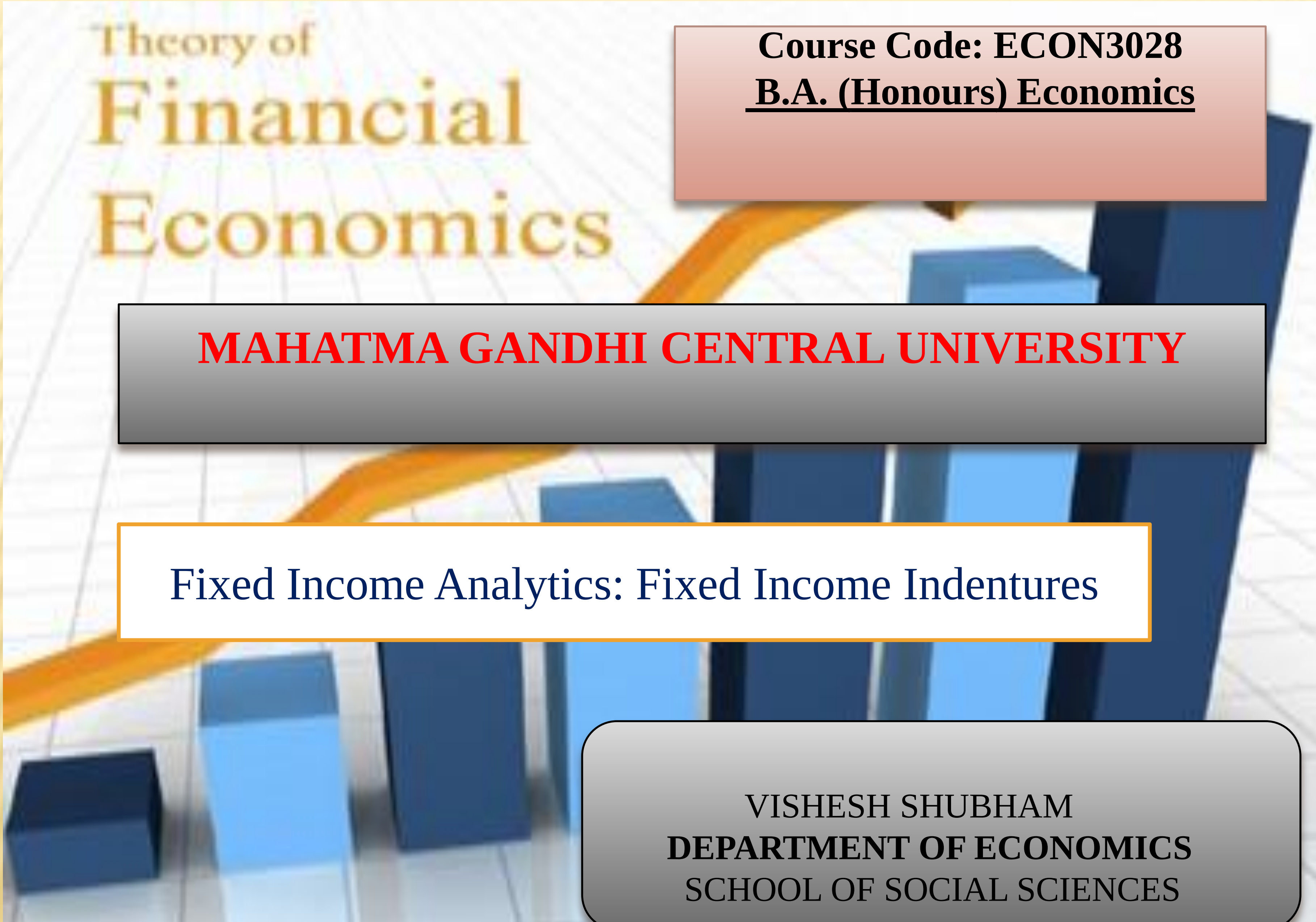


Course Code: ECON3028

B.A. (Honours) Economics

MAHATMA GANDHI CENTRAL UNIVERSITY

Fixed Income Analytics: Fixed Income Indentures

VISHESH SHUBHAM
DEPARTMENT OF ECONOMICS
SCHOOL OF SOCIAL SCIENCES

FIXED INCOME INDENTURES

Fixed-income securities constitute the most prevalent means of raising capital globally. A fixed-income security is an instrument that allows governments, companies, and other types of issuers to borrow money from investors. Any borrowing of money is debt. The promised payments on fixed-income securities are, in general, contractual (legal) obligations of the issuer to the investor. For companies, fixed-income securities contrast to common shares in not having ownership rights. Payments of interest and repayment of principal (amount borrowed) are a prior claim on the company's earnings and assets compared with the claim of common shareholders. Thus, a company's fixed-income securities have, in theory, lower risk than that company's common shares.

In portfolio management, fixed-income securities fulfill several important roles. They are a prime means by which investors—individual and institutional—can prepare to fund, with some degree of safety, known future obligations such as tuition payments or pension obligations. The correlations of fixed-income securities with common shares vary; but, adding fixed-income securities to portfolios including common shares is usually an effective way of obtaining diversification benefits.

Three important elements that an investor needs

- The bond’s features, which determine its scheduled cash flows and thus the bondholder’s expected and actual return.
