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Fixed Income Securities
Fixed Income Markets: Issuance, Trading & Funding

Study Session 12

Reading No – 40
Version 2022

Learning Outcome Statements

<u>The candidate Should be able to:</u>

a. describe classifications of global fixed-income markets;

b. describe the use of interbank offered rates as reference rates in floating-rate debt;

c. describe mechanisms available for issuing bonds in primary markets;

d. describe secondary markets for bonds;

e. describe securities issued by sovereign governments;

f. describe securities issued by non-sovereign governments, quasi-government entities, and supranational agencies;

g. describe types of debt issued by corporations;

h. describe structured financial instruments;

i. describe short-term funding alternatives available to banks;

j. describe repurchase agreements (repos) and the risks associated with them.

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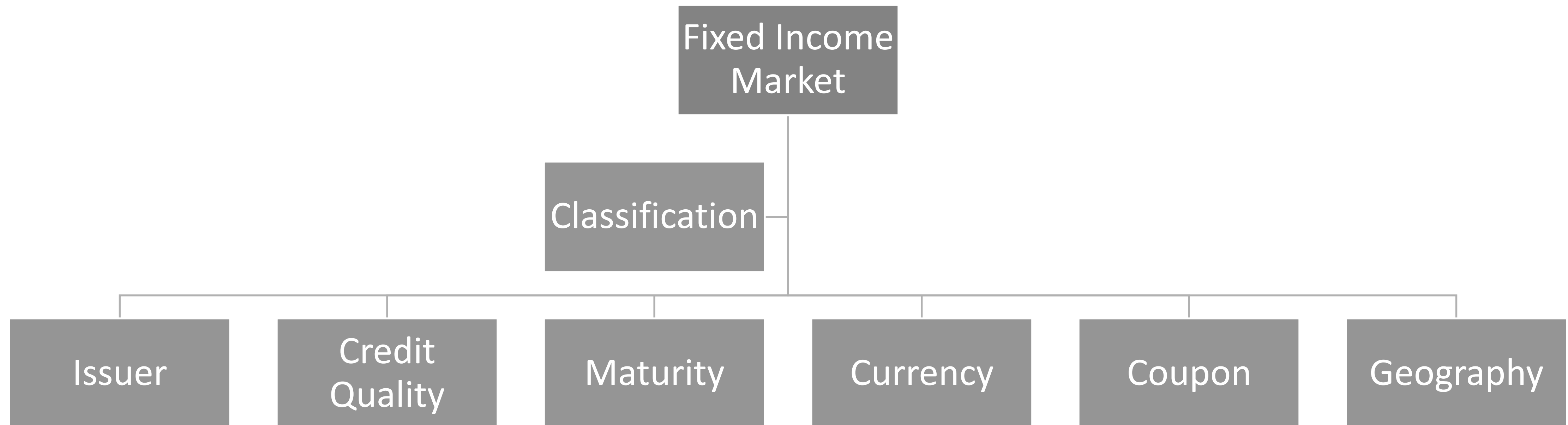
Los a,b: Fixed Income Market Classification

We will try to understand the vast fixed Income market based on the below classification approach



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Los a,b:Fixed Income Market - Classification

- Issuer:
  - Supranational (international) organizations, such as the World Bank
  - Sovereign bonds
  - Non-sovereign (local) governments, such as provinces, regions, states, or cities
  - Quasi-government entities they are either owned or sponsored by governments
  - corporate sector include bonds issued by financial and non-financial companies

- Credit quality
  - Issuer’s creditworthiness is judged by credit rating agencies
  - Ratings of Baa3 or above by Moody’s Investors Service or BBB– or above by Standard & Poor’s (S&P) and Fitch Ratings are considered investment grade
  - Ratings below these levels are referred to as non-investment grade, high yield, speculative, or “junk.”

