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BONDS: A FORMAL CONTRACT TO REPAY BORROWED MONEY WITH INTEREST AT FIXED INTERVALS

RAVI THAREJA, SONAL PATHAK

ABSTRACT

In finance, a bond is a debt security, in which the authorized issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay interest (the coupon) and/ or to repay the principal at a later date, termed maturity. A bond is a formal contract to repay borrowed money with interest at fixed intervals.

Bonds and stocks are both securities, but the major difference between the two is that stockholders have an equity stake in the company (i.e., they are owners), whereas bondholders have a creditor stake in the company (i.e., they are lenders). Another difference is that bonds usually have a defined term, or maturity, after which the bond is redeemed, whereas stocks may be outstanding indefinitely. An exception is a console bond, which is perpetuity (i.e., bond with no maturity).

KEYWORDS: Bonds, Stocks, Foreign Currencies.

INTRODUCTION

Bonds are issued by public authorities, credit institutions, companies and supranational institutions in the primary markets. The most common process of issuing bonds is through underwriting. In underwriting, one or more securities firms or banks, forming a syndicate, buy an entire issue of bonds from an issuer and re-sell them to investors. The security firm takes the risk of being unable to sell on the issue to end investors. However government bonds are instead typically auctioned. In reality, the financial crisis tested the willingness of the securities firms to actually perform underwriting. Primary issuance is arranged by bookrunners who arrange the bond issue, have the direct contact with investors and act as advisors to the bond issuer in terms of timing and price of the bond issue. The bookrunners willingness to underwrite must be discussed prior to opening books on a bond issue as there may be limited appetite to do so.

Thus a bond is like a loan: the issuer is the borrower (debtor), the holder is the lender (creditor), and the coupon is the interest. Bonds provide the borrower with external funds to finance long-term investments, or, in the case of government bonds, to finance current expenditure. Certificates of deposit (CDs) or commercial paper are considered to be money market instruments and not bonds. Bonds must be repaid at fixed intervals over a period of time.

FEATURES OF BONDS

The most important features of bonds are:

NOMINAL, PRINCIPAL OR FACE AMOUNT

The amount on which the issuer pays interest, and which, most commonly, has to be repaid at the end. Some structured bonds can have a redemption amount which is different to the face amount and can be linked to performance of particular assets such as a stock or commodity index, foreign exchange rate or a fund. This can result in an investor receiving less or more than his original investment at maturity.

ISSUE PRICE

The price at which investor's buy the bonds when they are first issued, which will typically be approximately equal to the nominal amount. The net proceeds that the issuer receives are thus the issue price, less issuance fees.

MATURITY DATE

The date on which the issuer has to repay the nominal amount. As long as all payments have been made, the issuer has no more obligations to the bond holders after the maturity date.

The length of time until the maturity date is often referred to as the term or tenor or maturity of a bond. The maturity can be any length of time, although debt securities with a term of less than one year are generally designated money market instruments rather than bonds.

Most bonds have a term of up to thirty years. Some bonds have been issued with maturities of up to one hundred years, and some even do not mature at all. In early 2005, a market developed in euros for bonds with a maturity of fifty years. In the market for U.S. Treasury securities, there are three groups of bond maturities:

1. Short term (bills): maturities up to one year;
2. Medium term (notes): maturities between one and ten years;
3. Long term (bonds): maturities greater than ten years.

COUPON

The interest rate that the issuer pays to the bond holders. Usually this rate is fixed throughout the life of the bond. It can also vary with a money market index, such as LIBOR, or it can be even more exotic. The name coupon originates from the fact that in the past, physical bonds were issued which coupons had attached to them. On coupon dates the bond holder would give the coupon to a bank in exchange for the interest payment.

TYPES OF BONDS

1. **Fixed rate bonds** have a coupon that remains constant throughout the life of the bond.
2. **Floating rate notes** (FRNs) have a variable coupon that is linked to a reference rate of interest, such as LIBOR or Euribor. For example the coupon may be defined as three month USD LIBOR + 0.20%. The coupon rate is recalculated periodically, typically every one or three months.
3. **Zero-coupon bonds** pay no regular interest. They are issued at a substantial discount to par value, so that the interest is effectively rolled up to maturity (and usually taxed as such). The bondholder receives the full principal amount on the redemption date. An example of zero coupon bonds is Series E savings bonds issued by the U.S. government. Zero-coupon bonds may be created from fixed rate bonds by a financial institution separating "stripping off" the coupons from the principal. In other words, the separated coupons and the final principal payment of the bond may be traded separately. See IO (Interest Only) and PO (Principal Only).
4. **Inflation linked bonds**, in which the principal amount and the interest payments are indexed to inflation. The interest rate is normally lower than for fixed rate bonds with a comparable maturity (this position briefly reversed itself for short-term UK bonds in December 2008). However, as the principal

amount grows, the payments increase with inflation. The United Kingdom was the first sovereign issuer to issue inflation linked Gilts in the 1980s. Treasury Inflation-Protected Securities (TIPS) and I-bonds are examples of inflation linked bonds issued by the U.S. government.