- The legal, regulatory, and tax considerations that apply to the contractual agreement between the issuer and the bondholders.
- The contingency provisions that may affect the bond’s scheduled cash flows.

What Is an Indenture?

Indenture refers to a legal and binding agreement, contract, or document between two or more parties. Traditionally, these documents featured indented sides or perforated edges. Historically, indenture has also referred to a contract binding one person to work for another for a set period of time (indentured servant), particularly European immigrants. In modern day finance, the word indenture most commonly appears in bond agreements, real estate deals, and some aspects of bankruptcies.

Indenture is a term that originated from England. In the U.S., there can be several types of indentures, all typically involved with debt agreements, real estate, or bankruptcy.

KEY TAKEAWAYS:

- An indenture is a legal and binding contract usually associated with bond agreements, real estate, or bankruptcy.
- An indenture provides detailed information on terms, clauses, and covenants.
- There can be a few different types of indentures and many different types of indenture clauses.

Types of Indentures

- Real Estate Indenture
- Bankruptcy Indenture
- Credit Indentures

Real Estate Indenture

In real estate, an indenture is a deed in which two parties agree to continuing obligations. For example, one party may agree to maintain a property and the other may agree to make payments on it.

Bankruptcy Indenture

In bankruptcy law, an indenture may be referenced as proof of a claim on property. Indentures in general provide details on collateralized property, constituting the claim a lender has against a debtor, usually secured with a lien on the debtor's property.

