

Analyzing various types of debt instruments existing finance essay

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INTRODUCTION

First chapter describes the basis behind doing this study. Then, it examines the objectives of this study and some limitations of the study.

PURPOSE OF THE STUDY

The purpose of this study is to analyze various types of Debt instruments existing. It aims to develop an understanding of the growth of the topic. It also includes the impact of these instruments on the country and on various companies.

OBJECTIVES OF THE STUDY

The main objectives of this paper are -

To conduct a study on the requirement of debt instruments

To understand why debts instruments are important

To analyze these instruments

LIMITATIONS OF STUDY

Due to lack of information available the graphs and the statistics shown are of previous years (2007-2008)

As the data was gathered from secondary sources, the authority of the data could not be tested.

Another problem was knowledge constraint and this report is an attempt to gather as much of relevant data as possible.

However, every effort was made to ensure that these do not in any way adversely affect the results of the study.

INTRODUCTION

The debt markets today are a major source of financing than the banking system. It is any market situation where debt instruments are traded. It establishes a planned environment where the debts are traded amongst the interested parties. The debt markets are known by other names based on the types of instruments are traded. For example when municipal or corporate bond are traded, debt market is called bond market whereas if notes or securities or mortgages are traded market is called credit market.

The debt market is three times larger than stock/equity market. The debt markets are categorized into two other markets called money market and capital market.

Money market is a subsection of the fixed income market. It specializes in short-term debts with the maturity of one-year. Capital markets specialize in long-term debts. It is a market in which financial instruments are traded by the institutions and individuals. Institutions or organizations in either private or public sectors sell securities to raise funds in these markets. Both these terms are mistakenly applied.

In capital market assets (including equities) are taken into consideration and they are amortized over the period of time. Money market is more of debts which are readily sold at price predictable within short time. But it is very

difficult to distinguish between money and non-money based on one year maturity line.

Some of the debt instruments are traded Over-the-counter and not through exchanges. They are traded in an electronic network market where the brokers or dealers act as mediators. Money markets are not accessible by small investors except through MFs.

Corporate associates or groups or even individual investors may participate in the debt market. There may be very little difference between how corporate associates or an individual participate depending on the regulations of the government. The interest rates are the price of the money which increases with the increase in the demand to borrow money. The debt market is influenced by credit-worthiness of the borrower, term-to-maturity, security for loan and many other factors. But government also tries to regulate the interest rates to stimulate the economies with complete focus on inflation.

The main advantage of debt market is the degree of risk associated with the investment opportunity is very low. For the investors who avoid participating in the riskier ventures in which there is less or smaller returns favors bonds and similar investments. A significant amount of money is earned even if returns are not high in the debt market.

WHAT ARE DEBT INSTRUMENTS?

For every individual financial planning is an important task. For the preservation of principal amount the investors should distribute a major portion of their investments in debt instruments.

A debt instrument is an electronic obligation or any paper that permits an issuing party to raise funds by assuring it to pay back a lender in accordance with the terms and conditions of a contract. The predetermined conditions which are mentioned in the contract are the periodicity and rate of interest and the date of the repayments of the principal amount.

Debt instruments are an easier way for participants and markets transfer the rights of debt obligations from one party to another. Debt obligation transferability increases liquidity and gives creditors a means of trading debt obligations on the market. Without debt instruments acting as a means to facilitate trading, debt is an obligation from one party to another. When a debt instrument is used as a medium to facilitate debt trading, debt obligations can be moved from one party to another quickly and efficiently.

In Indian Securities market, the term “ bond” is used for debt instrument given by Central and state government and the term “ debenture” is used for the instruments issued by private sectors.

OBJECTIVE OF DEBT INSTRUMENT

Preservation of principal amount and getting modest returns is the main objective of the debt funds.

Investors look for both short-term and long-term investments. There are many instruments available in the market so one can choose easily any or mix of instruments according to its requirements.

FEATURES OF DEBT INSTRUMENTS

The features of the instruments are:

Safety of the principal amount

Guaranteed returns for the investors.

Some of these instruments also qualify for tax rebates under Section 80C.

Currently 8-9% interest per annum are quoted for medium to long-term deposits whereas it is 6-7% returns for short-term deposits

Nowadays, many banks provide funds sweep-in /sweep-out facility where a balance beyond a certain limit automatically gets converted into a fixed deposit and banks pay the fixed deposit interest on it. This can be an option for a short-term horizon.