Los a,b :Fixed Income Market - Classification

- **Maturity**

- Securities can be classified by the original maturity of the bonds when they are issued
- Securities that are issued with a maturity Up to 1 year – Money market Securities
- Example Treasury bills issued by sovereign governments, commercial paper and negotiable certificates of deposit issued by corporate sector
- Securities that are issued with a maturity > 1 year – Capital market Securities

- **Currency Denomination**

- The currency denomination of the bond’s cash flows influences which country’s interest rates affect a bond’s price
- For example, if a bond is denominated in yen, its price will be primarily driven by the credit quality of the issuer and by Japanese interest rates

Los a,b:Fixed Income Market - Classification

- **Type of Coupon**
- Some bonds pay a fixed rate of interest for example coupon is 5% of par value
- Floating-rate notes (FRNs) or floaters, pay a rate of interest that adjusts to market interest rates at regular, short-term intervals (e.g., quarterly)

Coupon=Reference Rate+ Quoted Margin

The **London interbank offered rate (Libor)** is the reference rate for many floating-rate bonds

The margin is usually set when the bond is issued and remains constant until maturity example 1% or 1.5%

Los a,b:Fixed Income Market - Classification

❑ **Geography**

- Bond markets may also be classified as developed markets or emerging markets
- Emerging markets are countries whose capital markets are less well-established than those in developed markets

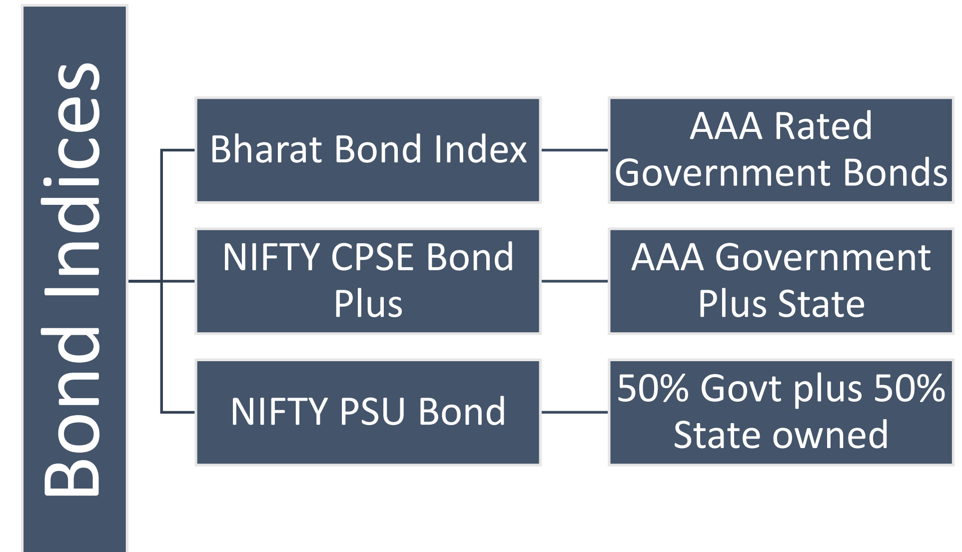
❑ **Other Classifications**

- Inflation-linked bonds offer investors protection against inflation by linking the coupon payment and/or the principal repayment to an index of consumer prices
- Income tax exemption for some of the bonds can be issued by governments or by some non-profit organizations. For example local governments can issue municipal bonds (or munis) that are tax exempt

Los a,b: Fixed-Income Indices

- A fixed-income index is a tool used by investors and investment managers to describe a bond market or sector, as well as to evaluate the performance of investments and investment managers
- Most fixed-income indices are constructed as portfolios of securities that reflect a particular bond market or sector
- Index Construction varies across indices
- Example: Barclays capital US aggregate bond Index

Generally people are not ware of bond indices because of its limited use for retail investors



NSE Bond Indexes

Los a,b: Investors in Fixed-Income Securities

There are different types of investors in fixed-income securities.

- Major categories of bond investors include
    I. central banks,
    II. institutional investors,
    III. retail investors
- The central banks, institutional investors typically invest directly in fixed-income securities
- Retail investors often invest indirectly through fixed-income mutual funds or exchange-traded funds (ETFs)
- Central banks use open market operations to implement monetary policy. Open market operations refer to the purchase or sale of bonds, usually sovereign bonds issued by the national government. By purchasing (selling) domestic bonds, central banks increase (decrease) the monetary supply in the economy
- Institutional investors, including pension funds, hedge funds, charitable foundations and endowments, insurance companies, and banks, represent the largest groups of investors in fixed-income securities
- Retail investors like the price and income stability generally associated with fixed income securities relative to equity market

CFA Curriculum Question

The distinction between investment-grade debt and non-investment-grade debt is *best* described by differences in:

A tax status.

