EUROBONDS **G A WALKER**

4. INTERNATIONAL BOND FINANCE

Bonds may be issued in a number of forms, with differing rights and entitlements, as well as corresponding obligations attached. Bonds are essentially negotiable certificates (either paper or an electronic representation) evidencing an underlying medium to long term debt. The issuer undertakes to pay the principal amount (set out on the face of the bond) on maturity as well as to make interest or coupon payments (on either a fixed or floating basis) during the term of the bond.

The four main classes of bonds are international (Eurobonds), domestic government and domestic corporate as well as foreign bonds (issued by overseas parties in a local capital market). While original issues were ten to fifteen years (and up to thirty years), the more recent trend has been towards short medium (two to ten years) and then other short notes (of less than one year). These principally include US Medium Term Notes (MTNs) and Euronotes (including Note Issue Facilities (NIFs) or Revolving Underwriting Facilities (RUFs)) and Commercial Paper (US or UK) (the difference between Euronotes and Commercial Paper is that there is an underlying commitment to purchase Euronotes). A large number of variations nevertheless exist within each of these main formats.

Some of the most commonly used structures are considered next.

(1) Eurobonds

Eurobonds are transferable debt securities denominated in a currency other than that of the issuer's home territory. Eurobonds are generally unsecured and issued in a bearer form. They are usually negotiable as well as transferable and sold to international investors rather than solely within the domestic capital markets. The investor group principally consists of other financial institutions or professional investors as well as other sophisticated investors and wealthy individuals.

The Eurobond markets began in the early 1960s and developed in parallel with the syndicated loan market. The first Eurobond issue was for the Italian motorway corporation, Autostrade (US dollars 15 million) in July 1963. Early growth was stimulated by the imposition of an interest equalisation tax in the US in 1963 by President Kennedy. As well as the Voluntary Restraint Program introduced by President Johnson. The first imposed a tax on the purchase of foreign bonds by American investors while the second required international investors to obtain funds outside the US[1]. Subsequent growth was substantial, mainly due to the transferable and anonymous nature of the instrument.

The use and value of the security was subsequently improved with the development of a large number of variations on the core debt obligation involved.

(1) Plain Vanilla and Variable Bonds

The basic Eurobonds is referred to as a plain vanilla fixed coupon instrument. This pays the interest or coupon in fixed equal amounts at agreed intervals (usually six months) in arrears calculated having regard to a specified reference rate. Other fixed rate options include:

(i) Zero Coupon Bonds[2];
(ii) Foreign Currency Bonds[3];
(iii) Reverse Dual Currency Bonds[4];
(iv) First Coupon on Partly Paid Bonds[5];
(v) Currency Change Bond[6].
(vi) Annuity Bonds[7];

---

[1] Arun Kumar Sarwal, 'KPMG International Handbook of Financial Instruments and Transactions' (Butterworths London 1989) 94.

[2] No interest is paid with the investor benefiting from the increase in value of the bond over time. This may either be issued at a discount and redeemed at par or issued at par and redeemed at a premium. Deep discount securities are issued at a substantial discount, with a lower interest being paid during term. Zero coupon bonds pay no interest with the investor benefiting from the difference between the original discount price and the par value.

[3] Interest is paid in a different currency (other than that in which the bond was originally issued and denominated) at the spot rate at the time of payment.

[4] Interest is paid in a currency other than that of denomination at a fixed rate (rather than spot rate as under a foreign currency bond).

[5] Interest varies having regard to the amount of the issue price paid up.

[6] Interest payments are made in different currencies at fixed exchange rates set at the time of issue.

[7] Partial repayments of principal are included within the fixed interest rate payments.

(2) Floating Rate Notes (FRNs)

Floating Rate Notes (FRNs) provide for the payment of interest at a variable rather than fixed rate. The most commonly used reference rate is the London Inter Bank Offered Rate (LIBOR)[8]. The first FRN was in 1970 with FRN issues making up 37% of the bond market by 1983[9]. Maturities were also shortened as issuers were reluctant to commit themselves to long periods of fixed interest payments with the high levels of market volatility that persisted. Typical maturities were between five and fifteen years with minimum denominations of 1,000 dollars[10]. FRNs nevertheless still have the disadvantages of not being able to offer flexible draw downs or interest payment adjustment options[11].

