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New Financial Instruments

Chapter Objectives

This chapter will enable you to develop an understanding of the following::

1. *Meaning of new financial instrument*
2. *New financial instruments such as floating rate bonds, zero interest bonds, deep discount bonds, revolving underwriting finance facility, auction rated debentures, secured premium notes with detachable warrants, non-convertible debentures with detachable equity warrants, secured zero interest partly convertible debentures with detachable and separately tradable warrants, fully convertible debentures with interest (optional), differential shares, securitized paper, collateralized debt obligations, and inverse float bonds, perpetual bonds, and municipal bonds.*

INTRODUCTION

The Indian financial system has undergone a significant transformation in the 1990s. The deregulation of lending rates, free pricing of equity issues, entry of private sector institutional investors including foreign institutional investors, opening up of the banking sector to the private sector, allowing Indian companies to directly tap the foreign capital markets, and so on are some of the major reforms which have changed the scenario of the Indian financial system. This new found freedom has increased competition in the Indian corporate sector.

The capital market is an important source of meeting the growing long-term financial requirements of corporates, both in private and public sectors.

On the one hand, due to the colossal fund requirements of both corporates and financial institutions, the competition has become intense among the various classes of issuers to corner a share of the investors' funds, and on the other hand, investors are proving to be increasingly finicky and savvy. Hence, to cater to the differing requirements of both issuers and investors, it has become essential for issuers (borrowers) to innovate and design new financial instruments. Financial engineering has been at the back of these innovations, which have revolutionalized the business world.

What is a New Financial Instrument?

A new financial instrument may be one which has some new features in the terms of agreement, when compared with the features of presently available instruments. Very few financial instruments are completely new products. Many are just new features added to the conventional financial instruments to make them marketable. The conventional financial instruments are equity shares, preference shares, debentures—partly convertible, fully convertible, and non-convertible. When certain new features like attaching a warrant to the non-convertible portion of a debenture are added, a conventional instrument turns into a new instrument.

Reasons for Innovations in Financial Instruments

- Every product needs constant re-engineering. Moreover, it has to be tailored according to the needs of the consumers. The investment environment does not get a boost if there are repeated offerings of the same product. Hence, new designs of financial products are always needed.
- The interest rates had declined and this trend forced the corporate world to think of new financial instruments.
- Investors also prefer not to be saddled with long-term instruments. Hence, instruments with varying maturity periods and with various put and call options are preferred.
- The old trend of getting finance from financial institutions has changed. Now companies prefer the capital market as a source of finance. To successfully tap capital markets, companies are compelled to offer attractive terms even on debt securities, in order to raise funds.

- Investors have shied away from the equity market in the last few years due to various capital market scams. Attractive financial instruments are needed to lure these investors back.

In the post-reforms period, a host of innovative instruments have been introduced in the capital market. Most of these instruments are debt instruments. These instruments have not only been structured and designed properly, they have also been successfully marketed at the retail level.

NEW FINANCIAL INSTRUMENTS

Floating Rate Bonds

- Floating Rate Bonds are bonds wherein the interest rate is not fixed and is linked to an anchor/benchmark rate.

The interest rate on these bonds is linked to a benchmark/anchor rate and is not fixed. It is a concept which has been introduced primarily to take care of the falling market or to provide a cushion in times of falling interest rates in the economy. It helps the issuer to hedge the loss arising due to interest rate fluctuations.

In India, the State Bank of India (SBI) was the first to introduce bonds with floating rates for retail investors. The SBI floating rate bonds were linked to the bank's term deposit rate which served as an anchor rate. The treasury bill rate can also be the anchor rate. The interest rate is linked to the anchor rate as it reflects the economic indicators. The NSE Mibor is used now-a-days as the anchor rate for floating rate bonds.

To make this bond attractive to investors, the interest rate always has a fixed mark-up price over and above the anchor rate. In case of IDBI bond issues, the fixed mark-up was 2 per cent and the anchor rate was the 364-days treasury bill rate.

Floating rate bonds ensure that neither the borrower nor the lender suffer due to volatile interest rates. If the interest rate rises, the lender (investor) benefits, as he earns a higher interest and if the interest rate falls, it is advantageous to the borrower, as he can raise funds at a low cost.

Borrower companies issue floating rate bonds with a cap or a floor. The cap is the maximum interest that the issuer can pay while the floor is the minimum interest that a subscriber earns, leading to an advantage, both to the issuer and the subscriber.

Most of the outstanding government market loans are in the form of plain vanilla fixed rate bonds. The government issued, in November/December 2001, two floating rate bonds with maturity periods of 5 years and 8 years for a total amount of ₹5,000 crore in view of the asset-liability management (ALM) and risk-weight needs of the major investors such as banks. FRBs serve as diversifying instruments in debt management as they take advantage of the term premium while minimizing the refinancing risk. However, FRBs are vulnerable to interest rate risk.

FRB is an innovative instrument in a falling interest rate regime but it requires an active secondary debt market.

- Zero interest bonds carry no periodic interest payment and are sold at a huge discount to face value.

Zero Interest Bonds

As the name suggests, there is no periodic interest payment and they are sold at a huge discount to the face value. These bonds benefit both the issuers and the investors by limiting funding cost when interest rates are volatile for the issuer and by reducing the reinvestment risk for the investor. Zero coupon bonds are sometimes convertible into equity on maturity which entails no outflow for the issuer, or into a regular interest bearing bond after a particular period of time.

Companies such as Mahindra and Mahindra, HB Leasing and Finance have been pioneers in introducing these bonds in the Indian market.

These bonds are the best options for individuals and institutional investors who look for safe and good returns and are ready to hold them till the bond matures. Moreover, these bonds do not carry any interest, which is otherwise taxable.

These bonds are attractive for issuer companies with projects having a long gestation period as there is no immediate interest commitment and, on maturity, the bonds can be converted into equity shares or non-convertible debentures depending on the capital structure requirements of the company.

Zero interest bonds require an active secondary debt market for attracting investors.

Deep Discount Bonds (DDBs)

A deep discount bond is a zero coupon bond whose maturity is very high, say 15 years onwards and is offered at a discount to the face value. The Industrial Development Bank of India (IDBI) was the first financial institution to offer DDBs in 1992.

- Deep discount bonds are zero coupon bonds with high maturity.

The issuers have successfully marketed these bonds by luring the investor to become a 'lakhpati' in 25 years. Moreover, these instruments are embedded with 'call' and 'put' options, providing an early redemption facility both to the issuer and the investor at a predetermined price and date. The issuer becomes free from intermittent cash flow problems and the funds can be deployed in infrastructure projects which involve long gestation periods.