B credit quality.

C maturity dates.

A bond issued internationally, outside the jurisdiction of the country in whose currency the bond is denominated, is *best* described as a:

A Eurobond.

B foreign bond.

C municipal bond.

When classified by type of issuer, asset-backed securities are part of the:

A corporate sector.

B structured finance sector.

C government and government-related sector.

Compared with developed market bonds, emerging market bonds *most likely*:

A offer lower yields.

B exhibit higher risk.

C benefit from lower growth prospects.

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Solutions

1. B
2. A
3. B
4. B

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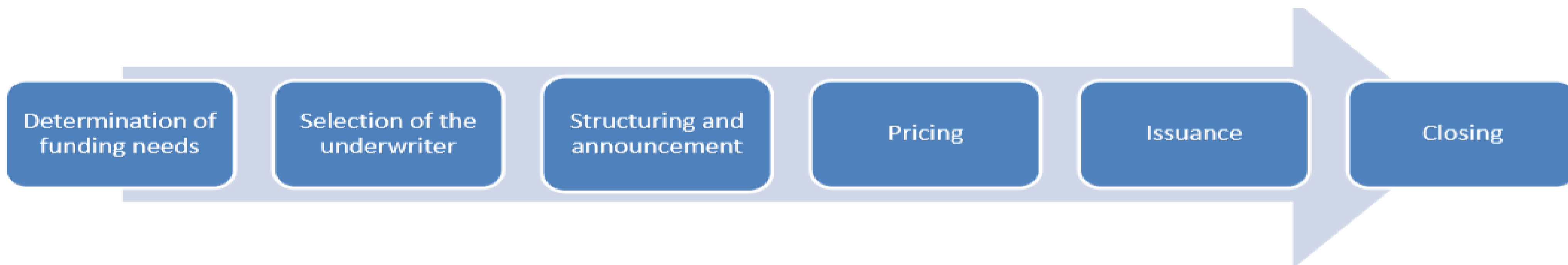
Los c. describe mechanisms available for issuing bonds in primary markets

Primary Market: Primary bond markets are markets in which issuers first sell bonds to investors to raise capital. Bonds can be sold (issued) via a public offering or a private raise capital

- A bond issue can be sold via a public offering (or public offer), in which any member of the public may buy the bonds, or via a private placement, in which only a selected investor, or group of investors, may buy the bonds
- In an **underwritten offering**, also called a **firm commitment offering**, the investment bank guarantees the sale of the bond issue at an offering price that is negotiated with the issuer In a **best effort offering**, the investment bank only serves as a broker. It only tries to sell the bond issue at the negotiated offering price if it is able to for a commission.
- If a bond issue is underwritten by a group of underwriters then its called as **syndicated offering.**
- Shelf registration: Allows the issuer to file a single, all-encompassing offering circular that covers a series of bond issues.
- An **auction** is a method that involves bidding. It is helpful in providing price discovery



Los c. describe mechanisms available for issuing bonds in primary markets

Primary Dealers: Financial institutions that are authorised to deal with government securities. For e.g. ICICI Bank is one of the primary dealers for RBI bonds in India

Private Placement

A private placement is typically a non-underwritten, unregistered offering of bonds that are sold only to an investor or a small group of investors

- Typical investors in privately placed bonds are large institutional investors
- A private placement can be accomplished directly between the issuer and the investor(s) or through an investment bank
- Because privately placed bonds are unregistered and may be restricted securities that can only be purchased by some types of investors, there is usually no active secondary market to trade them
- Trading may be possible under certain conditions

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Los d: secondary markets

- Securities can be traded directly from investor to investor, or through a broker or dealer to facilitate the transaction
- There are two main ways for secondary markets to be structured:

1. as an organized exchange or
2. as an over-the-counter market

- Liquidity is supplied by Eurobond market makers, of which approximately 35 are registered with the International Capital Market Association
- The bid–offer spread or bid–ask spread, which reflects the prices at which dealers will buy from a customer (bid) and sell to a customer (offer or ask), is very often used as an indicator of liquidity
- Settlement is the process that occurs after the trade is made. The bonds are passed to the buyer and payment is received by the seller. Secondary market settlement for government and quasi-government bonds typically takes place either on a cash basis or on a T + 1 basis

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CFA Curriculum Question

An investment bank that underwrites a bond issue *most likely*:

- **A** buys and resells the newly issued bonds to investors or dealers.
- **B** acts as a broker and receives a commission for selling the bonds to investors.
- **C** incurs less risk associated with selling the bonds than in a best-efforts offering.

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Solutions

- A is correct. In an underwritten offering (also called firm commitment offering), the investment bank (called the underwriter) guarantees the sale of the bond issue at an offering price that is negotiated with the issuer. Thus, the underwriter takes the risk of buying the newly issued bonds from the issuer and then reselling them to investors or to dealers, which then sell them to investors. B and C are incorrect because the bond issuing mechanism in which an investment bank acts as a broker and receives a commission for selling the bonds to investors, and incurs less risk associated with selling the bonds, is a best-efforts offering (not an underwritten offering).

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Los e: describe securities issued by sovereign governments;

Sovereign : bonds issued National governments

1. Sovereign bonds denominated in local currency have different names in different countries. For example, they are named US Treasuries in the United States
2. Treasury bills (T-bills) →original maturity is one year or shorter
3. Treasury notes (T-notes) →original maturity is longer than one year and up to 10 years
4. Treasury bonds (T-bonds) → original maturity is longer than 10 years

Credit Quality of Sovereign Bonds

1. Highly rated sovereign bonds denominated in local currency are virtually free of credit risk

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Los e: describe securities issued by sovereign governments;

Types of Sovereign Bonds:

Fixed-Rate Bonds: National governments routinely issue two types of fixed-rate bonds:

1. Zero-coupon bonds (or pure discount bonds) it is issued at a discount to par value and redeemed at par at maturity
2. Coupon bonds

Floating-Rate Bonds: The price of a bond changes in the opposite direction from the change in interest rates

1. Inflation-Linked Bonds: the index to which the coupon payments and/or principal repayments are linked is typically an index of consumer prices

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Los f. describe securities issued by non-sovereign governments, quasi-government entities, and supranational agencies;

Non-sovereign government

1. Issued by states, provinces, counties
2. Bonds issued to finance public projects, such as schools, motorways, hospitals, bridges, and airports. The sources for paying interest is taxing authority of the local government
3. Default rates of non-sovereign bonds are historically low

Agency/Quasi-government Bond

1. A bond issued by an entity that is either owned or sponsored by a national government. Also called agency bond
2. Examples of quasi-government entities include government-sponsored enterprises (GSEs) in the United States, such as the Federal National Mortgage Association ("**Fannie Mae**"), the Federal Home Loan Mortgage Corporation ("**Freddie Mac**")
3. Rated very high by the credit rating

Supranational Bonds: A bond issued by a supranational agency such as the World Bank

Example Bond issued by World Bank, or the International Monetary Fund (IMF)

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CFA Curriculum Question

Which factor is associated with a more favorable quality sovereign bond credit rating?

A Issued in local currency, only

B Strong domestic savings base, only

C Issued in local currency of country with strong domestic savings base

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Solution

- C is correct. Bonds issued in the sovereign's currency and a strong domestic savings base are both favorable sovereign rating factors. It is common to observe a higher credit rating for sovereign bonds issued in local currency, because of the sovereign's ability to tax its citizens and print its own currency. Although there are practical limits to the sovereign's taxing and currency-printing capacities, each tends to support a sovereign's ability to repay debt. A strong domestic savings base is advantageous because it supports the sovereign's ability to issue debt in local currency to domestic investors.