There are three main features of debt instruments

Maturity

Coupon

Principal

Maturity

Maturity refers to the date on which the bond matures. It is the date on which the borrower agrees to repay the principal amount. Term-to-maturity refers to the number of years remaining for the bond to mature. It changes every day from the date of the issue to the maturity of the bond. It is also called the tenure or term of the bond.

Coupon

Coupon Rate refers to the periodic payment of interest made by the issuer of the bond to the lender of the bond. Coupons are declared either by stating the number (example: 8%) or with a benchmark rate (example: MIBOR+0.5%). It is usually represented as a percentage of the face value or the par value of the bond.

Principal

It is the amount which is borrowed. It is the face or the par value of the bond. The product of the coupon rate and principal is the coupon.

For example a GS CG2008 11.40% bond refers to a Central Government bond maturing in the year 2008, and paying a coupon of 11.40%. Since Central Government bonds have a face value of Rs. 100, and normally pay coupon semi-annually, this bond will pay Rs. 5.70 as six-monthly coupon, until maturity, when the bond will be redeemed.

The term to maturity of a bond can be calculated on any date, as the distance between such a date and the date of maturity. It is also called the term or the tenor of the bond. For instance, on February 17, 2004, the term

to maturity of the bond maturing on May 23, 2008 will be 4.27 years. The general day count convention in bond market is 30/360 European which assumes total 360 days in a year and 30 days in a month. There is no rigid classification of bonds on the basis of their term to maturity. Generally bonds with tenors of 1-5 years are called short-term bonds; bonds with tenors ranging from 4 to 10 years are medium term bonds and above 10 years are long term bonds. In India, the Central Government has issued up to 30 year bonds.

CHARACTERISTICS OF DEBT INSTRUMENTS

The primary characteristics of debt instruments are:

Issuance of an instrument is easy

Any company with or without past track record can issue these instruments

Rate of interest are fixed or floating

Fixed commitments are imposed on servicing

Debt instruments may be flexible in the period of repayment or nature of interest but they impose fixed commitments on servicing or business. Failure to do servicing of these instruments would be termed as default with adverse effects on the company's standing in the financial sector.

Risk is low

Investors in such instruments being creditors of the company have priority over equity and preference shareholders in receiving return (in the form of

interest) in such instruments. These carries priority claim on the assets of the firm (if secured) in the event of bankruptcy.

TYPES OF DEBT INSTRUMENTS

There are various debt instruments. The debt instruments can be categorized into long-term and short-term debt depending on the time for which the amount has been raised or the repayment period. The debt instruments are mentioned as follows:

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Long term Debt

Long-term debts are mainly bonds and debentures with the tenure greater than one year.

Debentures

A debenture is an instrument of debt executed by the company acknowledging its obligation to repay the sum at a specified rate and also carrying an interest. Company can raise loan capital from debentures

A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital.

The main characteristics of debentures are:

Fixed interest instrument with changeable period of maturity

May or may not be listed on stock exchange, if listed they should be rated by any of the credit rating agencies chosen by SEBI

Can be either offered for subscription or privately placed

A debenture redemption reserve has to be maintained when offered for subscription

The period of maturity varies from 3 to 10 years and may also be more for projects having high gestation period

Types of debentures

Various types of debentures are as follows:

Non convertible debentures (NCD)

Fully convertible debentures (FCD)

Partially convertible debentures (PCD)

NCDs are those in which total amount of instrument is redeemed by the lender whereas FCDs are those in which the whole value of the instrument is converted into equity. The conversion price is given when the instrument is borrowed. PCDs are those in which part of the instrument is redeemed and part of it is converted into equity. Conversion price is the price of each equity share received by converting the par or face value of the debenture. The number of equity shares exchangeable per unit of the convertible security i.e. debentures is called the conversion ratio. The period of time after which the debenture is converted into equity is called the conversion period. The

convertible instruments are generally used to stem the sudden outflow of the capital at the time of maturity of the instrument causing temporary liquidity problems. Alternately, the company has to raise funds from a different source or issue fresh instruments to tide over and also has to bear the transaction costs in the process. Debentures might be either callable or puttable. Callable debenture is a debenture in which the issuing company has the option of redeeming the security before the specified redemption date at a pre-determined price. Similarly, a puttable security is a security where the holder of the instrument has the option of getting it redeemed before maturity.

Bonds

A bond is a debt security in which authorized borrower or issuer owes the lender or the holder a debt and is obliged to repay the principal amount and interest at maturity. It is a loan in the form of securities having varying terminologies: The issuer is equivalent to the borrower, the bond holder to the lender, and the coupon to the interest. It enables the issuer to finance long-term investments with external funds.