Many variations of DDBs and zero interest bonds have come into the market. Some of them are as follows:

Zero Interest Secured Premium Convertible Bond The investor can convert his bond into an equity share at 30 per cent discount on average price at the end of one year. If the conversion price is lower than the face value, the issuer will redeem the difference. A similar option of conversion into two equity shares is available on the maturity of the bond. The bond may also have a warrant attached.

Zero Interest Fully Convertible Debenture The investors in these debentures are not paid any interest. However, there is a notified period after which, fully paid, fully convertible debentures (FCDs) will be automatically and compulsorily converted into shares. In the event of a company going for rights issue prior to the allotment of equity, resulting from the conversion of equity shares into FCDs, FCD holders shall be offered securities as may be determined by the company.

Revolving Underwriting Finance Facility (RUFF)

It is a 91-day debenture with two important, distinct features. These are as follows:

- RUFF is a 91-day debenture which is rolled over after its maturity.

- There is an underwriter (a banker or financial institution) who will be prepared to pick up the lot if it is not fully sold.
- After 91 days, the stock will be rolled over, *i.e.*, the debentures will be redeemed and reauctioned. Through this roll over, the debentures can be kept in the market for upto five years. If, at some stage, the money markets are tight and there are not enough takers for the issue, the underwriters step in and pick up the lot at a previously agreed rate.

The treasury bill rate is the benchmark rate and a premium is added to it to attract the investors. The premium depends on the demand and supply of the 91-day instrument. The overall rate never exceeds the prime lending rate (PLR). This instrument is rated by a credit rating agency.

RUFF is beneficial to the issuers, underwriters, and investors. The issuer gets long-term funds at short-term rates, the underwriter gets a regular fee, and the investor gets a liquid debt instrument.

Auction Rated Debentures (ARDs)

It is a secured, redeemable (after 90 days), non-convertible instrument with interest determined by the market and placed privately with bids. ARDs are a hybrid of commercial papers and debentures. ANZ Grindlays designed this new instrument for Ashok Leyland Finance (ALF). This was a three-year instrument which had a zero coupon rate and was sold at a discount. The company repurchased the ARDs after three months of the issue and then re-issued them through fresh auctions. The interest rates were negotiated at quarterly auctions; this continued for three years. ALF raised ₹30 crore through this unique zero coupon instrument. ARD is technically a short-term instrument but it provides long-term finance for the company.

Secured Premium Notes (SPNs) with Detachable Warrants

This instrument is redeemable after a notified period, of say four to seven years. There is a lock-in period during which no interest is paid. The attached warrants ensure that the holder has the right to apply for and to be allotted equity shares, provided the SPN is fully paid. This conversion is done within the time limit notified by the company.

The SPN holder has an option to sell back the SPN to the company at par value after the lock-in period. If the holder exercises this option, no interest/premium will be paid on redemption. In case the SPN holder holds it further, he will be repaid the principal amount along with the additional amount of interest/premium on redemption in instalments as decided by the company. SPNs free the firm from the debt-serving costs in the initial years. TISCO and Bombay Dyeing were among the early issuers of SPNs.

Non-convertible Debentures (NCDs) with Detachable Equity Warrants

The holder of this instrument is given an option to buy a specific number of shares from the company at a pre-determined price and time frame. The warrants attached to the NCDs are issued, subject to full payment of the NCDs value. There is a specific lock-in period after which the detachable warrant holders have to exercise their option to apply for equities. If the option to apply for equities is not exercised, the unapplied portion of shares would be disposed of by the company at its liberty.

Escorts, Bombay Dyeing, and Indian Rayon were among the early issuers of NCDs with warrants attached.

Secured Zero Interest Partly Convertible Debentures with Detachable and Separately Tradable Warrants

This instrument has two parts. Part A is convertible into equity shares at a fixed amount on the date of allotment. Part B is non-convertible, to be redeemed at par at the end of a specific period from the date of allotment. Part B carries a detachable and a separate tradable warrant which will provide an option to the warrant holder to receive an equity share for every warrant held at a price determined by the company.

Fully Convertible Debentures (FCDs) with Interest (Optional)

This instrument will not yield any interest for a specified short time period. After this period, FCD holders have the option to apply for equities at a 'premium' for which no additional amount is payable. This option needs to be indicated in the application form itself. However, interest on FCDs is payable at a determined rate from the date of conversion to the second/final conversion and equity shares are issued in lieu of the interest.

Domestic Convertible Bonds

These are hybrid securities that allow investors to separate the embedded equity portion from the bond and trade it separately. Because of the option to convert debt into equity, issuers can raise debt at a lower interest rate. These bonds were proposed by the Finance Minister in his 2008–09 budget speech to deepen the corporate bond market. However, this would require policy changes in different regulations and hence, the SEBI proposed an alternative instrument—Non-convertible debentures with detachable warrants. This instrument would help companies raise low-cost debt. It also allows the investors to detach the equity component from the instrument and trade on it.

Differential Shares

- Differential Shares are a class of shares with differential rights to voting or dividend.

Differential shares are shares with differential rights to voting and dividends. They are a class of shares which carry voting rights with varying rates of dividend. In fact, differential shares can be issued with no voting rights but high dividends or, with varying rights and dividends. If the voting right of the shareholder is taken away, the shareholder is compensated by higher returns. This concept originated in Canada and was highly successful. This concept was introduced in India through the Companies (Second Amendment) Act, 2000. According to this law, a company can issue shares with differential rights 'as to voting or dividend or otherwise.'

Companies are now allowed to issue shares with differential voting rights including non-voting shares, to the extent of 25 per cent of the total share capital, provided, they had profits that could be distributed, in the preceding three years. However, companies will not be allowed to convert their equity capital, with regular voting rights. into shares with differential voting rights and vice-versa.

Differential shares are positioned between ordinary equity shares and preference shares. The preference shareholders are entitled to certain assured dividends but no voting rights while ordinary equity shareholders have voting rights in proportion to the number of shares held but are not entitled to any assured return.

Rules for Issue of Differential Shares The issue of differential voting rights shares has to be approved by shareholders in a general meeting. Further, listed companies are required to obtain the shareholders' approval also through a postal ballot. The issue of such shares has to be authorized by the articles of association of the company.

The companies proposing to issue shares with differential rights should not have been convicted of any offence under the Securities and Exchange Board of India Act, 1992, Securities Contract (Regulation) Act, 1956, and Foreign Exchange Management Act (FEMA), 1999. The companies which have defaulted in filing annual returns in the preceding three years or have failed to repay deposits or interests thereon or, redeem debentures or pay dividends on the due date, will not be eligible to issue shares with differential rights. Additionally, the companies should not have defaulted in addressing investors' grievances.

