BCS GLOBAL MARKETS

RISK DISCLOSURE: bonds and other debt securities

1. A *debt security* is a financial instrument that represents a claim against the issuer of the instrument. There are various types of fixed debt instruments depending on the issuer that has issued the instrument, the security provided for the loan by the issuer, the term until the maturity date, and the type of payment of interest.

2. A *money-market instrument* is a borrowing of cash for a period, generally no longer than six months, but occasionally up to one year, in which the lender takes a deposit from the money markets in order to lend (or advance) it to the borrower.

3. A *bond* is a debt security through which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate. Owners of bonds are debt holders, or creditors, of the issuer.

4. A *discount paper* is a debt financial instrument that instead of paying interest, is sold at discount. Upon sale, the price of the instrument is calculated by discounting the instrument amount, including calculated interest, to current value. The current value or the price is lower than the amount received upon maturity. Certificates of deposit and treasury bills are examples of discount paper.

5. A *state premium bond* is *a*nother form of fixed-income financial instrument, in which interest on the bonds is distributed by lottery among the holders of premium bonds.

6. Similar to bonds, a *debenture* is an agreement between the debenture holder and issuing company, showing the amount owed by the company towards the debenture holders. The capital raised is the borrowed capital; that is why the status of debenture holders is like creditors of the company. Debentures carry interest, which is to be paid at periodic intervals. The amount borrowed is to be repaid at the end of the stipulated term, as per the terms of redemption. The issue of debentures publicly requires credit ratings.

7. The following are, however, the major differences between bonds and debentures:
   - a financial instrument issued by the government agencies, for raising capital is known as bonds. A financial instrument issued by the companies whether it is public or private for raising capital is known as debentures.
   - bonds are backed by assets. Conversely, the debentures may or may not be supported by assets.
   - the interest rate on debentures is higher as compared to bonds.
   - the payment of interest on debentures is done periodically whether the company has made a profit or not while accrued interest can be paid on the bonds.
   - the risk factor in bonds is low which is just opposite in the case of debentures.
   - bondholders are paid in priority to debenture holders at the time of liquidation.

8. Most debt securities share some common basic characteristics including:
   - *Face value* is the money amount the security will be worth at its maturity, and is also the reference amount the issuer uses when calculating interest payments.
   - *Coupon rate* is the rate of interest the issuer will pay on the face value of the security, expressed as a percentage.
   - *Coupon dates* are the dates on which the issuer will make interest payments. Typical intervals are annual or semi-annual coupon payments.
   - *Maturity date* is the date on which the debt instrument will mature and the issuer will pay the holder the face value of the instrument.

- *Duration* is a measurement of how long, in years, it takes for the price of a debt security to be repaid by its internal cash flows.
- *Yield to maturity* is the internal rate of return (IRR, overall interest rate) earned by an investor who buys the debt security today at the market price, assuming that the seccurity will be held until maturity, and that all coupon and principal payments will be made on schedule.
- *Credit rating* is a financial indicator assigned by credit rating agencies such as Moody's, Standard & Poor's and Fitch Ratings that represents the quality of a debt security.

9. Debt securities may be issued by:
   - Legal entities, like companies and banks.
   - Municipalities. Municipal bonds can offer tax-free coupon income for residents of those municipalities.
   - Governments. For example, U.S. Treasury bonds (more than 10 years to maturity), notes (1-10 years maturity) and bills (less than one year to maturity) are collectively referred to as simply "Treasuries".

10. A *Eurobond* is a bond denominated in a currency other than the home currency of the country or market in which the bond is issued. Issuance is usually handled by an international syndicate of financial institutions on behalf of the borrower, one of which may underwrite the bond, thus guaranteeing purchase of the entire issue.