Bonds and stocks are both securities, but the major difference between the two is that stock-holders are the owners of the company (i. e., they have an equity stake), whereas bond-holders are lenders to the issuing company. 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 consol bond, is a perpetuity bond (i. e., bond with no maturity).

There may be many types of bonds- such as infrastructure, regular income, deep discounts or tax savings.

These are instruments having fixed interest rate and a definite period of maturity. The main difference between bonds and debentures is that debenture is secured and bond is not. Hence bonds have higher rate of interest than debentures.

There are many kinds of bonds available such as:

Floating rate or fixed rate bonds

High yield bonds

Subordinated bonds

Perpetual bonds

Asset-backed securities

Bearer bond

Zero Coupon bonds

Registered bond

Inflation linked bonds

Book entry bonds

Municipal bonds

War bond

Lottery bond

Medium term loan

These are loans extended for a period of 2 to 5 years. The purposes for which these loans are issued are:

Short gestation projects: The short gestation projects could be for purchase of balancing equipment, for incremental expansion of capacity.

Refinancing of loans in case of very long projects where the repayment of the term loans might occur prior to sufficient cash flows being generated by the project.

For meeting any other medium term shortfall in funding arising out of an acquisition or bulleted repayment of a large loan, etc

The methods for issuing medium term loans are similar to those required for project finance.

In case of meeting a medium term mismatches not linked to a project or equipment, the financing decision would be on the basis of a cash flow analysis indicating the need for such medium term funding and an analysis of overall profitability and financial to the business to provide lender comfort.

Other than these aspects, the procedures for availing Medium Term loans follows the requirements sought by the lenders in case of Project financing/ long term lending.

Public Deposits

These are those deposits that are achieved by many small and large firms from the public. The public deposits are issued mainly to finance the working capital requirements of the firm. The rate of interest offered varies with time period of the public deposits. The rate of interest which is mostly offered by the companies on the deposits made on one year is 8-9%, for two year deposits rate is 9-10% and for three years rate offered is 10-11%. For public deposits there are some rules which the companies have to follow according to Companies Amendment Rules 1978:

3 years is the maximum period of maturity for public deposits whereas 6 months is minimum period

For NBFC 5 years is the maximum period of maturity

The companies need to disclose the information regarding the financial position and performance

10% of the deposits need to be kept aside by the companies every year by 30th April by the companies having public deposits. This will mature by 31st March next year.

Advantages enjoyed by companies

Simple and Easy process in gaining public deposit

No restrictive agreement

Reasonable cost incurred after tax

No collateral

Disadvantages

Very limited funds raised

Short period of maturity

Advantages enjoyed by investors

Higher rate of interest

Shorter maturity period

Disadvantages

No tax exemption

No collateral

Short-term debts

The debts which are raised for less than one year are short-term debts.

These are categorized into market instruments and financial assistance granted by NBFC, Commercial Banks and Term Lending Institutions focusing on the short term needs of a business.

Commercial Paper

These are unsecured promissory notes. These are issued by those companies having high credit ratings. The maturity of CPs is 1 to 270 days.

They are issued at face value and redeemed at face value. CPs can be issued by companies, which have a minimum networth of Rs. 4 crores and needs a

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mandatory credit rating of minimum A2 (ICRA), P2 (Crisil), D2 (Duff & Phelps) and PR2 (Credit Analysis & Research). The rating should not be more than 2 months old. It can be issued for a minimum amount of Rs. 25 lakhs and more in multiples of Rs. 5 lakh.

Since the companies are not pledging any collateral, only companies having high credit-worthiness are allowed to issue CPs. They are usually sold at discounts and have higher interest repayments dates than bonds.

Advantages:

Flexibility in maturity

Lower cost of capital with high credit ratings

Disadvantages:

It brings down credit limits of the banks

Very restrictive about issuance of CPs

Limited to blue chip companies

Inter-Corporate Deposits (ICDs)

These are funds raised by corporate companies from other corporate. This is a form of dis-intermediated financing, where corporate with surplus funding directly lend to those in need of funding of such funds and thereby save on the spreads that banks would have charged in borrowing from one to lend to the other.

This is very efficient means of investment. The ICDs issuance was very poor in India. In early nineties companies raised funds from public without even identifying the projects for investments.

These sums were then deployed in the ICDs market where the borrowers more often than not invested in the booming financial assets (shares) or real estate. Often monies were lent to group companies for propping up the shares of different companies of the group. The end of the boom in financial and real assets saw significant amounts of defaults in ICDs and a virtual closure of the market.