A company issuing differential shares should not fail to give dividends for three consecutive years. Otherwise these shares will be converted into equity shares. If the company fails to give dividends for three consecutive years, the investors will not be able to exercise their voting powers during the period and will also not receive any return.

The companies planning to issue such shares will have to append in their notice to the shareholders, an explanatory statement detailing the differences in the rights they will carry, and the scale or in proportion to which the voting rights of such shares or types of shares will differ. Also, the entitlements on rights and/or bonus issues among different classes of shareholders will have to be predetermined and mentioned upfront.

Benefits of Differential Shares The differential shares provide varied benefits to both investors and issuers. The majority of the shareholders in India do not bother about the voting rights. Hence, a large section of investors would favour shares without voting rights but with higher dividend entitlements.

The issue of shares with differential rights imparts flexibility to promoters to raise funds without diluting their stakes. The differential shares can be effectively used as an anti-takeover tool. This instrument reduces dependence on outside funds and hence is a good cash management tool for new business firms. The differential shares help in leveraging the capital structure of the issuing company.

Differential shares are more beneficial to the issuers than investors. Investors lose control over the affairs of the company. Moreover, international experience shows that there is a problem of low liquidity with this instrument. Hence, both, the government and the issuer should take initiatives for increasing the liquidity of this instrument.

Securitized Paper

- In a securitization transaction, the originator transfers future receivables to a special purpose vehicle (SPV), which in turn, issues securitized instruments called pass through certificates (PTCs) to investors. Pass through certificates are instruments which pass on the cash flows from the underlying loans on a pro-rata basis.

It is a popular fund-raising technique in the developed markets such as the US and the UK. Asset securitization began in the US in the 1960s with the pooling of residential mortgages. Now, this concept extends to a whole range of financial assets such as receivables and mortgages held by businesses and financial firms.

Securitization is a process by which a company raises money by selling off its receivables. These receivables are sold off to cash-rich investors by converting them into securities. The receivables are sold at a discount to the investors which represents the yield.

Put in simple terms, securitization is a process through which illiquid assets are packaged and converted into tradable securities known as pass-through certificates (PTCs). These securities are also referred to as asset-backed securities (ABSs). If the instrument securitized is a housing loan, the resultant instrument is referred to as mortgage backed securities (MBSs). In case of bond receivables, they are known as collateralized bond obligations (CBOs) and in case of industrial loan receivables, they are referred to as collateralized loan obligations (CLOs).

In securitization, the assets to be securitized are identified on the basis of their creditworthiness. Then, the security is rated by a specialized credit rating agency. The pool is sold to a special purpose vehicle (SPV) which acts as a trustee. SPV is the entity that owns the assets once they are securitized. The assets are held by the SPV to ensure that the investors' interest is secure even if the originator goes bankrupt. The SPV is usually in the form of a trust. The SPV issues the asset backed security and the task of collecting the interest due on the underlying asset is left either to the seller or a third party.

An asset backed security can be of four types: pass-through, asset-backed bond, pay-through, and real estate mortgage investment conduit (REMIC). A pass through security represent a pro-rata share of assets in a pool wherein principal and interest payments are passed through to investors on a schedule similar to the assets. These assets do not remain on the issuer's balance sheet. An asset backed bond is a debt obligation wherein the schedule of the payment of interest and the principal differs from that of the asset. The assets remain on the issuer's balance sheet. Pay-through assets are similar to the asset-backed bonds except that they do not remain on the issuer's balance sheet. In real estate mortgage investment conduit, the principal and interest payments are passed through to one or more regular classes of securities and one residual class. Assets are transferred to the REMIC in a non-taxable manner. In India, PTCs are issued and are more popular.

The securities can then be listed on the NSE. As the securities are negotiable instruments and listed, they can be traded in the secondary market.

Since the securities are assets for the seller, the process is called asset securitization. However, once it is listed on a stock exchange, it becomes a debt product for the investor and hence, the process is called 'debt' securitization.

The key drivers of securitization are raising low cost funds through new sources in an off the balance sheet manner. For the issuer, once an asset is securitized, it goes off the balance sheet. It offers a higher yield to the investor and adds value to his investment portfolio.

Securitization is far superior to bills discounting or factoring. Bills discounting is a short-term source, while securitization is a medium to long-term source. The quantum of paper work is higher in bills discounting than in securitization. Factoring is quite similar to securitization as the factor buys the receivables of a company at a discount. However, there is no rating or creation of a secondary market in factoring. Moreover, factoring has evolved as a trade financing tool rather than for medium-or long-term financing.

Securitization Deals The first securization relating to auto financing took place between Citi Bank and ICICI Bank in 1990–91.

It is more than a decade since this concept was introduced in India but the level of activity was quite low. Only a few corporates and some state electricity boards securitized their assets. Since the onset of the twenty-first century, volumes in securitization have surged up.

ICICI successfully offloaded loan assets worth ₹7,000 crore in 2001 to raise funds for the merger with ICICI Bank. This boosted the activity in securitization. In the first quarter of 2002–03, ICICI Bank securitized corporate loans worth ₹2,250 crore and housing loans worth ₹50 crore to meet its statutory liquidity requirements after the merger. The securitization activity got a further boost with the introduction of the 'Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance 2002' which was promulgated in June 2002. This ordinance has given a legal status to securitization as an activity.

In February 2000, Housing and Urban Development Corporation (HUDCO), securitized assets worth ₹1,500 crores from its infrastructure portfolio. The municipal corporations across the country have raised more than ₹600 crores through securitization or structured obligations.

The current trend among banks and financial institutions is to issue PTCs to off-load illiquid assets from their balance sheets by converting them into marketable securities. This enables the issuers to realise up-front cash which in turn could be utilized for more efficient asset–liability management (ALM) and maintain the capital adequacy ratio.

The increasing popularity of securitization can be known from the number of securitized transactions rated by credit rating agencies. Crisil has rated 14 securitized transaction worth ₹363 crore during April–June 2002–03 as compared to only two transactions worth ₹52.7 crore in April–June 2001–02. Icra too has rated higher transactions in 2002–03.

Securitization is witnessed more in auto-financing than in housing receivables as yield levels are higher in the former. But now the issuers are coming out with a variety of securitization deals. Citibank has securitized bank's personal loan portfolio of ₹284.1 crore. Citibank has also launched an on-tap securitization programme called, Citi SPOT which is a master set of terms and conditions under which companies can undertake a series of multiple securitization issuances in a year. ICICI has introduced 'securitized notes' structure instead of the traditional PTCs. The securitized notes are quite similar to PTCs but they give more flexibility to structure the underlying cash flows to meet the investors' needs. Securitized deals are now being tailor-made for the investors in terms of structure, tenor and coupon rate.