11. A *loan participation note* or *LPN* is a fixed-income security that permits investors to buy portions of an outstanding loan or package of loans. Comparable to other bonds, LPN holders participate, on a pro rata basis, in collecting interest and principal payments. However, in contrast to "normal" bonds, there is a three-party relationship involved in an LPN: normally, a special purpose vehicle is set up as the "legal issuer"; however, the actual borrower is some other company in the background (that can be a bank or other financial institution) known as the "commercial issuer". That commercial issuer obtains its debt financing from the legal issuer indirectly in the marketplace, in that the legal issuer issues LPNs for the sole purpose of financing the loan that has been granted to the commercial issuer.

12. A *zero-coupon* bond it a debt security that does not pay out regular coupon payments, and instead is issued at a discount and its market price eventually converges to face value upon maturity.

13. A *subordinated* debt security is a security that ranks below some loans and other debt securities with regard to claims on a company's assets or earnings. Subordinated debt is also known as a junior security or subordinated loan. In the case of borrower default, creditors who own subordinated debt won't be paid out until after senior debtholders are paid in full.

14. A *perpetual* bond is a fixed income security with no maturity date. One major drawback to these types of bonds is that they are not redeemable. Given this drawback, the major benefit of them is that they pay a steady stream of interest payments forever. A perpetual bond is also known as a "consol" or a "perp".

15. A *convertible* debt security is a debt security with an embedded call option that can be changed into common stock. Conversion only occurs at specific times at specific prices under specific conditions detailed at the time the debt security is issued. Holders of regular or plain vanilla convertibles receive stock in exchange for the debt at a time when the stock price is going up. Similar to traditional debt, convertibles also have seniority in case of default of the issuer.

16. *Contingent convertible* debt securities, also known as CoCos are similar to traditional convertible debt in that there is a strike price, which is the cost of the stock when the debt converts into stock. What differs is that instead of converting debt instruments to common shares based solely on stock price

appreciation, investors in contingent convertibles agree to take equity in exchange for debt when the company's capital ratio falls below a certain point.

17. A *convertible subordinate* note is a short-term debt security that is convertible and ranks below other loans (it is subordinate to other debt). In the event the issuer becomes bankrupt and liquidates its assets, as a subordinate debt the convertible subordinate note will be repaid after other debt securities have been paid. As with all debt securities, however, the note will be repaid before stock.

18. A *covered* bond is a security backed by a separate group of loans; it typically carries a maturity rate of two to 10 years and enjoys relatively high credit ratings. An issuer of a covered bond purchases investments that produce cash, typically mortgages or public sector loans, puts the investments together and issues bonds covered by the cash flowing from the investments. The underlying loans of a covered bond stay on the balance sheet of the issuer. The issuer may therefore replace defaulted or prepaid loans with performing loans to minimize risk of the underlying assets not performing as well as expected. If the issuer becomes insolvent, investors holding the bonds may still receive their scheduled interest payments from the underlying assets of the bonds, as well as the principal at the bond's maturity.

19. A *guaranteed* debt security is a debt security that offers a secondary guarantee that interest and principal payment will be made by a third party, should the issuer default due to reasons such as insolvency or bankruptcy. A guaranteed debt can be municipal or corporate, backed by an insurer, a fund or group entity, or a government authority. A guaranteed debt security therefore removes an inherent risk of default that could mean a holder never gets the principal back upon maturity and loses out on periodic interest payments by creating a back-up payer in the event that the issuer is unable to fulfill its obligation. Because of this lowered risk, guaranteed debt security generally have a lower interest rate than non-guaranteed debt instruments.

20. A *callable* debt security is a fixed-income security that can be redeemed by the issuer prior to its maturity. It means that the issuer can return the investor's principal and stop interest payments before the bond's maturity date. Redeeming a callable debt security prior to maturity is the right, but not the obligation, of the issuer. Callable debt securities may be characterised with *yield to call option* (YTC), which is the yield of a bond or note if holders were to buy and hold the security until the call date, but this yield is valid only if the security is called prior to maturity.

21. A *puttable* debt security is a fixed-income security that allows the holder to force the issuer to repurchase the security at specified dates before maturity. The repurchase price is set at the time of issue, and is usually the par value.