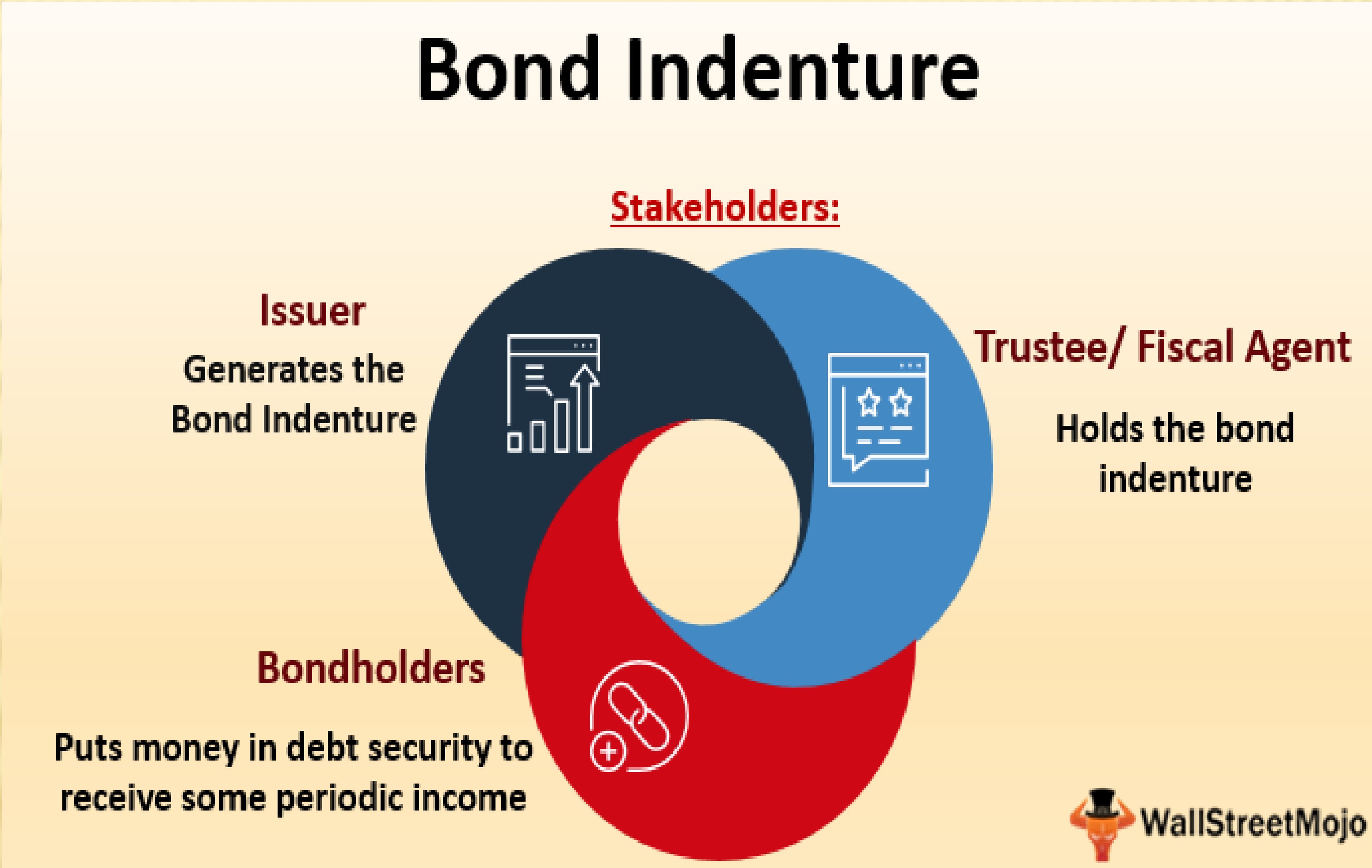
Credit Indentures

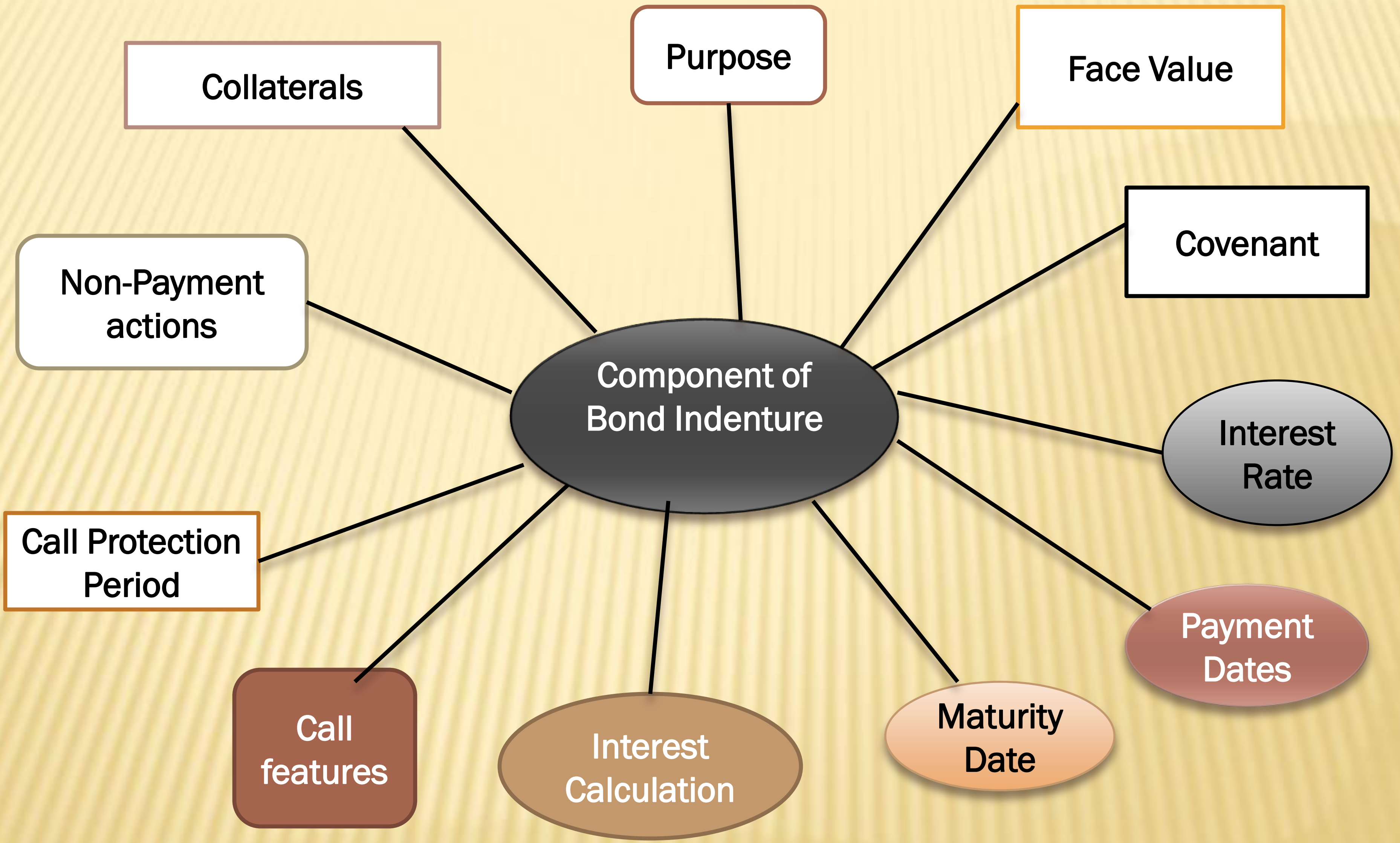
A credit indenture is the underlying contract agreement that details all of the provisions and clauses associated with a credit offering. In non-secured, uncollateralized bond offerings, these indentures can also be called debentures.

BOND INDENTURES

A bond is a security issued to a lender, the bondholder, for a loan in the amount of the bond's price. To issue a bond, a 3rd-party **trustee**, which is usually a bank or a trust company, is assigned by the issuer to serve the needs of the bondholders, including bringing suit in the event of a default. The **bond indenture** (aka **trust indenture**, **deed of trust**) is a legal contract between the issuer and the trustee that specifies the scope and the responsibilities of the borrower, the trustee, and the lender, and the characteristics of the bond, such as the maturity date, coupon rate, and so on. The indenture, a copy of which must be filed with the Securities and Exchange Commission (SEC), is required by the *Trust Indenture Act of 1939* for issues registered under the *Security Act of 1933*, which includes most corporate bonds, but not for issues for less than $5,000,000, municipal bonds, and bonds issued by governments.

The indenture will specify, among other things, the interest rate, the date of maturity, the procedures to modify the indenture after issuance, and the purpose of the bond issue. The name and contact information of the trustee will be listed in the indenture. If the bond has coupons, the indenture will specify where the coupons can be presented for payment.