Domestic mutual funds, invested heavily into securitized papers such as asset backed securities (ABS) for trading profits as returns, were diminishing from other fixed income products as well as trading opportunities.

In October 2004, ICICI Bank offloaded 12 per cent of its retail auto loan portfolio through a ₹823.5 crore securitization deal—the largest of its kind in India. The issue consisted of four senior tranches (strips), namely A1, A2, A3, and P strips. Strips A1, A2, and A3 had an average tenor of 7 months, 18 months, and 27 months respectively, while the size of strips A1, A2, A3, and P were ₹268 crore, ₹248 crore, ₹111 crore, and ₹198 crore, respectively. ICICI Bank acted as the sole originator, structure, and arranger for private placement.

Private sector banks like ICICI Bank and HDFC Bank securitized retail loans to foreign banks and public sector banks in 2006. Through such sales, they earned liquidity and got additional capital to reinvest in assets further. Increase in the asset base led to a reduction in their operating costs. Moreover, such asset sales enable banks to transact more business without augmenting their regulatory capital.

Securitization Law The Ordinance on Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest was promulgated on June 24 2000. The ordinance will help banks and financial institutions to turn their assets in to tradeable securities, in setting up asset reconstruction companies (ARCs) to recover their bad assets, and clean their balance sheets to a great extent. This law will also provide for statutory recognition for hypothecation.

To create a market in securitized debt, the government has floated a company called the Asset Reconstruction Company India Ltd. (ARCIL), wherein, the government holds a 49 per cent stake, ICICI a 24.5 per cent stake, and the rest is held by financial institutions.

Factors Inhibiting the Growth of this Market Inspite of the recent surge in securitization, the size of the market of this instrument is quite small. There have been many constraints in the pace of growth of this product.

- Lack of liquidity in the secondary market. The secondary market, which provides an exit route to investors, is non-existent.
- Lack of clarity on a number of legal issues relating to issuers. For instance, there is no clarity on reporting requirements, securitization accounting, and process.
- Lack of regulatory framework for SPVs.
- A narrow investor base confined to mutual funds, private banks and foreign banks.
- Lack of awareness and participation from public sector banks.
- Most of the securitized paper is sold on a private placement basis, thereby, limiting its growth potential.
- Certain provisions of the income tax law inhibit the process.
- Even after the introduction of the ordinance on Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest, it is not clear to which authority the originator should report before the launch of the issue.
- At present, there are no laws governing the recognition of the income of various entities engaged in the securitization deals.
- The securitization process becomes expensive because of the stamp duty. This stamp duty varies across states. Stamp duty structures on industrial loans across states is a major impediment for the securitization of these loans. Public sector banks' portfolio is dominated more by industrial loans as opposed to retail loans.
- The Securities Contract Regulation Act (SCRA) does not include securitized debt in the definition of 'securities' nor does it recognize special purpose vehicles, which issue securitized debt known as pass through certificates. This impedes the listing and trading of securitized paper. Listing of securitized paper improves transparency and leads to better price discovery.

For securitization to grow at a rapid pace, there is a need to increase the investor base by persuading public sector banks, provident funds, trusts, and foreign institutional investors to invest in this market, develop standard procedures and accounting standards, introduce changes in tax laws, and develop an active secondary market. The dealings in securitized instruments need to be transparent. A formal regulatory framework for securitization is needed. The RBI has set up a working group to suggest modalities for widening the investor base, improving the quality of assets, creating liquidity for trading in such assets, and related issues.

- The Securities Contract Regulation ACT (SCRA) does not include securitized debt in the definition of 'securities' nor does it recognize special purpose vehicles which issue securitized debt known as pass through certificates. This impedes the listing and trading of securitized paper.

The Reserve Bank issued draft guidelines on assets securitization in February 2006, to protect interests of investors in securitized debt. The regulations provide for a liquidity facility, which helps borrowers to tide over temporary cash shortages and may result due to timing differences faced by special purpose vehicles, between the receipt of cash flows from the underlying assets and the payments to be made to investors.

According to the guidelines:

- Liquidity facility should be drawn only where there is a sufficient level of non-default assets to cover the drawings.
- Liquidity facility to meet temporary mismatches in receivables should not be drawn for the purposes of providing credit enhancement, covering losses of SPVs, serving as a permanent revolving funding and covering any losses incurred in the underlying pool of exposures.
- Liquidity facility should not be available for meeting recurring expenses of securitization, funding acquisition of additional assets by SPV, funding the final scheduled repayment of investors and funding breach of warranties.
- Securities–issued SPVs would be in the nature of non-SLR securities. The counter party for investors will not be SPV, but the underlying assets, of which, the cash flow, are expected from the borrowers. Therefore, such investments will be included to reckon overall exposures to any individual or group borrower, industry or geographic area wherever the obligators in the pool constitute 5 per cent or more of the receivables or ₹5 crore, whichever is lower.
- The profits from securitization should be amortized over the life of the securitized asset. Hence, banks will not be able to use securitization to show good results in a bad year.
- Banks have to bring in the required capital for the credit enhancement facility provided by the originator. Credit enhancement is the support provided, including through cash collaterals, to enhance the credit rating of the securitized assets.

Collateralized Debt Obligations (CDO)

- Collateralized debt obligation is securitization of corporate obligations such as corporate loans, bonds, and asset-backed securities.

Collateralized debt obligation is securitization of corporate obligations such as corporate loans, corporate bonds, and asset-backed securities. Collectively, CDO consists of collateralized bond obligations, collateralized loan obligations, and credit linked notes that emanate from the same financial family. Banks and financial institutions use this instrument to meet regulatory obligations and to increase their revenues. Under the Basel Accord formulated in 1988 by the Basel Committee on Banking and Supervision, banks in most of the developed countries are required to maintain a risk-based capital of 8 per cent of the outstanding balance of commercial loans. These high risk-based capital requirements make the holding of commercial loans unattractive as the margins on these loans are also low. By securitizing loan portfolios, banks are not only in a position to trim their balance sheets but they are able to generate funds from these portfolios.

The structure of a CDO consists of multiple layers called tranches which are formed by pooling underlying assets. Each tranch will have a pool of assets from corporate loans and bonds of similar seniority and maturity. These tranches are then rated by a credit rating agency and marketed.

These instruments offer higher yield to investors but the risk of default is high. Off-balance sheet financing has earned disrepute globally after the Enron fiasco. Many CDOs had Enron credit as part of their underlying exposure and these were defaults. This instrument is being increasingly used by European banks and the Bank of Japan besides American banks.