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Los g. describe types of debt issued by corporations;

Bank debt

- Bilateral loan – loan from a single lender to a single borrower
- Syndicated loan - a loan from a group of lenders, called the "syndicate," to a single borrower
- Most bilateral and syndicated loans are floating-rate loans and can be more expensive than corporate bonds

Commercial paper (CP)

- A short-term, unsecured promissory note issued in the public market or via a private placement
- A valuable source of flexible, readily available, and relatively low-cost short-term financing. It is a source of funding for working capital and seasonal demands for cash
- It is also a source of **bridge financing**—that is, interim financing that provides funds until permanent financing can be arranged
- The maturity of commercial paper can range from overnight to one year, but a typical issue matures in less than three months
- The yield on commercial paper is typically higher than that on short-term sovereign bonds of the same maturity for two main reasons. First, commercial paper is exposed to credit risk. Second, commercial paper markets are generally less liquid than short-term sovereign bond markets

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Los g. describe types of debt issued by corporations;

Credit Quality of Commercial Paper:

1. Usually commercial paper is issued by the more reputed and stable companies.
2. Companies usually fund the maturity of the initial commercial paper with a new issue.
3. Also companies might be required to back up the issue with a "Line of credit"
4. The U.S Commercial paper market is the largest and papers issued internationally are called as Euro commercial paper

Exhibit 5 Commercial Paper Ratings

Credit Quality	Moody's	S&P	Fitch
Superior	P1	A1+/A1	F1+/F1
Satisfactory	P2	A2	F2
Adequate	P3	A3	F3
Speculative	NP	B/C	F4
Defaulted	NP	D	F5

Exhibit 6 USCP vs. ECP

Feature	US Commercial Paper	Eurocommercial Paper
Currency	US dollar	Any currency
Maturity	Overnight to 270 days[a]	Overnight to 364 days
Interest	Discount basis (instrument is issued at a discount to par value)	Interest-bearing (instrument issued at par and pays interest) or discount basis
Settlement	T + 0 (trade date)	T + 2 (trade date plus two days)
Negotiable	Can be sold to another party	Can be sold to another party

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Los g. describe types of debt issued by corporations;

Maturities:

Bonds

1. Those securities with maturities between 1 and 12 years are often considered notes, whereas securities with maturities greater than 12 years are considered bonds

Medium-term note

1. A corporate bond offered continuously to investors by an agent of the issuer, designed to fill the funding gap between commercial paper and long-term bonds
2. Financial and non-financial companies issue conventional coupon bonds that pay a fixed periodic coupon during the bond's life. They also issue bonds for which the periodic coupon payments adjust to changes in market conditions and/or changes to the issuer's credit quality
3. Zero-coupon bonds pay no coupon
4. settlement takes longer for new bond issued than for the secondary trading of bonds, for which settlement is typically on a T + 2 or T + 3 basis

