Describe basic features of a fixed-income security.

LOS 51.a

Basic features of a fixed income security include the issuer, maturity date, par value, coupon rate, coupon frequency, and currency.

- Issuers include corporations, governments, quasi-government entities, and supranational entities.
- Bonds with original maturities of one year or less are money market securities. Bonds with original maturities of more than one year are capital market securities.
- Par value is the principal amount that will be repaid to bondholders at maturity. Bonds are trading at a premium if their market price is greater than par value or trading at a discount if their price is less than par value.
- Coupon rate is the percentage of par value that is paid annually as interest. Coupon frequency may be annual, semiannual, quarterly, or monthly. Zero-coupon bonds pay no coupon interest and are pure discount securities.
- Bonds may be issued in a single currency, dual currencies (one currency for interest and another for principal), or with a bondholder's choice of currency.

Describe content of a bond indenture.

A bond indenture or trust deed is a contract between a bond issuer and the bondholders, which defines the bond's features and the issuer's obligations. An indenture specifies the entity issuing the bond, the source of funds for repayment, assets pledged as collateral, credit enhancements, and any covenants with which the issuer must comply.

Compare affirmative and negative covenants and identify examples of each.

Covenants are provisions of a bond indenture that protect the bondholders' interests. Negative covenants are restrictions on a bond issuer's operating decisions, such as prohibiting the issuer from issuing additional debt or selling the assets pledged as collateral. Affirmative covenants are administrative actions the issuer must perform, such as making the interest and principal payments on time.

Describe how legal, regulatory, and tax considerations affect the issuance and trading of fixed-income securities.

Legal and regulatory matters that affect fixed income securities include the places where they are issued and traded, the issuing entities, sources of repayment, and collateral and credit enhancements.

- Domestic bonds trade in the issuer's home country and currency. Foreign bonds are from foreign issuers but denominated in the currency of the country where they trade. Eurobonds are issued outside the jurisdiction of any single country and denominated in a currency other than that of the countries in which they trade.
- Issuing entities may be a government or agency; a corporation, holding company, or subsidiary; or a special purpose entity.
- The source of repayment for sovereign bonds is the country's taxing authority. For non-sovereign government bonds, the sources may be taxing authority or revenues from a project. Corporate bonds are repaid with funds from the firm's operations. Securitized bonds are repaid with cash flows from a pool of financial assets.

(Continued on next card)

Describe how legal, regulatory, and tax considerations affect the issuance and trading of fixed-income securities.

(Continued from previous card)

- Bonds are secured if they are backed by specific collateral or unsecured if they represent an overall claim against the issuer's cash flows and assets.
- Credit enhancement may be internal (overcollateralization, excess spread, tranches with different priority of claims) or external (surety bonds, bank guarantees, letters of credit).

Interest income is typically taxed at the same rate as ordinary income, while gains or losses from selling a bond are taxed at the capital gains tax rate. However, the increase in value toward par of original issue discount bonds is considered interest income. In the United States, interest income from municipal bonds is usually tax-exempt at the national level and in the issuer's state.

Describe how cash flows of fixed-income securities are structured.

A bond with a bullet structure pays coupon interest periodically and repays the entire principal value at maturity.

A bond with an amortizing structure repays part of its principal at each payment date. A fully amortizing structure makes equal payments throughout the bond's life. A partially amortizing structure has a balloon payment at maturity, which repays the remaining principal as a lump sum.

A sinking fund provision requires the issuer to retire a portion of a bond issue at specified times during the bonds' life.

Floating-rate notes have coupon rates that adjust based on a reference rate such as Libor.

Other coupon structures include step-up coupon notes, credit-linked coupon bonds, payment-in-kind bonds, deferred coupon bonds, and index-linked bonds.

Describe contingency provisions affecting the timing and/or nature of cash flows of fixed-income securities and identify whether such provisions benefit the borrower or the lender.

Embedded options benefit the party who has the right to exercise them. Call options benefit the issuer, while put options and conversion options benefit the bondholder.

Call options allow the issuer to redeem bonds at a specified call price.

Put options allow the bondholder to sell bonds back to the issuer at a specified put price.

Conversion options allow the bondholder to exchange bonds for a specified number of shares of the issuer's common stock.

Describe classifications of global fixed-income markets.

Global bond markets can be classified by:

- **Type of issuer:** Government (and government-related), corporate (financial and nonfinancial), securitized.
- **Credit quality:** Investment grade, noninvestment grade.
- Original maturity: Money market (one year or less), capital market (more than one year).
- **Coupon:** Fixed rate, floating rate.
- **Currency and geography:** Domestic, foreign, global, eurobond markets; developed, emerging markets.
- **Other classifications:** Indexing, taxable status.

Describe the use of interbank offered rates as reference rates in floating-rate debt.

Interbank lending rates, such as London Interbank Offered Rate (Libor), are frequently used as reference rates for floating-rate debt. An appropriate reference rate is one that matches a floating-rate note's currency and frequency of rate resets, such as six-month U.S. dollar Libor for a semiannual floating-rate note issued in U.S. dollars.

Describe mechanisms available for issuing bonds in primary markets.

Bonds may be issued in the primary market through a public offering or a private placement.

A public offering using an investment bank may be underwritten, with the investment bank or syndicate purchasing the entire issue and selling the bonds to dealers; or on a best-efforts basis, in which the investment bank sells the bonds on commission. Public offerings may also take place through auctions, which is the method commonly used to issue government debt.

A private placement is the sale of an entire issue to a qualified investor or group of investors, which are typically large institutions.