we can also face, that is called the sovereign risk and what do we mean by the sovereign risk? It is the risk that the government is unable or unwilling to serve its state, due to some political changes. You can have any kind of situation that can arise within that particular economy. There may be some kind of political unrest, some political instability, that can also prevail in that particular system.

So, at that particular point of time, we are generally exposed to this sovereign risk. So, these are the 2 broader types of risk, generally what we face. Whenever we try to invest in the foreign bond market.

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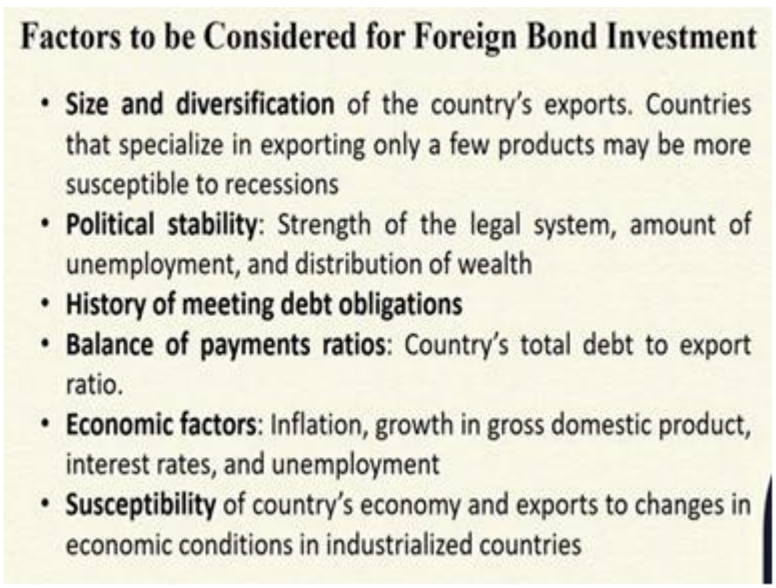

So, if you look at there are certain factors which should be considered whenever we are going to invest in the foreign bond or anybody wants to invest in the foreign bond market and then they have to look at certain things. First of all, they have to look at the size and diversification of the country's exports. So, the countries that specialize in exporting only a few products may be more successful always, there is a probability that if the exports are commodities are limited.

There is always a suspicion that they can go into a recession. The probability of facing a recession is quite high. If this size of the export is relatively less. Then the political stability, the strength of the legal system, the amount of unemployment and the distribution of wealth in aggregate, we call the stability of the system. How strong is your judiciary system? The macroeconomic factors like unemployment, growth, income distribution, and all these things are sometimes also responsible factors to destabilize the economy.

So, wherever these particular bonds are issued there is a possibility that the company may not perform in that particular context because of this kind of dynamics. So, in that case, the political stability will be hampered or the political system may be unstable. So, in that case, the company's bond performance also gets hampered. In the history of meeting the debt obligations, you can also look at the history, how this debt obligation history looks like in that particular country or a particular kind of company.

So, that also can help you to decide that whether you should invest in that particular bond or foreign bond or not. The balance of payments ratio contains the total debt to export ratio, that also you can look at because that generally gives you the idea of how much exposure or how much kind of obligations the particular country has with the rest of the economy or the rest of the world. Inflation growth in gross domestic product or the GDP, interest rates; these are all factors that also have to be considered where the particular companies are operating or wherever these particular bonds are issued.

That is also quite important in that particular context. So, if you look at mostly what you are trying to explain here, we are trying to explain overall if you see the macroeconomic fundamentals and the political stability. Macroeconomic fundamentals and political stability are the 2 major factors we have to consider whenever any bond investor wants to invest in that particular foreign bond.

So, macroeconomic factors include the GDP, inflation and all these things; interest rates and all and political stability includes we can say that stability of the government, strength of the legal system, distribution of wealth and all these things are relatively subjective in nature. But that also, you can always look at a proper assessment of that before deciding whether you should go invest in that particular foreign bond or not.

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Then we have a Euro currency market. So, this is a kind of money market. The euro currency market is the money market equivalent of the euro bond market. Here, in this market, the funds are generally the maturity period of the particular funds are relatively less and they are intermediated, deposited or loaned outside the country of the currency in which the funds are denominated.

For the large investor the market offers 2 types of instruments one is the Euro currency CDs and the second is the primary deposits. The Euro currency CDs are denominated as currencies outside the currency's country. The Maturity of Euro currency CDs ranges from one day to several years, with the most common maturity being 1, 3, 6 and 12 months. The rates on CDs are usually negotiated between the investor and the bank and they can be either fixed or the floating. The rates frequently quoted relative to the LIBOR rate or in terms of the Singapore Interbank offer rate.