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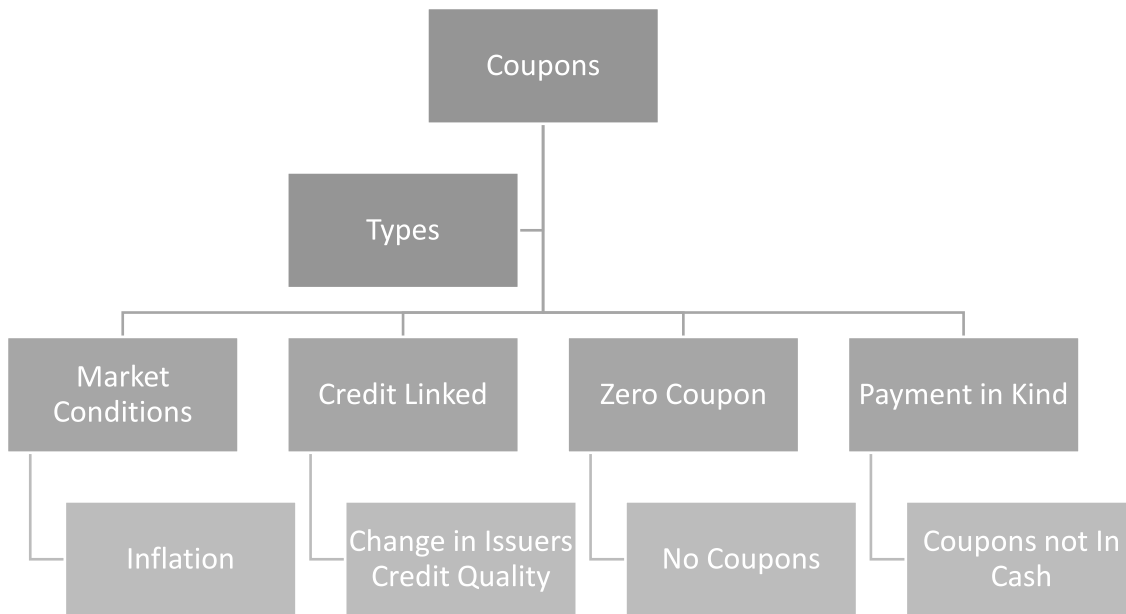
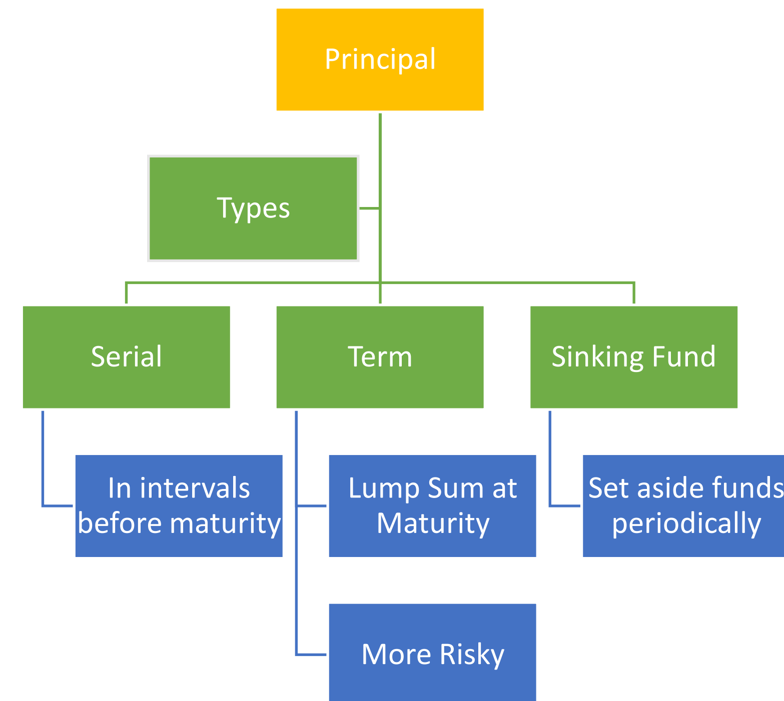
Los g. describe types of debt issued by corporations;

- Coupon and Principal Payment Structure:





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Los g. describe types of debt issued by corporations;

- **Asset or Collateral Backing**: companies may try to reduce the risk of their offering by offering various levels of credit risk. For e.g. seniority in terms of investors being paid when a default occurs, usually done when we issue unsecured debt. In cases of secured debt, the debt is covered by physical assets or financial.
- **Contingency Provisions**: Call, put and conversion are three features which can be added in bonds to change their risk categories.
  - Callable bonds: Gives the right to the issuer to retire bonds before maturity(Usually when the interest rates might be low)
  - Puttable Bonds: Gives the right to the investor to sell the bond back to the issuer at a pre determined price
  - Conversion: A bond may have a conversion feature to stocks, this can be used by companies who are facing difficulty raising capital with usual bonds

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CFA Curriculum Question

Which of the following statements relating to commercial paper is *most accurate*?

A There is no secondary market for trading commercial paper.

B Only the strongest, highly rated companies issue commercial paper.

C Commercial paper is a source of interim financing for long-term projects.

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Solution

- C is correct. Companies use commercial paper not only as a source of funding working capital and seasonal demand for cash but also as a source of interim financing for long-term projects until permanent financing can be arranged. A is incorrect because there is a secondary market for trading commercial paper, although trading is limited except for the largest issues. B is incorrect because commercial paper is issued by companies across the risk spectrum, although only the strongest, highly rated companies issue *low-cost* commercial paper.

