

International Bond Market

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Chapter Objective:

This chapter continues discussion of international capital markets with a discussion of the structure of the international bond market.

Chapter Outline

- The World's Bond Markets: A Statistical Perspective
- Foreign Bonds and Eurobonds
- Types of Instruments
- Currency Distribution, Nationality, Type of Issuer
- International Bond Market Credit Ratings
- Eurobond Market Structure & Practices
- International Bond Market Indices

The World's Bond Markets

- A statistical perspective:
- The total market value of the world's bond markets are about *50% larger* than the world's equity markets.
- Most issues are denominated in U.S. dollars, Japanese Yen are second, followed by Deutchmarks in a distant third.

A Statistical Perspective:

	<i>Domestic</i>	<i>International</i>	<i>Total</i>
\$	47.8%	45.1%	47.5%
¥	18.0%	11.7%	17.2%
<i>DM</i>	7.0%	10.3%	7.4%

Foreign Bonds and Eurobonds

- Bearer Bonds and Registered Bonds
- National Security Registrations
- Withholding Taxes
- Recent Regulatory Changes
- Global Bonds

Bearer Bonds and Registered Bonds

- Bearer Bonds are bonds with no registered owner. As such they offer anonymity but they also offer the same risk of loss as currency.
- Registered Bonds: the owners name is registered with the issuer.
- U.S. security laws require Yankee bonds sold to U.S. citizens to be registered.

National Security Registrations

- Yankee bonds must meet the requirements of the SEC, just like U.S. domestic bonds.
- Many borrowers find this level of regulation burdensome and prefer to raise U.S. dollars in the Eurobond market.
- Eurobonds sold in the primary market in the United States may not be sold to U.S. citizens.
- Of course, a U.S. citizen could buy a Eurobond on the secondary market.

Withholding Taxes

- Prior to 1984, the United States required a 30 percent withholding tax on interest paid to nonresidents who held U.S. government or U.S. corporate bonds.
- The repeal of this tax led to a substantial shift in the relative yields on U.S. government and Eurodollar bonds.
- This lends credence to the notion that market participants react to tax code changes.

Recent Regulatory Changes

- Shelf Registration (SEC Rule 415)
 - Allows the issuer to preregister a securities issue, and then offer the securities when the financing is actually needed.
- SEC Rule 144A
 - Allows qualified institutional investors to trade private placements.
 - These issues do not have to meet the strict information disclosure requirements of publicly traded issues.

Global Bonds

- A global bond is a very large international bond offering by a single borrower that is simultaneously sold in North America, Europe and Asia.
- Mostly institutional investors are the purchasers so far.
- SEC Rule 415 and 144A have likely facilitated global bond offerings, and more can be expected in the future.

Types of Instruments

- Straight Fixed Rate Debt
- Floating-Rate Notes
- Equity-Related Bonds
- Zero Coupon Bonds
- Dual-Currency Bonds
- Composite Currency Bonds

Straight Fixed Rate Debt

- These are “plain vanilla” bonds with a specified coupon rate and maturity and no options attached.
- Since most Eurobonds are *bearer bonds*, coupon dates tend to be annual rather than semi-annual.
- The vast majority of new international bond offerings are straight fixed-rate issues.

Floating-Rate Notes

- Just like an adjustable rate mortgage.
- Common reference rates are 3-month and 6-month U.S. dollar LIBOR
- Since FRN reset every 6 or 12 months, the premium or discount is usually quite small...*as long as there is no change in the default risk.*

Equity-Related Bonds

- Convertibles
 - Convertible bonds allow the holder to surrender his bond in exchange for a specified number of shares in the firm of the issuer.
- Bonds with equity warrants
 - These bonds allow the holder to keep his bond but still buy a specified number of shares in the firm of the issuer at a specified price.

Zero Coupon Bonds

- Zeros are sold at a large discount from face value because there is no cash flow until maturity.
- In the U.S., investors in zeros owe taxes on the “imputed income” represented by the increase in present value each year, while in Japan, the gain is a tax-free capital gain.
- Pricing is very straightforward:
$$PV = \frac{PAR}{(1+r)^T}$$

Dual-Currency Bonds

- A straight fixed-rate bond, with interest paid in one currency, and principal in another currency.
- Japanese firms have been big issuers with coupons in yen and principal in dollars.
- Good option for a MNC financing a foreign subsidiary.

Composite Currency Bonds

- Denominated in a currency basket, like the SDRs or ECUs instead of a single currency.
- Often called *currency cocktail bonds*.
- Typically straight fixed rate debt.

Characteristics of International Bond Market Instruments

<i>Instrument</i>	<i>Frequency of Payment</i>	<i>Size of Coupon</i>	<i>Payoff at Maturity</i>
<i>Straight Fixed-Rate</i>	Annual	Fixed	Currency of issue
<i>Floating Rate Note</i>	Every 3 or 6 months	Variable	Currency of issue
<i>Convertible Bond</i>	Annual	Fixed	Currency of issue or conversion to equity shares.
<i>Straight fixed rate with equity warrants</i>	Annual	Fixed	Currency of issue plus conversion to equity shares.
<i>Zero</i>	none	zero	Currency of issue
<i>Dual Currency Bond</i>	Annual	Fixed	Dual currency
<i>Composite Currency Bond</i>	Annual	Fixed	Composite currency of issue

Currency Distribution of International Bond Offerings

<i>Currency</i>	<i>1997</i>
<i>U.S. dollar</i>	45%
<i>Deutsche mark</i>	16.8
<i>Yen</i>	4.5
<i>Pound Sterling</i>	8.9
<i>Swiss franc</i>	2.6
<i>Italian lira</i>	5.4
<i>French franc</i>	6.4
<i>Other</i>	10.4
<i>Total</i>	100

Distribution of International Bond Offerings by Nationality

<i>Nationality</i>	<i>1997 (U.S. \$b)</i>
<i>Australia</i>	13.4
<i>Canada</i>	22.8
<i>France</i>	43.6
<i>Germany</i>	152.1
<i>Italy</i>	16.1
<i>Japan</i>	41.6
<i>Sweden</i>	15.4
<i>United Kingdom</i>	52.2
<i>United States</i>	189.3
<i>Other OECD countries</i>	170.6
<i>Non-OECD countries</i>	85.9
<i>International Development</i>	28.9
<i>Total</i>	831.6

Distribution of International Bond Offerings by Type of Issuer

<i>Type of Issuer</i>	<i>1997 (U.S. \$ Billion)</i>
<i>Governments</i>	97.5
<i>Public enterprises</i>	83.6
<i>Banks</i>	293.0
<i>Private organizations</i>	301.2
<i>International organizations</i>	56.3
<i>Total</i>	831.6

International Bond Market

Credit Ratings

- Fitch IBCA, Moody's and Standard & Poor's sell credit rating analysis.
- Focus on default risk, not exchange rate risk.
- Assessing sovereign debt focuses on political risk and economic risk.

Eurobond Market Structure

- Primary Market
 - Very similar to U.S. underwriting.
- Secondary Market
 - OTC market centered in London.
 - ◆ Comprised of market makers as well as brokers.
 - ◆ Market makers and brokers are members of the International Securities Market Association (ISMA).
- Clearing Procedures
 - Euroclear and Cedel handle most Eurobond trades.

International Bond Market Indices

- There are several international bond market indices.
- J.P. Morgan and Company
 - Domestic Bond Indices
 - International Government bond index for 18 countries.
 - Widely referenced and often used as a benchmark.
 - Appears daily in *The Wall Street Journal*

End Chapter Seven