22. *Distressed* debt securities are debt securities issued by a company that is near to or currently going through bankruptcy. As a result of the issuing company's inability to meet its financial obligations, these securities have suffered a substantial reduction in value, but because of their implicit riskiness, they offer investors the potential for high returns. In most cases, these debt instruments carry a CCC or below credit rating from debt-rating agencies. Distressed securities contrast with junk bonds, which traditionally have a credit rating of BBB or lower.

23. It is important that you fully understand the risks associated with debt securities. These risks include the following:

(a) **Interest Rate Risk**. There is an inverse relationship between debt securities prices and interest rates, that is the price of securities rises when interest rates fall, and fall when interest rates rise. Generally speaking, the longer a security's maturity, the greater the degree of price volatility. An investor holding a debt security until maturity may be less concerned about these price fluctuations (which are known as

interest-rate risk, or market risk), because the investor will receive the par, or face, value of the debt security at maturity. Changes in market interest rates have a substantially stronger impact on the prices of zero coupon bonds than on the prices of ordinary bonds because the discounted issue prices are substantially below par. If market interest rates increase, zero coupon bonds can suffer higher price losses than other bonds having the same maturity and credit rating.

(b) **Call features**. A debt security may contain a "call" feature giving the issuer the right to retire, or redeem, the security, fully or partially, before the scheduled maturity date. A call feature creates uncertainty for the investor as to whether the security will remain outstanding until its maturity date, especially in the case of a high coupon debt security in a falling interest rate environment. Investors risk losing a security paying a higher rate of interest when rates decline because the issuer may decide to call in their debt securities, thus limiting the security's price appreciation potential.

(c) **Credit risk**. Credit risk is the potential for loss resulting from an actual or perceived deterioration in the financial health of the issuer. Two subcategories of credit risk are default risk and downgrade risk.

- Default Risk. Defaults occur when an issuer fails to pay an interest or principal payment to a debt holder as scheduled and as specified in its terms of issue (contained in the "indenture"). The risk of default on principal or interest, or both, is greater for high-yield debt securities than for investment-grade securities. Debt securities of issuers in default may trade at very low prices, if they trade at all, and liquidity may disappear.
- Downgrade risk. Downgrades result when a rating agency lowers its rating on a debt security or the company that issued a debt security. Downgrades are usually accompanied by security price declines.

(d) **Liquidity risk**. Liquidity risk refers to the investor's ability to sell a debt security quickly and easily, as reflected in the size of the bid-ask spread, or the difference between the price at which buyers are willing to buy (the bid) and the price at which sellers are willing to sell (the ask) a debt security. High-yield debt securities may be less liquid than investment-grade securities, depending on the issuer and the market conditions at any given time.

(e) **Economic risk**. Economic risk describes the vulnerability of a debt security to downturns in the economy. Virtually all types of high-yield debt securities are vulnerable to economic risk. In recessions, high-yield debt security prices typically fall more than investment-grade securities, a reflection of their credit quality.

(f) **Company and industry "event" risk**. Event risk encompasses a variety of pitfalls that can affect a company's ability to repay its debt obligations on time. These may include poor management, changes in management, failure to anticipate shifts in the company's markets, rising costs of raw materials, regulation and new competition. Events that adversely affect a whole industry can have a blanket effect on all the debt securities in that sector.

BEFORE TRADING ANY PARTICULAR DEBT INSRUMENT, YOU SHOULD THOROUGHLY EXAMINE RELEVANT OFFERING DOCUMENTS TO UNDERSTAND THE EXACT TERMS AND CONDITIONS OF THE INTRUMENTS, INCLUDING ITS CREDIT RATING, ITS MATURITY, ITS RATE AND YIELD, WHETHER IT IS CALLABLE, PUTTABLE, SUBORDINATED OR PERPETUAL AND WHETHER ANY RESTRICTIONS ON SALE AND TRANSFER OF DEBT INSRUMENTS APPLY.