If it is available in the Asian market, Asian dollar CDs are quoted in terms of the Singapore interbank offer rate that is called this SIBOR. The rates on the Eurodollar CDs are typically higher than the rates on comparable domestic CDs. Because of the relatively high risk, then the primary deposits are time deposits with negotiated rates and short-term maturities. So, these are the basically the characteristics of the instruments of the euro currency market.

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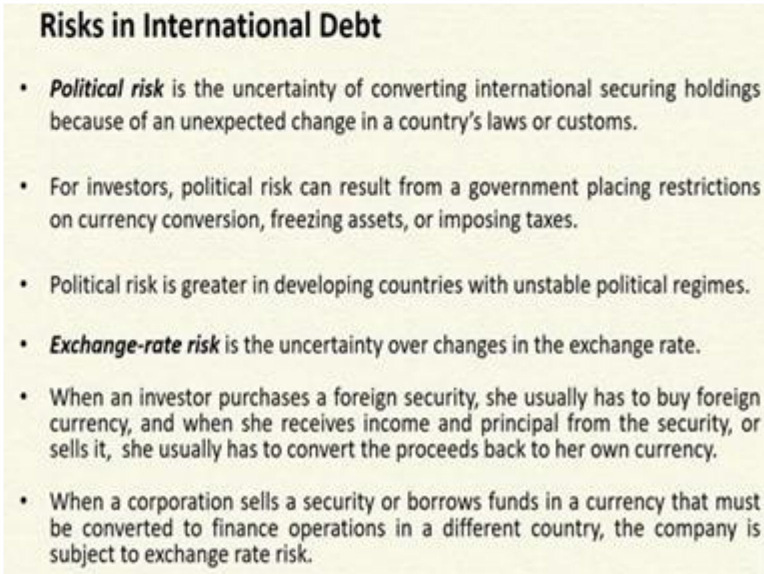

So, already we have discussed certain factors with respect to the investment point. But if you look at the investment in general in the international debt market, we look at the political risk and the exchange rate risk. Political risk is defined as the uncertainty of converting the international securing holdings because of unexpected changes in the country's laws or customs. So, for investors, political risk can result from the government placing restrictions on currency conversion, freezing the assets, imposing taxes and all these things.

Because of government policies, some regulations and political risks are always greater in developing countries with unstable political reasons. Generally, that happens many times and exchange rate risk is basically the uncertainty over the change in the exchange rate that generally happens every day. And when an investor purchases a foreign currency or foreign security, then he or she usually has to buy the foreign currency.

And when he or she receives income and principal from the security or sells it she or he usually has to convert the process back to her own currency and that conversion whenever they do that time the exchange rate plays a significant role. So, when a corporation basically sells security or borrows the funds in a currency that must be converted to finance the operations in a different country. Then the company is subject to the exchange rate risk.

So, both from the issuer's point of view and from the investor's point of view, they are always exposed to exchange rate risk. That is a common risk always; we face whenever we operate in the international debt market. So, this is the major risk although there is another type of risk;

common risk also involved. But these are the different risks that we generally come across whenever we try to discuss the international debt markets.

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So, what we have discussed is that foreign bonds generally are sold in the currency of the local currency. Foreign bonds generally provide the access to the funds to finance the operations of foreign companies in other countries, wherever they are operating. Multinational corporations generally finance their operations or investments, whenever they do Global operations by selling the Euro bond.

And market makers generally handle the secondary market for Euro bonds. And investors in the international debt market generally face various types of risks like cross-border risks, Sovereign risks, foreign exchange risks, political risk and all. So, these are a common risk what we face.

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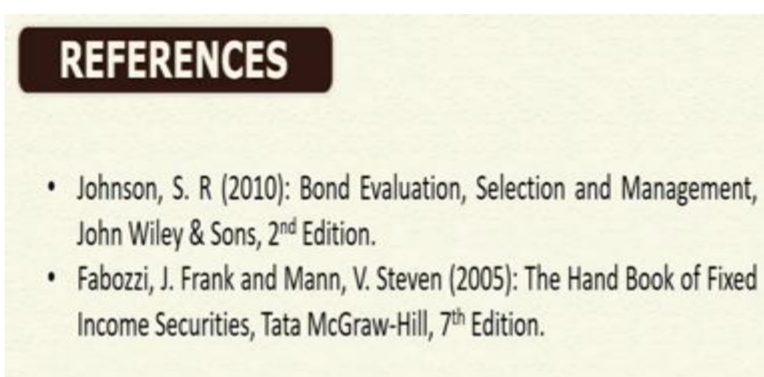

So, these are the references you can go through for the detailed discussion. Thank you.