Bond Indenture
Stakeholders:
Issuer
Generates the Bond Indenture
Trustee/ Fiscal Agent
Holds the bond indenture
Bondholders
Puts money in debt security to receive some periodic income
WallStreetMojo


Component of Bond Indenture
Collaterals
Purpose
Face Value
Covenant
Non-Payment actions
Interest Rate
Call Protection Period
Payment Dates
Maturity Date
Call features
Interest Calculation

Protective Covenants

Because the value of a bond depends on the creditworthiness of the issuer, indentures usually include **protective covenants** (aka **restrictive covenants**) that restrict the issuer from doing things that would make it less creditworthy, which would lower the bond's price in the secondary market, and increase the chance of default in interest payments or principal repayment.

Protective covenants usually provide at least the following provisions:

- ❑ Pay the interest and principal of its bonds
- ❑ Specify when bonds can be presented for payment
- ❑ Maintain the collateral in good condition
- ❑ Insure the collateral against loss
- ❑ Defend the legal title to the property
- ❑ Pay all taxes and assessments, including property, income, and franchise taxes (otherwise, tax authorities can place a lien on the businesses property that is superior to that of other creditors, even secured creditors)
- ❑ Maintain the business to ensure that the business can continue as a going concern, including maintaining the corporate structure and the right to do business

CONTD……

The protective covenants are a compromise between what the issuer wants and what the bond buyers want. Issuers want to pay the least amount of interest with the least restrictions in their freedoms, while bond buyers would want the highest interest with those restrictions that would maintain the creditworthiness of the issuer. The bond issuer willingly adds restrictions, however, since the bonds would sell for a lower yield. Hence, the degree of protection for bondholders is inversely related to the bond yield—more protection, less yield, and vice versa. This is congruent with the general principle that the greater the risk of the security, the greater its yield must be to entice investors.

Callable Bonds

The indenture will specify whether the bond is callable, and if it is, it will specify the conditions under which it can be called, including the dates when it is callable, and the price—the call premium—that will be paid if called. Generally, a bond cannot be called before a certain date, and the call premium is usually more than par value at earlier dates, but diminishes as the bond approaches maturity.

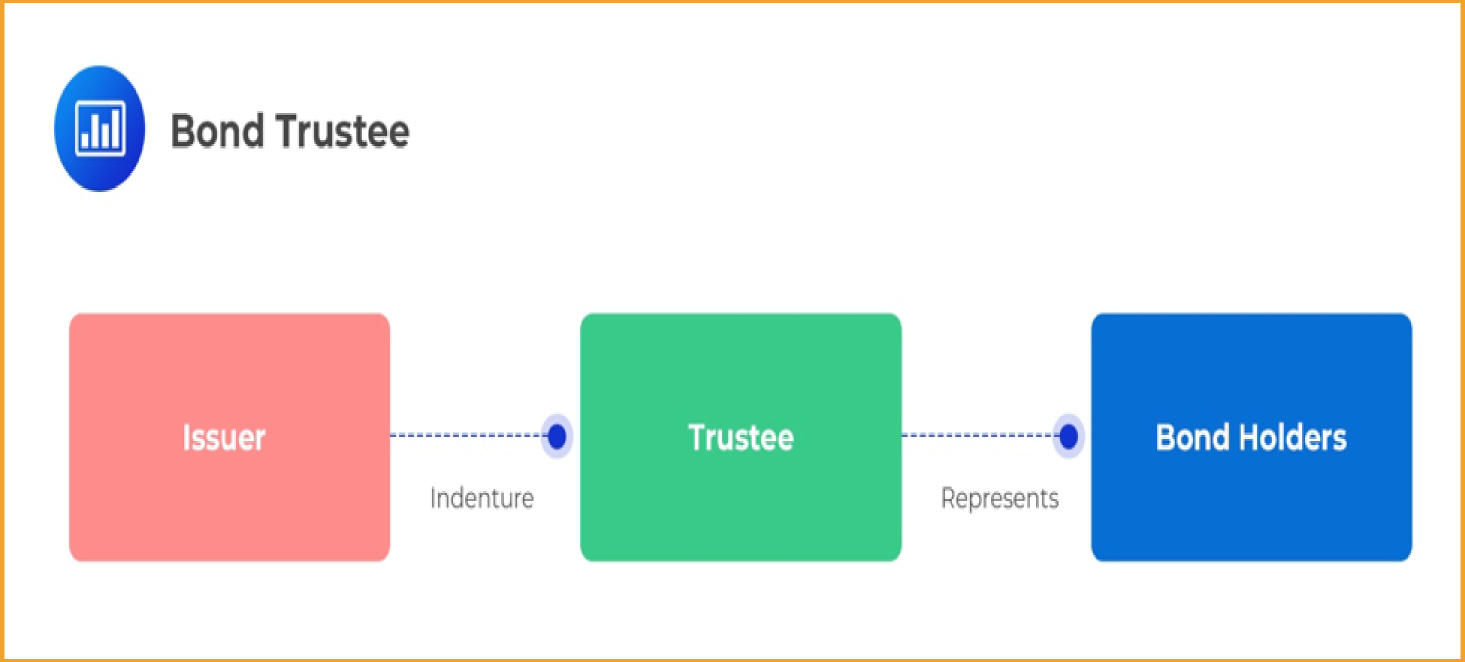
The coupon rate is the interest rate that the issuer agrees to pay to the bondholder each year. The coupon rate can be a fixed rate or a floating rate. Bonds may offer annual, semi-annual, quarterly, or monthly coupon payments depending on the type of bond and where the bond is issued.