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Los h: Structured Financial Instruments

1.Capital Protected Instruments:

Buying zero coupon bond(99000) + buying call option at $1000

The zero-coupon bond provides the investor capital protection; at maturity, the investor will receive 100% of the capital invested even if the call option expires worthless. The call option provides upside potential if the price of the underlying asset rises and a limited downside if the price of the underlying asset falls. The downside is limited to the price, often called the premium, paid for the call option

2. Yield Enhancement Instruments: Credit-linked note (CLN): The credit protection buyer holds a bond or loan that is subject to default risk and issues its own security (the credit-linked note) with the condition that if the bond or loan it holds defaults, the principal payoff on the credit-linked note is reduced accordingly. Thus, the buyer of the credit-linked note effectively insures the credit risk of the underlying reference security.

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Los h: Structured Financial Instruments

3.Participation Instruments:

- Floating-rate bonds can be viewed as a type of participation instrument
- Floaters differ from fixed-rate bonds in that their coupon rate adjusts periodically according to a pre-specified formula
- The coupon formula is usually expressed as a reference rate adjusted for a spread

4. Leveraged Instruments: An inverse floater is an example of a leveraged instrument

- The cash flows are adjusted periodically and move in the opposite direction of changes in the reference rate
- When the reference rate decreases, the coupon payment of an inverse floater increases.

A general formula for an inverse floater's coupon rate is:

Inverse floater coupon rate = C – (L × R) where C is the maximum coupon rate reached if the reference rate is equal to zero, L is the coupon leverage, and R is the reference rate on the reset date

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Los i. describe short-term funding alternatives available to banks;

1. **Short Term Wholesale Funds**

Reserve Funds

- When banks run short of required reserves. This imbalance is solved through the central bank funds market, which allows banks that have a surplus of funds to loan money to banks that need funds for maturities of up to one year

Certificate of deposits (CD)

- Instrument that represents a specified amount of funds on deposit for a specified maturity and interest rate. CDs are an important source of funds for financial institutions
- If the CD is non-negotiable, the deposit plus the interest are paid to the initial depositor at maturity
- A negotiable CD allows any depositor (initial or subsequent) to sell the CD in the open market prior to the maturity date

Central Bank fund / Inter-bank fund

- The interbank market is the market of loans and deposits between banks
- The term to maturity of an interbank loan or deposit ranges from overnight to one year
- The rate on an interbank loan or deposit can be quoted relative to a reference rate, such as an interbank offered rate or as a fixed interest rate

2: Retail Deposits

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Los j. describe repurchase agreements (repos) and the risks associated with them.

Repurchase agreement or repo: is the sale of a security with a simultaneous agreement by the seller to buy the same security back from the purchaser at an agreed-on price and future date

Structure:

- One party is borrowing money and providing collateral for the loan at an interest rate that is typically lower than on an otherwise similar bank loan
- The other party is lending money while accepting a security as collateral for the loan
- Central banks are also active users of repurchase agreements in their daily open market operations; they either lend to the market to increase the supply of funds or withdraw surplus funds from the market
- The interest rate on a repurchase agreement is called the repo rate

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Los j. describe repurchase agreements (repos) and the risks associated with them.

Factors affecting Repo Rate:

Repo rate is higher when

- longer the repurchase agreement+
- Credit quality of collateral security is lower
- Lower creditworthiness of the counterparty
- if the collateral is in Excess supply or if there is a low demand for it

Credit Risk Associated with Repo:

Repo margin (Haircut) is lower when:

- Shorter the repurchase agreement
- Credit quality of collateral security is higher
- Higher creditworthiness of the counterparty
- if the collateral is in Low supply or if there is a excess demand for it