5. **Other indexed bonds,** for example equity-linked notes and bonds indexed on a business indicator (income, added value) or on a country's GDP.
6. **Asset-backed securities** are bonds whose interest and principal payments are backed by underlying cash flows from other assets. Examples of asset-backed securities are mortgage-backed securities (MBS's), collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs).
7. **Subordinated bonds** are those that have a lower priority than other bonds of the issuer in case of liquidation. In case of bankruptcy, there is a hierarchy of creditors. First the liquidator is paid, then government taxes, etc. The first bond holders in line to be paid are those holding what is called senior bonds. After they have been paid, the subordinated bond holders are paid. As a result, the risk is higher. Therefore, subordinated bonds usually have a lower credit rating than senior bonds. The main examples of subordinated bonds can be found in bonds issued by banks, and asset-backed securities. The latter are often issued in tranches. The senior tranches get paid back first, the subordinated tranches later.
8. **Perpetual bonds** are also often called perpetuities. They have no maturity date. The most famous of these are the UK Consols, which are also known as Treasury Annuities or Undated Treasuries. Some of these were issued back in 1888 and still trade today, although the amounts are now insignificant. Some ultra-long-term bonds (sometimes a bond can last centuries: West Shore Railroad issued a bond which matures in 2361 (i.e. 24th century)) are virtually perpetuities from a financial point of view, with the current value of principal near zero.
9. **Bearer bond** is an official certificate issued without a named holder. In other words, the person who has the paper certificate can claim the value of the bond. Often they are registered by a number to prevent counterfeiting, but may be traded like cash. Bearer bonds are very risky because they can be lost or stolen. Especially after federal income tax began in the United States, bearer bonds were seen as an opportunity to conceal income or assets. U.S. corporations stopped issuing bearer bonds in the 1960s, the U.S. Treasury stopped in 1982, and state and local tax-exempt bearer bonds were prohibited in 1983.
10. **Registered bond** is a bond whose ownership (and any subsequent purchaser) is recorded by the issuer, or by a transfer agent. It is the alternative to a Bearer bond. Interest payments, and the principal upon maturity, are sent to the registered owner.
11. **Lottery bond** is a bond issued by a state, usually a European state. Interest is paid like a traditional fixed rate bond, but the issuer will redeem randomly selected individual bonds within the issue according to a schedule. Some of these redemptions will be for a higher value than the face value of the bond.
12. **War bond** is a bond issued by a country to fund a war.
13. **Serial bond** is a bond that matures in installments over a period of time. In effect, a $100,000, 5-year serial bond would mature in a $20,000 annuity over a 5-year interval.
14. **Revenue bond** is a special type of municipal bond distinguished by its guarantee of repayment solely from revenues generated by a specified revenue-generating entity associated with the purpose of the bonds. Revenue bonds are typically "non-recourse," meaning that in the event of default, the

bond holder has no recourse to other governmental assets or revenues.

BONDS ISSUED IN FOREIGN CURRENCIES

Some companies, banks, governments, and other sovereign entities may decide to issue bonds in foreign currencies as it may appear to be more stable and predictable than their domestic currency. Issuing bonds denominated in foreign currencies also gives issuers the ability to access investment capital available in foreign markets. The proceeds from the issuance of these bonds can be used by companies to break into foreign markets, or can be converted into the issuing company's local currency to be used on existing operations through the use of foreign exchange swap hedges. Foreign issuer bonds can also be used to hedge foreign exchange rate risk. Some foreign issuer bonds are called by their nicknames, such as the "samurai bond." These can be issued by foreign issuers looking to diversify their investor base away from domestic markets. However, it is important to note, that not all of the following bonds are restricted for purchase by investors in the market of issuance. These bond issues are generally governed by the law of the market of issuance, e.g., a samurai bond issue, issued by an investor based in Europe, will be governed by Japanese law.

1. **Eurodollar bond**, a U.S. dollar-denominated bond issued by a non-U.S. entity outside the U.S
2. **Kangaroo bond**, an Australian dollar-denominated bond issued by a non-Australian entity in the Australian market
3. **Maple bond**, a Canadian dollar-denominated bond issued by a non-Canadian entity in the Canadian market
4. **Samurai bond,** a Japanese yen-denominated bond issued by a non-Japanese entity in the Japanese market
5. **Shibosai Bond** is a private placement bond in Japanese market with distribution limited to institutions and banks.
6. **Yankee bond**, a US dollar-denominated bond issued by a non-US entity in the US market
7. **Shogun bond**, a non-yen-denominated bond issued in Japan by a non-Japanese institution or government
8. **Bulldog bond**, a pound sterling-denominated bond issued in London by a foreign institution or government
9. **Matrioshka bond**, a Russian rouble-denominated bond issued in the Russian Federation by non-Russian entities. The name derives from the famous Russian wooden dolls, Matrioshka, popular among foreign visitors to Russia
10. **Arirang bond**, a Korean won-denominated bond issued by a non-Korean entity in the Korean market
11. **Kimchi bond**, a non-Korean won-denominated bond issued by a non-Korean entity in the Korean market
12. **Formosa bond,** a non-New Taiwan Dollar-denominated bond issued by a non-Taiwan entity in the Taiwan market
13. **Panda bond**, a Chinese renminbi-denominated bond issued by a non-China entity in the People's Republic of China market
14. **State of Israel bond,** a bond denominated in multiple currencies issued by the State of Israel through the Development Corporation of Israel.

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