The yield to maturity is the discount rate that equates the present value of the bond’s future cash flows until maturity to its price. Yield to maturity can be considered an estimate of the market’s expectation for the bond’s return.

A plain vanilla bond has a known cash flow pattern. It has a fixed maturity date and pays a fixed rate of interest over the bond’s life. The bond indenture or trust deed is the legal contract that describes the form of the bond, the issuer’s obligations, and the investor’s rights. The indenture is usually held by a financial institution called a trustee, which performs various duties specified in the indenture.

Sinking fund agreements provide another approach to the periodic retirement of principal, in which an amount of the bond’s principal outstanding amount is usually repaid each year throughout the bond’s life or after a specified date.

Stakeholders in Bond Indenture



Issuer

Issuer generates the Bond Indenture. The indenture contains all the legal details of the issuer of the bond to give a clear picture to the investors.

- Like in the case of a Sovereign bond, which government body will be responsible as an issuer. Such as HM Treasury in the United Kingdom, RBI in India.
- For corporate bonds, details of corporate legal entity will be mentioned.
- In the case of the securitized bond, details of the sponsor that will be a financial institution and is the in-charge of the securitization process.

Trustee/ Fiscal Agent

The trustee is a bank or financial institution that holds the bond indenture. Trustee roles are primarily providing financial and legal assistance to bondholders. The main role of the trustee is holding the funds until payments are done to bondholders, invoicing the issuer for interest and principal payments, calling meetings of bondholders, ensuring all the terms and conditions mentioned in Indenture are properly adhered by the issuer.

Bondholders

The bondholder is the investor that puts his money in this debt security to receive some periodic income from interest and receive the principal amount at the time of maturity of the bond.

ADVANTAGE

1. Bond Indenture is the legal document, all the clauses mentioned in the document are applicable to all the stakeholders involved in the transaction.

2. Bond Indenture protect the interest of all the stakeholders and reduce the chance of default.

3. Indenture clearly defines all the information related to the bond.

4. Rights and Duties of all the stakeholders are clearly defined in the Indentures that helps in avoiding any confusion.

5. This document ensures all the stakeholders must be aware of the covenants for proper transparency.

6. Indenture is the only legal document that is referred in case of any dispute regarding the bond.

Disadvantages

1.Indentures are non-transferable hence there are very limited options available to exit these contracts.

2. These contracts once signed are not renegotiable, so any change in the interest rate due to policy change may have financial repercussions.

Conclusion

Bond Indenture is a core legal document that safeguards the right of both investors and issuers. It contains all information related to bond along with the Rights and responsibility of both issuer and bondholders. Indenture has legal binding on all the stakeholders and in case of any dispute or default indenture will be considered for any resolution.

THANK YOU