Apart from plain vanilla FRNs, other options include:
(i) Floor FRNs[12];
(ii) Drop Lock FRNs[13];
(iii) Double Drop Lock FRNs[14];
(iv) Cap FRNs[15];
(v) Caller FRNs (or Minimax FRNs)[16];
(vi) Inverse FRNs (or Bull/Reverse FRNs)[17];
(vii) Step Down FRNs[18];
(viii) Step Up FRNs[19];
(ix) Margin as a percentage FRN[20];
(x) Floating then Zero FRNs;
(xi) Fixed then Floating FRNs;
(xii) Variable Rate Notes (VRNs)[21];
(xiii) Zero Coupon (or Deep Discount) FRNs[22];
(xiv) Rolling Rate Notes (RRNs)[23].
Other interest rate options include:
(i) Bunny (or Multiplier) Bonds or Notes[24];

---

8 LIBOR (or LIBID or LINEAN) will be calculated on six monthly intervals with regard to the relevant LIBOR rate. Shorter three month LIBOR rates may also be used or six month SUS Treasury Bill Rates.

9 Fisher, *International Bonds* (Euro Money).

10 Sarwal (n 62) 96.

11 Sarwal notes that they were described as "disguised syndicated loans" despite these disadvantages. Sarwal (n 62) 98.

12 The note only fluctuates above a minimum floor rate such as 5% (for US, Sterling and French Franc bonds) and 3% (for earlier Deutsche Mark bonds). An "initial floor" FRN only operates for a minimum commencement period. 80% of FRNs issued in 1986 were Floor FRNs. Sarwal (n 62) 107.

13 The interest becomes fixed at the floor rate when it arrives at an agreed "trigger level". If interest rates subsequently rise, the bonds may be purchased by other investors preferring fixed rate instruments (such as pension funds or insurance companies) for a ¾% or ¹/₁₆% annual fee. Sarwal (n 62) 107.

14 The interest rate only becomes fixed or Locked where the trigger level is breached on two consecutive fixing dates. This is used where rates may vary widely.

15 The interest rate is limited (or capped) at a certain level (such as 13% for US dollar FRNs). This imposes an upper limit. A "Delayed Cap FRN" only operates for a specified period after the initial commencement time.

16 Both maximum and minimum interest rate limits are imposed (floors and caps). A Minimax FRN operates within narrower upper and lower limits.

17 Interest rates move in an inverse relationship with the benchmark rate selected. They are also known as Yield Curve Adjustable Notes (YCANs). "High Margin FRNs" operate on a fluctuating basis until a specified rate is reached, after which they are converted into inverse FRNs. Sarwal notes that Inverse FRNs were used after mid-1986. Sarwal (n 62) 108.

18 The margin is reduced proportionately over time. This is only common in longer bonds such as thirty year or perpetual FRNs. This will be supported by a right of re-purchase (callable at par) after an initial period (such as five years) "high first coupons" provide for an initial large payment and then subsequent fixed rate margins over the life of the bond. Sarwal (n 62) 108.

19 The margin increases proportionately over the duration of the instrument. A "Step Up With Claw Back" allows negative interest payments to be deducted subsequently where the margin was set at a rate below the reference rate.

20 The rate is set as a percentage of the benchmark rate.

21 The margin or spread is re-set for each interest period. This can either be calculated on an auction basis (such as under the Warburg model) or by agreement (under the Merrill Lynch model). These were introduced in 1988 to promote interest in declining FRN use. Sarwal (n 62) 110.

22 Deep discount securities are issued at a discount on their par or redemption value with a lower interest or coupon being paid during term. Zero coupon bonds pay no interest with an amount equivalent to the interest otherwise payable over the life of the instrument being deducted up front. They are then redeemable at par value. The interest would effectively be rolled up within the redemption price which would benefit from capital gains tax which may be payable at a rate lower than income tax. This was particularly attractive in the UK for corporate and wealthy individual investors, although the tax advantage has since been closed. Sarwal (n 62) 197 – 198.

23 Interest is calculated on a monthly but payable six-monthly basis using the agreed six month reference rate with the accrued interest being added to the capital amount. George S Ugeux, *FRNs* (Euromoney); Fisher, *International Bonds* (Euromoney); and "Types of Bonds" *Current Issues of International Financial Law* [116].

(ii) Lender's Option-Borrower's Option (LOBO)[25];
(iii) Borrowers' Option-Lender's Option (BOLO)[26].