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Summary

- The most widely used ways of classifying fixed-income markets include the type of issuer; the bonds' credit quality, maturity, currency denomination, and type of coupon; and where the bonds are issued and traded.
- Based on the type of issuer, the four major bond market sectors are the household, non-financial corporate, government, and financial institution sectors.
- Investors distinguish between investment-grade and high-yield bond markets based on the issuer's credit quality.
- Money markets are where securities with original maturities ranging from overnight to one year are issued and traded, whereas capital markets are where securities with original maturities longer than one year are issued and traded.
- The majority of bonds are denominated in either euros or US dollars.
- Investors distinguish between bonds that pay a fixed rate versus a floating rate of interest. The coupon rate of floating-rate bonds is often expressed as a reference rate plus a spread. Interbank offered rates, such as Libor, historically have been the most commonly used reference rates for floating-rate debt and other financial instruments but are being phased out to be replaced by alternative reference rates.
- Based on where the bonds are issued and traded, investors distinguish between domestic and international bond markets. The latter includes the Eurobond market, which falls outside the jurisdiction of any single country and is characterized by less reporting, regulatory, and tax constraints. Investors also distinguish between developed and emerging bond markets.
- Investors and investment managers use fixed-income indexes to describe bond markets or sectors and to evaluate performance of investments and investment managers.
- The largest investors in bonds include central banks; institutional investors, such as pension funds, hedge funds, charitable foundations and endowments, insurance companies, mutual funds and ETFs, and banks; and retail investors, typically by means of indirect investments.
- Primary markets are markets in which issuers first sell bonds to investors to raise capital. Secondary markets are markets in which existing bonds are subsequently traded among investors.

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Summary

- There are two mechanisms for issuing a bond in primary markets: a public offering, in which any member of the public may buy the bonds, or a private placement, in which only an investor or small group of investors may buy the bonds either directly from the issuer or through an investment bank.
- Public bond issuing mechanisms include underwritten offerings, best-efforts offerings, shelf registrations, and auctions.
- When an investment bank underwrites a bond issue, it buys the entire issue and takes the risk of reselling it to investors or dealers. In contrast, in a best-efforts offering, the investment bank serves only as a broker and sells the bond issue only if it is able to do so. Underwritten and best-efforts offerings are frequently used in the issuance of corporate bonds.
- The underwriting process typically includes six phases: the determination of the funding needs, the selection of the underwriter, the structuring and announcement of the bond offering, pricing, issuance, and closing.
- A shelf registration is a method for issuing securities in which the issuer files a single document with regulators that describes and allows for a range of future issuances.
- An auction is a public offering method that involves bidding and is helpful both in providing price discovery and in allocating securities. Auctions are frequently used in the issuance of sovereign bonds.
- Most bonds are traded in OTC markets, and institutional investors are the major buyers and sellers of bonds in secondary markets.
- Sovereign bonds are issued by national governments primarily for fiscal reasons. These bonds take different names and forms depending on where they are issued, their maturities, and their coupon types. Most sovereign bonds are fixed-rate bonds, although some national governments also issue floating-rate bonds and inflation-linked bonds.
- Local governments, quasi-government entities, and supranational agencies issue bonds, which are named non-sovereign, quasi-government, and supranational bonds, respectively.
- Companies raise debt in the form of bilateral loans, syndicated loans, commercial paper, notes, and bonds.
- Commercial paper is a short-term unsecured security that companies use as a source of short-term and bridge financing. Investors in commercial paper are exposed to credit risk, although defaults are rare. Many issuers roll over their commercial paper on a regular basis.
- Corporate bonds and notes take different forms depending on the maturities, coupon payment, and principal repayment structures. Important considerations also include collateral backing and contingency provisions.
- Medium-term notes are securities that are offered continuously to investors by an agent of the issuer. They can have short-term or long-term maturities.
- The structured finance sector includes asset-backed securities, collateralized debt obligations, and other structured financial instruments. All of these seemingly disparate financial instruments share the common attribute of repackaging risks.
- Many structured financial instruments are customized instruments that often combine a bond and at least one derivative. The redemption and often the coupons of these structured financial instruments are linked via a formula to the performance of the underlying asset(s). Thus, the bond's payment features are replaced with non-traditional payoffs derived not from the issuer's cash flows

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Summary

- but from the performance of the underlying asset(s). Capital protected, yield enhancement, participation and leveraged instruments are typical examples of structured financial instruments.
- Financial institutions have access to additional sources of funds, such as retail deposits, central bank funds, interbank funds, large-denomination negotiable certificates of deposit, and repurchase agreements.
- A repurchase agreement is similar to a collateralized loan. It involves the sale of a security (the collateral) with a simultaneous agreement by the seller (the borrower) to buy back the same security from the purchaser (the lender) at an agreed-on price in the future. Repurchase agreements are a common source of funding for dealer firms and are also used to borrow securities to implement short positions.

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