The ICICI Bank's first CDO issue failed to takeoff in March 2002 and was recalled because of unfavourable market conditions and lack of regulatory guidelines. In February 2004, the bank altered the product structure by bringing down the average maturity of the issue to around two years. The ₹100 crore CDO issue was mopped up by institutional investors. The ICICI bank sold corporate loans, given to 15 borrowers of varying sizes across 11 industries, through this issue to raise new assets as well as enhance exposure management in terms of specific sectors.

CDOs are new in the Indian market and new products take time to gain market acceptance. However, with an increase in investor awareness and setting up of a regulatory framework, this instrument will be preferred by Indian banks and financial institutions in times to come.

Inverse Float Bonds

These bonds are the latest entrants in the Indian capital market. Inverse float bonds are bonds carrying a floating rate of interest that is inversely related to short-term interest rates. The floating rate could be the

Mibor (Mumbai inter-bank offer rate) or some other rate. If the Mibor falls, the return for the investor rises and vice versa. The actual rate payable on these bonds is arrived at by subtracting the floating rate from a fixed benchmark rate. Suppose the fixed benchmark rate is 12 per cent and the six-month Mibor is 6 per cent, then the interest rate payable on these bonds is 6 per cent (12–6).

- Inverse float bonds carry a floating rate of interest that is inversely related to short-term interest rates.

These bonds enable investors to earn high returns in a low interest rate environment. As interest rates are highly volatile, the investor has to observe the interest rate behaviour carefully over the entire bond period, else he could end up getting a poor return. Thus, both the investor and the issuer have to hedge the interest rate risk. If the interest rates go up, the issuer benefits as the coupon rate of his bonds will decline inspite of higher interest rates.

Inverse float bonds were introduced in the US market in 1990. In India, the Aditya Birla Group, Grasim, and Hindalco issued inverse float bonds in August 2002. The Cholamandalam Investment and Finance Company Limited (CIFCL) were the first non-banking finance company to raise funds through the issue of inverse floaters.

Perpetual Bonds

They are debt instruments which do not have a maturity date. The investors receive a stream of interest payments for perpetuity. The bonds can be issued to retail investors with market making to ensure liquidity. The oldest perpetual bonds that continue to be in existence are those issued by the British Government in 1814 to fund the Napoleonic wars.

- Perpetual bonds are bonds with no maturity date and carry interest payments for perpetuity.

In case of liquidation, holders of perpetual bonds are paid second last, after all other depositors and creditors but before equity shareholders. Being permanent in nature, they qualify as Tier I capital (*i.e.*, equity and free reserves) of banks.

Another hybrid instrument similar to perpetual bonds is perpetual preference shares.

Municipal Bonds

They are debt securities issued by the municipal corporation of a city to raise funds for financing their growing investment needs for a host of infrastructure projects. The Indian municipalities need a sum of ₹28,500 crore to finance a number of basic projects. The financial health of municipalities is in a poor state. Till now, only the large municipalities were able to tap the market through issuance of such municipal bonds. Large municipalities issued bonds worth ₹1,500 crores. These bonds had limited appeal because the annual cumulative ceiling on municipal bond issues was a measly ₹150–200 crore and the tax-free status was available only for select issues. At times, these bonds were made saleable through government guarantee.

- Municipal bonds are issued by municipal corporations to finance infrastructure projects.

The Ahmedabad Municipal Corporation was the first urban local body to raise funds through municipal bonds. It was the first urban local body to receive a general obligation rating for its municipal bonds in February 1996 and raise funds through municipal bonds without a state government guarantee. The Bangalore Mahanagar Pallike (BMP) was the first to issue municipal bonds for ₹125 crore, with seven-year maturity and a coupon of 13 per cent per annum in December 1997.

Under the new proposal approved by the Central Government in June 2006, the bonds would have a coupon rate of interest of 8 per cent and be tax-free. All urban local bodies in a state will form a State Pooled Finance Entity (SPFE) which will enter the bond market on a regular basis. In turn, the SPFE will provide a secure flow of debt to the projects proposed by the municipalities. This will hedge risks against longer spectrum of activities than an individual urban legal body (ULB). The municipal bonds to be issued by the SPFE will be rated by a credit rating agency so as to improve its marketability. To ensure that there is absolutely no default risk, the funds raised by the SPFE will be invested in triple A rated papers only, till they are deployed in projects. The centre will also deploy a sum of ₹400 crore as seed capital to finance the SPFEs. This will limit the extent of the financial exposure of the centre to these bonds.

The Indian municipal bond market constitutes a mere 0.1 per cent of the total corporate bonds traded in India in contrast to the US municipal bond market which accounts for about 12 per cent of the total corporate bond market. The preference of Indian investors, including insurance companies and banks, to invest in securities with shorter maturity, regulatory restrictions on investment allocation, and a fewer number of tax-free bonds acts as constraints on the development of this market.

Globally, municipal bonds constitute a huge market. In the US, investors hold about $1.7 trillion worth of municipal bonds. The investors of these long tenure and tax-free bonds are households and mutual funds. The daily trading in these bonds is about $11 billion.

SEBI issued a framework (Regulations) for public issue of debt securities by municipalities, and listing and trading of such securities in July, 2015.

ELIGIBILITY

Eligible Municipalities

1. No issuer shall be eligible to issue debt securities to public under these regulations, unless the following criteria are complied with:
   (a) Municipality, whether proposing to issue debt securities itself or through corporate municipal entity, should be eligible to raise funds under its constitution.
   (b) Accounts of municipality shall be prepared in accordance with National Municipal Accounts Manual or in accordance with similar Municipal Accounts Manual adopted by the respective state government for at least three immediately preceding financial years.
   (c) Municipality shall have surplus income as per its Income and Expenditure Statement, in any of the immediately preceding three financial years or any other financial criteria as may be specified by the Board from time to time:

   Provided that a corporate municipal entity shall not have negative net worth in any of immediately preceding three financial years.

   (d) Municipality shall not have defaulted in repayment of debt securities or loans obtained from banks or financial institutions, during the last three hundred and sixty five days:

   Provided that where the issuer is a corporate municipal entity, the requirements at clauses (b) and (d) shall be complied by the municipality which is being financed.

   (e) No order or direction of restraint, prohibition or debarment by Board against the corporate municipal entity or its directors is in force.
   (f) The corporate municipal entity, its promoter, group company or director(s), should not have been named in the list of the willful defaulters published by the Reserve Bank of India or should not have defaulted of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any.

REQUIREMENTS FOR PUBLIC ISSUE

General Conditions

2. (1) An issuer making public issue of debt securities shall only issue revenue bonds.
   (2) No issuer shall make a public issue of revenue bonds unless following conditions are complied with:
      (a) It has made an application to one or more recognized stock exchanges for listing of such securities therein:

      Provided that where the application is made to more than one recognized stock exchanges, the issuer shall choose one of them as the designated stock exchange:

      Provided further that where any of such stock exchanges have nationwide trading terminals, the issuer shall choose one of them as the designated stock exchange.