Other interest rate variations include:
(i) Graduated Rate Coupon Bonds[27];
(ii) Deferred Coupon Bonds[28];
(iii) Profit Sharing Bond[29];
(iv) Indexed Bonds[30];
(v) Duet Bonds[31].

(6) Euro Medium Term Notes

Medium Term Notes (MTNs) are unsecured debt instruments (generally promissory notes) issued for durations between nine months and fifteen years[32]. These are accordingly interim maturity instruments between long bonds and short notes. MTNs are issued on a rolling or continuous basis under a programme agreement with a separate agency agreement and information memorandum as well as possible trust deeds[33].

MTNs were introduced in the US in the early 1980s[34]. Total issue volumes increased from US 12 billion in 1984 to 36 billion dollars by 1986[35]. They are issued in small denominations (of between US 2 – 5 million dollars), bear interest and are quoted at a percentage of their face value. Issuers and investors both benefit from increased flexibility in terms of the options available in structuring the amount, maturity and interest payable on the notes at any time.

US MTNs issues will have a set of posted rates and maturities of between nine months to one year, one year to eighteen months, eighteen months to two years. Investors can then elect particular maturity dates. Most maturities are less than five years[36]. MTNs also benefit from certain regulatory concessions being issued on a continuous basis[37].

Variations on the plain vanilla MTN include:
(i) Euro MTNs (EMTNs)[38];
(ii) Global MTNs[39];
(iii) Continuously Offered Long Term Securities (COLTS)[40];
(iv) Continuously Offered Intermediate Notes (COINS)[41];
(v) Multi-Tranche Tap Notes (MTTNs)[42].

---

24 The investor is given the option to have the interest payments re-invested in identical bonds which provide a separate income stream. The option allows the issuer to pay lower interest rates while this may also be of advantage to the investor, depending upon whether interest rates are expected to rise or fall and the investor's preference for fixed or floating instruments. Sarwal (n 62) 110.

25 The investor can vary the interest rate at their choice, subject to the issuer's right to redeem at face value. This has been used by UK local authorities in issuing twenty year securities with an agreed opening interest rate.

26 The issuer is entitled to vary the interest, with the investor either being able to accept or call for redemption of all outstanding amounts due.

27 Interest is paid at different rates in the schedule attached at issue.

28 The first fixed interest payment is delayed until a pre-determined time.

29 Interest payments are linked to dividends on equity issued by the same company. The alternative is to make the bond convertible into equity.

30 Fixed interest payments calculated with regard to an agreed index, such as the Retail Price Index (RPI) in the UK.

31 The purchase and sale of two fixed rate bonds in different currencies which allows the issuer to benefit from different interest rates in the markets selected. Sarwal (n 62) 106 – 107.

32 Sarawl (n) 201. Wood notes that Euro MTNs can have a maturity range of between one month and thirty years. Wood (n 26) 9.37.

33 Wood (n 26) paras 9.38 – 39.

34 Early issuers were General Motors Acceptance Corporation, Ford Motor Credit and other automobile credit companies. Sarwal (n 62) 203.

35 Sarwal (n 62) 201.

36 Sarwal (n 62) 201. Interest may be fixed or floating.

37 MTNs fall within SEC Rule 415 (Shelf Registration) or may be exempt under SEC Regulation D. Foreign banks can now issue US MTNs (referred to as Deposit Notes) since September 1986 in place of earlier certificates of deposit (CDs). Non-banking based issues can also be made without registration provided a "letter of credit" is entered into by an exempt entity such as a bank. This is referred to as credit support. Sarwal (n 62) 202.

38 The EMTN market began in 1986. Maturities are generally between one and five years, with the notes being listed and cleared through Euroclear or Clearstream.

39 The issuer may either use the domestic US or Euro market with non-dollar denominations being supported by a currency swap.

40 World Bank issues are referred to as COLTS with a maturity of between three and thirty years.

41 Euro MTNs issued through an offshore insurance company.

(7) Euronotes

Euronotes are short dated bearer promissory notes with maturities of between seven days and one year[43]. Euronotes are usually issued at a discount and redeemed at par. Euronotes are usually issued in US Dollars or Euros with other countries prohibiting locally denominated notes. Currency swaps may, nevertheless, be used to obtain funding in a particular currency. Short dated instruments can, nevertheless, be issued as Sterling Commercial Paper under the relevant UK provisions. The terms Euronote and Commercial Paper are sometimes used interchangeably, although Euronote issues are generally underwritten by banks, whereas Commercial Paper is not. Euronotes are also generally issued by non-banks, with bank paper being referred to as certificates of deposit (CDs)[44].