      Explanation: For any subsequent public issue, the issuer may choose a different stock exchange as a designated stock exchange subject to the requirements of this regulation.

      (b) It has obtained in-principle approval for listing of its revenue bonds on the recognized stock exchanges where the application for listing has been made.
      (c) Credit rating has been obtained from at least one credit rating agency registered with the Board and is disclosed in the offer document:

      Provided that the revenue bonds intended to be issued shall have a minimum investment grade rating:

      Provided further that where credit ratings are obtained from more than one credit rating agencies, all the ratings, including the unaccepted ratings, shall be disclosed in the offer document.

      (d) It has entered into an arrangement with a depository registered with the Board for dematerialization of the revenue bonds that are proposed to be issued to the public, in accordance with the Depositories Act, 1996 and regulations made there under.
   (3) The revenue bonds shall have a minimum tenure of three years or such period as specified by the Board from time to time.
   (4) The revenue bonds shall have a maximum tenure of thirty years or such period as specified by the Board from time to time.

(5) The issuer shall appoint one or more merchant bankers registered with the Board at least one of whom shall be a lead merchant banker.
(6) The issuer shall create a separate escrow account for servicing of revenue bonds with earmarked revenue.
(7) The issuer shall appoint a monitoring agency such as public financial institution or a scheduled commercial bank to monitor the earmarked revenue in the escrow account under sub-regulation (6):

Provided that where the issuer is corporate municipal entity, it shall appoint a debenture trustee registered with the Board in accordance with the provisions of the Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993 and Companies Act, 2013.

Disclosures in the Offer Document

3. (1) The offer document shall contain true, fair and material disclosures, which are necessary for the subscribers of the revenue bonds to take an informed investment decision.
(2) Without prejudice to the generality of sub-regulation (1), the issuer, which is a municipality and the lead merchant banker, shall ensure that the offer document contains the following:
(a) Disclosures specified in these regulations.
(b) Disclosures with respect to compliance with regulation 12.
(c) Additional disclosures as may be specified by the Board:

Provided that in case of issuer being a corporate municipal entity, the issuer and the lead merchant banker shall ensure that the offer document contains the following:

(i) Disclosures as specified in Companies Act, 2013 and Companies (Prospectus and Allotment of Securities) Rules, 2014.
(ii) Disclosures specified in these regulations.
(iii) Disclosures with respect to compliance with regulation 12.
(iv) Additional disclosures as may be specified by the Board.

Filing of Draft Offer Document

4. (1) No issuer shall make a public issue of revenue bonds unless a draft offer document has been filed with the designated stock exchange through the lead merchant banker:

Provided that where an issuer has filed a shelf prospectus, not more than four public issuances shall be made through a single shelf prospectus during a financial year.

(2) The draft offer document filed with the designated stock exchange shall be made public by posting the same on the website of the designated stock exchange for seeking public comments for a period of seven working days from the date of filing the draft offer document with such exchange.
(3) The draft offer document may also be displayed on the website of the issuer, merchant bankers and the stock exchanges where the revenue bonds are proposed to be listed.
(4) The lead merchant banker shall ensure that the draft offer document specifies the names and contact details of the compliance officer of the lead merchant banker, the officer concerned and the project officer, wherever applicable, of the issuer including their postal and email address, telephone and fax numbers.
(5) The lead merchant banker shall ensure that all comments received on the draft offer document are suitably addressed:

Provided that where the issuer is a corporate municipal entity, the lead merchant banker shall ensure that all comments received on the draft offer document are suitably addressed prior to the filing of the final offer document with the Registrar of Companies.

(6) The issuer shall, before filing of draft offer documents with Board, obtain a “Viability Certificate” or Detailed Project Appraisal Report (DPR) from a scheduled commercial bank or public financial institution stating that the project is financially viable, based on the estimates/assumptions available at that time.
(7) A copy of draft and final offer document shall also be forwarded to the Board for its records, simultaneously with filing of these documents with designated stock exchange.
(8) The issuer filing a shelf prospectus shall file a copy of an information memorandum with the recognized stock exchanges and the Board and in case of a corporate municipal entity, file the same with the Registrar of Companies.

(9) Where the issuer is a corporate municipal entity, the information memorandum shall contain the disclosures specified in Companies Act, 2013 and rules made thereunder and shall include disclosures regarding summary term sheet, material updations including revision in ratings, if any, along with the rating rationale and financial ratios specified.

(10) The lead merchant banker shall, prior to opening of the public issue, furnish to the Board a due diligence certificate as per Schedule-II of these regulations:

Provided that where the issuer is a corporate municipal entity, the lead merchant banker shall, prior to filing of the final offer document with the Registrar of Companies, furnish to the Board a due diligence certificate these regulations.

(11) The debenture trustee, wherever appointed under proviso to sub-regulation (7) of Regulation 5 shall, prior to the opening of the public issue, furnish to the Board a due diligence certificate as specified in these regulations.

Utilization of Issue Proceeds

5. (1) The funds raised from public issue of debt securities shall be used only for projects that are specified under objects in the offer document.

(2) The proceeds of the issue shall be clearly earmarked for a defined project or a set of projects for which requisite approvals have been obtained from concerned authorities.

(3) The issuers shall maintain a bank account in which the amount raised from the issue shall be transferred immediately after the closure of the issue and such amount shall only be utilised for specified project(s):

Provided that where the issuer is a Corporate Municipal Entity, the issue proceeds, net of issue expenses, shall be used only for onward lending to municipalities, as disclosed in the offer document:

Provided further that where the issuer is a corporate municipal entity, it shall maintain sufficient interest margin while onward lending to the municipalities, to meet its operating expenses and obligations.

(4) The issuer shall establish a separate project implementation cell and designate a project officer who shall not be below the rank of deputy commissioner, who shall monitor the progress of the project(s) and shall ensure that the funds raised are utilised only for the project(s) for which the debt securities were issued:

Provided that where the issuer is a corporate municipal entity, such requirement shall be complied by the Municipality which is being financed.

(5) Issuer's contribution for each project shall not be less than twenty per cent of the project costs, which shall be contributed from their internal resources or grants:

Provided that where the issuer is a corporate municipal entity, contribution of the concerned municipality, which is being financed by the corporate municipal entity, shall not be less than twenty per cent of the project costs, which shall be contributed from its internal resources or grants.

(6) The issuer shall disclose the schedule of implementation of the project in the offer document in a tabular form and the funds raised by the issuer shall be utilized in accordance with the said schedule.

Underwriting

6. A public issue of revenue bonds may be underwritten by an underwriter registered with the Board and in such a case adequate disclosures regarding underwriting arrangements shall be disclosed in the offer document.

LISTING OF DEBT SECURITIES

Mandatory Listing

7. An issuer desirous of making an offer of debt securities to the public shall make an application for listing to one or more recognised stock exchanges:

Provided that in case of issuer being corporate municipal entity, such an application shall be made in terms of sub-section (1) of Section 40 of the Companies Act, 2013.

Conditions for listing of debt securities issued on private placement basis.

8. (1) An issuer may list its debt securities issued on private placement basis on a recognized stock exchange subject to the following conditions:
   (a) An issuer may issue general obligation bonds or revenue bonds;
   (b) Accounts of municipality being the issuer, shall be prepared in accordance with National Municipal Accounts Manual or in accordance with similar Municipal Accounts Manual adopted by the respective state government for at least three immediately preceding financial years;
   (c) No order or direction of restraint, prohibition or debarment by Board against the corporate municipal entity or its directors is in force.
   (d) The issuer, being a corporate municipal entity, has issued such debt securities in compliance with the provisions of Companies Act, 2013 and particularly Section 42 of the Companies Act, 2013 and rules prescribed thereunder and other applicable laws.
   (e) The issuer shall not solicit or collect funds by issue of debt securities, except by way of private placement.
   (f) The minimum subscription amount per investor shall not be less than rupees twenty five lakh or such amount as may be specified by Board from time to time.
   (g) Credit rating has been obtained in respect of such debt securities from at least one credit rating agency registered with the Board.
   (h) The debt securities proposed to be listed are in dematerialized form.
   (i) The disclosures as provided in these regulations have been made.

REQUIREMENTS FOR BOTH PUBLIC ISSUES AND PRIVATE PLACEMENT

Asset Cover

9. An issuer, proposing to issue debt securities shall maintain 100% asset cover sufficient to discharge the principal amount at all times for the debt securities issued.

Buy-back

10. The issuers may provide an option to buy-back the debt-securities at a value which shall not be less than the face value of the debt securities, from the investors:

    Provided in such cases, appropriate disclosure shall be made in the offer document

Prohibitions of Mis-statements in the Offer Document

11. (1) The offer document shall not omit disclosure of a material fact which may make the statements made therein misleading, in light of the circumstances under which they are made.
    (2) The offer document or abridged prospectus or any advertisement issued by an issuer in connection with a public issue of debt securities shall not contain any false or misleading statement.

Creation of Security for Secured Debentures

12. (1) The debentures shall be secured by the creation of a charge, on the properties or assets or the receivables of the issuer, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon:

    Provided that in case unsecured debentures are intended to be listed on stock exchange(s), then such debt securities shall either be backed by guarantee from state government or central government or shall have a structured payment mechanism whereby the issuer shall deposit debt servicing amounts in the designated bank account at least 10 working days before due date of payment.

    (2) The total value of secured debentures issued shall not exceed the market value of immovable property/other assets or receivables of the issuer, for which a charge shall be created.
    (3) The issuer shall give an undertaking in the offer document that the assets on which charge is created are free from any encumbrances and if the assets are already charged to secure a debt, the permissions or consent to create second or pari passu charge on the assets of the issuer have been obtained from the earlier creditor.
    (4) The issue proceeds shall not be utilized until the documents for creation of security are executed.

Trust Deed

13. (1) A trust deed for securing the issue of debentures shall be executed by the issuer in favour of the independent trustee or debenture trustee, as applicable, within three months of the closure of the issue.

(2) The trust deed shall contain such clauses as may be prescribed in Schedule-IV of the Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993:

Provided that in case of private placement by a corporate municipal entity, the trust deed shall, in-addition, contain such clauses as prescribed under Section 71 of the Companies Act, 2013 and Companies (Share Capital and Debentures) Rules 2014.

(3) The trust deed shall not contain a clause which has the effect of:

(a) Limiting or extinguishing the obligations and liabilities of the debenture trustees or the issuer in relation to any rights or interests of the investors;

(b) Limiting or restricting or waiving the provisions of the Act, these regulations and circulars or guidelines issued by the Board;

(c) Indemnifying the debenture trustees or the issuer for loss or damage caused by their act of negligence or commission or omission.

Redemption and Roll-over

14. (1) The issuer shall redeem the debt securities in terms of the offer document.

(2) Where the issuer being a corporate municipal entity, desires to roll-over the debt securities issued, it shall do so only upon passing of a special resolution to that effect and give twenty one days notice of the proposed roll-over to the holders of debt securities:

Provided where the issuer is a municipality, the notice shall be given to the holders of debt securities and stock exchanges where the debt securities are listed, upon the said decision.

Provided further that in case the issuer is a municipality, if the holders of debt securities do not provide consent for the proposed roll-over within the notice period, the issuer shall redeem the debt securities of such holders.

(3) The notice referred to in sub-regulation (2) shall contain disclosures with regard to credit rating and rationale for roll-over.

(4) The issuer being a corporate municipal entity shall, prior to sending the notice to holders of debt securities, file a copy of the notice and proposed resolution with the stock exchanges where such securities are listed, for dissemination of the same to public on their websites.

(5) The debt securities issued can be rolled-over subject to the following conditions:

(a) The roll-over is approved by a special resolution passed by the holders of debt securities through postal ballot having the consent of not less than 75% of the holders by value of such debt securities:

Provided that this condition shall not be applicable to the issuer, which is a municipality.

Provided further that in case of issuer being a municipality, a period of seven days shall be granted to the holders of debt securities to provide their consent.

(b) At least one rating is obtained from a credit rating agency within a period of six months prior to the due date of redemption and is disclosed in the notice referred to in sub-regulation (2).

(c) Fresh trust deed shall be executed at the time of such roll-over or the existing trust deed may be continued if the trust deed provides for such continuation.

(d) Adequate security shall be created or maintained in respect of such debt securities to be rolled-over.

(6) The issuer shall redeem the debt securities of all the holders, who have not given their positive consent to the roll-over.

Debenture Redemption Reserve

15. (1) For the redemption of the debentures issued by a corporate municipal entity, the issuer shall create debenture redemption reserve in accordance with the provisions of the Companies Act, 2013 and the rules made thereunder.

(2) Where the issuer is a corporate municipal entity and the issuer has defaulted in payment of interest on debt securities or redemption thereof or in creation of security as per the terms of the issue of debt securities, any distribution of dividend shall require approval of the debenture trustees.