The Euronote market was established in the late 1970s following the removal of exchange controls and other deregulatory changes and the dis-intermediation and securitisation of credit markets[45]. The first programmes were referred to Note Issuance Facilities (NIFs)[46]. Revolving Underwriting Facilities (RUFs) were subsequently developed in the early 1980s[47]. Other options included the Grantor Underwritten Note (GUN). These either operated on a sole placing agency (or Tap) basis or with a tender panel. Later variations included:

(i) Dual or Multiple Placing Agency[48];
(ii) Dealership Placement[49];
(iii) Issuer Set Margin[50];
(iv) Specialised Tender Panel[51];
(v) Unsolicited Tender[52];
(vi) Transferable Revolving Underwriting Facility (TRUF)[53].

The issuer will pay separate participation, underwriting, commitment and utilisation fees[54]. NIFs are generally 0.10% and 0.50% cheaper than a syndicated loan.

Euronote variations include:

(i) Short-Term Note Issuance Facility (SNIF);
(ii) Securities Note Commitment Facility (SNCF);
(iii) Revolving Acceptance Facility by Tender (RAFT);
(iv) Global Note Facility.

© G A WALKER

---

42 Merrill Lynch developed issues with an initial issue followed by subsequent tap issues to enhance liquidity. Sarwal (n 62) 204 – 205.

43 Sarwal (n 62) 121 – 129; Tennekoon (n 23) Ch 23 and 24; and Penn, Shea and Arora (n) Ch 10. See also Ugeux, *Floating Rate Notes* (1985); Bankson and Lee (ed), *Euronotes* (1985); Fabozzi, *Floating Rate Instruments* (1986); and Bullock, *Euronotes and Euro-Commercial Paper* (1987). See also Henderson, "Structuring and Documenting Euronotes" (1985) *IFLR* 18; Beaumont, "The Difference Between NIF's and RUF's" (1985) *IFLR* 31; and "Euronote Offer Documents Under UK Law" (1985) *IFLR* 32. [The first Euronote issuance was by Citicorp Investment Bank for New Zealand Shipping Corporation in 1978. The commercial objective was to create an instrument parallel to a bank certificate of deposit (CD) which could be issued by a high credit non-banking institution. Penn, Shea and Arora (n) para 10.02.

44 Sarwal (n 62) 121.

45 Sarwal notes that the first issue was by a non-US company which could raise funds from investors in Europe more easily than in the US domestic market. The second issue was by a sovereign borrower which was offered competitive financing provided that it could issue a marketable security rather than a loan. (n) 121 – 122.

46 A NIF is a medium term programme under which a borrower can issue short term securities in its own name with underwriting banks either purchasing any unsold notes or providing standby credit. NIFs were issued in denominations of over 500,000 dollars and had maturities of between five and seven years, with notes being issued on a revolving basis.

47 The first RUF was in 1982. This provides for the separation of the underwriting and sale with a sole placing agent (placing the notes) and a separate underwriting group purchasing any residual notes or extending loans in an equivalent value. A tender panel was subsequently introduced in 1983 to provide a back-stop facility with member banks bidding for notes with a specified spread. Continuous tender panels were then developed in 1984 to allow the underwriters to purchase notes from the lead manager up to a specified proportionate amount. Tender panels can be made up of between thirty and sixty member banks. Sarwal (n 62) 122 – 123. [A Tap issue is used with a sole placing agent to allow the borrower to feed paper into the market depending on investor interest, using one or more placing agents.]

48 Dealers compete to place the notes on a best efforts basis, with the competition producing better prices for the issuer.

49 Banks act as agents (rather than principal) in selling the paper and maintaining a secondary market.

50 The issuer sets the interest rate, with underwriters taking up agreed proportions through a continuous tender panel at the agreed (cap) rate.

51 A smaller tender panel is used with an existing high quality client base to take up the issue.

52 The banks bid to place paper as selling opportunities arise.

53 Underwriters are entitled to transfer their commitment subject to borrower approval.

54 The participation fee is for front end management in setting up the facility (0 – 0.20%). Annual or quarterly underwriting fees ($^1/_{32}$% and $^1/_8$%) and commitment fees (0.05% - 0.10%) based on the unutilised facility. A separate utilisation fee may also be charged for large "maximum spreads" (0.05% - 0.20%).