CONDITIONS FOR CONTINUOUS LISTING AND TRADING OF DEBT SECURITIES

Continuous Listing Conditions

16. (1) All the issuers making public issues of debt securities or seeking listing of debt securities issued on private placement basis, shall comply with conditions of listing including continuous disclosure and other requirements specified by the Board in general and those specified in Schedule-V to these regulations.
(2) Where the issuer is corporate municipal entity, one-third of its Board shall comprise of independent directors, as defined in Section 149 of the Companies Act, 2013.
(3) Every rating obtained by an issuer shall be periodically reviewed by the registered credit rating agency and any revision in the rating shall be promptly disclosed by the issuer to the stock exchange(s) where the debt securities are listed.
(4) In the event of credit rating being down graded by two or more notches below the rating assigned at the time of issue, the issuer shall present to all bond holders, the reasons for fall in rating and the steps, if any, it intends to take to recover the rating.
(5) Any change in rating shall be promptly disseminated in such manner as the stock exchange, where such securities are listed, may determine from time to time.
(6) The issuer, the respective debenture trustees, wherever appointed, and stock exchanges shall disseminate all information and reports regarding debt securities including compliance reports filed by the issuers and the debenture trustees, if appointed, to the investors and the general public by placing them on their websites.
(7) The information referred to in sub-regulation (5) shall also be placed on the websites, if any, of the debenture trustee, the issuer and the stock exchanges.

Trading and Reporting of Debt Securities

17. (1) The debt securities issued to the public or on a private placement basis, which are listed in recognized stock exchanges, shall be traded and such trades shall be cleared and settled in recognized clearing corporation subject to conditions specified by the Board.
(2) The trading lot for privately placed debt securities shall be one lakh rupees or such amount as may be specified by the Board.
(3) In case of trades of debt securities which have been made over the counter, such trades shall be reported on a recognized stock exchange having a nationwide trading terminal or such other platform as may be specified by the Board from time to time.
(4) The information in respect of issues such as issuer details, instrument details, ratings, rating migration, coupon, buy-back, redemption details, shall be required to be reported to a common database with depositories or any other platform as may be specified by the Board.

Conclusion

All the above new instruments have a potential large market. To market them effectively, the issuers and the government agencies need to increase investors' awareness, make legal amendments wherever necessary, and list them on the NSE to increase liquidity and depth of the Indian financial markets.

KEY TERMS

Auction Rated Debentures	Debt Obligations	Pass Through Certificates
Collateralized	Differential Shares	Securitized Papers
Deep Discount Bonds	Floating Rate Bonds	Zero Interest Bonds

SUMMARY

1. A new financial instrument may be one which has some new features in the terms of agreement when compared with the features of presently available instruments.
2. In the post-reforms period, a host of innovative instruments have been introduced in the capital market. Most of these instruments are debt instruments. These instruments have not only been structured and designed properly, they have also been successfully marketed at the retail level.
3. Floating rate bonds are those bonds wherein the interest rate is linked to a benchmark/anchor rate and is not fixed. It is a concept which has been introduced primarily to take care of the falling market or to provide a cushion in times of falling interest rates in the economy.

4. Zero interest bonds are those bonds wherein there is no periodic interest payment and they are sold at a huge discount to face value.
5. Deep discount bond is a zero coupon bond whose maturity is very high, say 15 years onwards and is offered at a discount to the face value.
6. Revolving underwriting finance facility is a 91-day debenture which is rolled over after its maturity with a facility of an underwriter who is prepared to pick-up the lot if it is not fully sold.
7. Auction rated debenture is a secured, redeemable (after 90 days), non-convertible instrument with interest determined by the market and placed privately with bids.
8. Secured premium notes with detachable warrants is redeemable after a notified period, of say four to seven years. There is a lock-in period during which no interest is paid. The attached warrants ensure that the holder has the right to apply and be allotted equity shares provided the secured premium note is fully paid.
9. Non-convertible debenture with detachable equity warrants is an instrument wherein the holder is given an option to buy a specific number of shares from the company at a pre-determined price and time frame.
10. Secured zero interest partly convertible debentures with detachable and separately tradable warrants consists of two parts: Part A is convertible into equity shares at a fixed amount on the date of allotment, while Part B is non-convertible, to be redeemed at par at the end of a specific period from the date of allotment and carries detachable and separate tradable warrants.
11. Differential shares are a class of shares which carry voting rights with varying rates of dividend. They can be issued with no voting right but high dividends or, with varying voting rights and dividends.
12. Securitization is a process by which a company raises money by selling off its receivables. These receivables are sold off to cash-rich investors by converting them into securities. The receivables are sold at a discount to the investors which represents the yield.
13. Collateralized debt obligation is securitization of corporate obligations such as corporate loans, corporate bonds, and asset backed securities. Collectively, CDO consists of collateralized bond obligations, collateralized loan obligations, and credit linked notes that emanate from the same financial family.
14. Inverse float bonds are the latest entrants in the Indian capital market. Inverse float bonds are bonds carrying a floating rate of interest that is inversely related to short-term interest rates.
15. Perpetual bonds are debt instruments with no maturity date.
16. Municipal bonds are debt seuirities issued by the municipal corporation of a city to finance infrastructure projects.

REVIEW QUESTIONS

1. What are new instruments? What are the reasons for innovations in financial instruments.
2. What are deep discount bonds? How do they differ from zero interest bonds?
3. 'Floating rate bonds are gaining popularity in India.' Discuss.
4. What is a securitized paper? What are the reasons for its growing popularity in India? What are the problems hindering the growth of securitization?
5. What are the distinctive features of revolving underwriting finance facility?
6. What are differential shares? How are they beneficial?
7. What are municipal bonds? Describe the process of issuance of municipal bonds.
8. Answer the following in brief:
   i. What are perpetual bonds and inverse float bonds?
   ii. What is a collateralized debt obligation?
   iii. How do deep discount bonds differ from zero-interest bonds?
   iv. What is a pass through certificate?
9. Choose the right answer
   i. Municipal bonds are debt securities issued by the ____________to raise funds.
      (a) Central Government
      (b) State Government
      (c) Municipal Corporation of a city
      (d) Local body of a village
   ii. ___________ bonds do not have a maturity date.
      (a) Zero-interest
      (b) Convertible bonds
      (c) Non-convertible bonds
      (d) Perpetual
   iii. In deep discount bonds, there is:
      (a) no periodic interest payment and low maturity.
      (b) periodic interest payments and high maturity.
      (c) no periodic interest payments, high maturity, and offered at a discount to its face value.
      (d) periodic interest payments, high maturity, and offered at a discount to its face value.
   iv. Inverse float bonds enable investors to earn high returns in a _________ interest rate environment
      (a) high (c) stable
      (b) low (d) volatile
   v. __________ debentures are a hybrid of commercial papers and debentures
      (a) Non-convertible
      (b) Convertible
      (c) Auction rated

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