CLIENT NOTE

ETERNAL BONDS

MYTH OR REALITY?

OVERVIEW

In the modern financial market, there is a tendency to diversify financial/debt instruments. Nowadays, sovereign governments, local governments, supranational bodies, such as the World Bank and corporations, tend to involve "hybrid" or "quasi" financial instruments.[1] The significance of such instruments is based on their mixed nature. As a fundraising and investment source, they provide the main advantages that equity financing would generally provide, as well as dissolve the main risks that debt instruments can cause.

For the economic development of the country, it is important to have a strong, divaricated market of financial instruments. Most of the participants of the economic market are now trying to find new ways and mechanisms to involve investments. At the same time, the potential investors tend to diversify and balance their contributions by using different risk-based financial instruments. This being said, the purpose of this Client Note is to introduce you to a relatively "new" HYBRID DEBT INSTRUMENT, its specific features and benefits, and the possibility of using them in Armenia.

[1] See https://books.mec.biz/tmp/books/HREWWOJW3VCSQK68FBNW.pdf

One of the “quasi” debt instruments in the market is the Perpetual Bond, also known as the "Perp." The history of Perps goes back to medieval Europe, particularly to the 8th century, when the Catholic church was one of the first issuers of such bonds[2] (if not the first).

The most famous Perps were the “British Consols.” They were first issued in 1751 and were traded for more than two hundred fifty years until they were fully redeemed in 2015[3].

Although they are currently not as famous as other types of bonds or debt instruments, they are attractive mechanisms for raising capital for businesses that have problems with capital raising, especially during problematic economic times.

WHAT ARE PERPETUAL BONDS?

The Perp is a type of bond which has a fixed income and no maturity date[4]. Generally, these bonds are characterized as “(…) a security certifying the right of its holder to receive from the issuer of the bond within the term specified therein the nominal value of the bond or any other property equivalent. A bond also gives its holder the right to receive interest on the nominal value of the bond or other property rights[5].”

Although the Perp is a specific type of bond, it has the general features of bonds and mirrors their main nature. At the same time, the Perp has specific features which define it as a “hybrid” or “quasi” debt instrument. Namely, as any other bond, the Perp:

i. Is a type of security,
ii. Can be issued by governments, their agencies, local authorities and corporations,
iii. Is a right of the holder to receive the nominal value of the bond or any other equivalent,
iv. Is a right to the holder to receive interest (coupon) on the nominal value or any other property right.

SPECIFIC FEATURES

Due to its specific nature, the Perp is often considered as a type of equity, rather than debt. The features that allow us to make such an assumption are the following:

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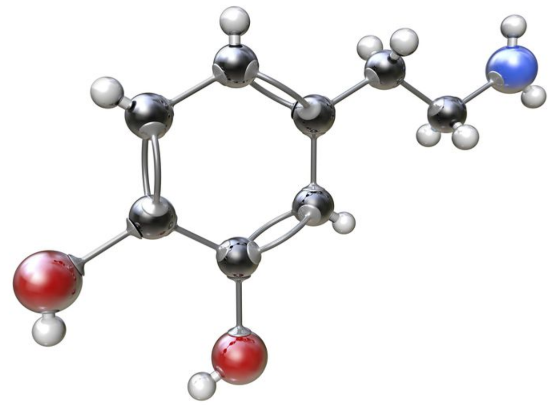
[2] See https://www.bloomberg.com/opinion/articles/2019-11-11/perpetual-bonds-are-the-bedrock-of-modern-financen

[3] See https://news.yale.edu/2015/09/22/living-artifact-dutch-golden-age-yale-s-367-year-old-water-bond-still-pays-interest

[4] See Gregory A. Kuhlemeye, Fundamentals of Financial Management, Chapter 4, (2014)

[5] RA Civil Code Article 154 (1), Code N ՀՕ–239, dated 05.05.1998, amended as of 24 October 2018.



No maturity date: As the name itself supposes, perpetual bonds do not have maturity dates. This means that potentially, the issuer might never pay back the nominal value of the bond.

Perps are callable bonds: These bonds usually have a callable feature. This means that the issuer is entitled to terminate the loan and pay back the bondholder at a predetermined price whenever they want, or on certain dates or in certain periods which are defined when the loan is initially issued (if available).

Perps are not secured: These kinds of bonds cannot be secured, as the essential element, such as the term of the main obligation (the obligation of the issuer to pay the nominal value of the bond) is not present. Therefore, the absence of the main obligation's term will contradict the nature of securing the obligation.

Forever paid interests: Since there is no maturity date for the Perp and it may not have a redemption schedule, the issuer will end up paying the fixed interest or coupon amount forever. Based on this feature, the payment of interests is quite similar to the distribution of dividends to a shareholder, as the payment of interest and dividends will continue until the owner sells the security.

Place in the hierarchy of claims: Another feature that can describe the Perps as equity rather than debt instrument is its place in the hierarchy of claims. In the hierarchy, the Perp is subordinated to secured and unsecured debt/bonds but has priority over equity/shares. Namely, the hierarchy of claims will be as follows:

1) Senior/Secured debts,
2) Junior/Subordinated debts,
3) Perpetual securities,
4) Preferred shares,
5) Ordinary shares.

Specific redemption schedule (not always): Like many other bonds, Perps may also have specific schedules for redemption, yet establishing such a schedule is not common practice. The main idea of this feature is that it fixes a specific date, such as the 3rd, 5th or 10th year after the issue date, when the issuer will be entitled to redeeming the bond. Still, if the call is not exercised, the Perp could exist forever, and it is possible that the nominal value of the bond will not be paid.

Redemption is more likely when an issuer can involve investment or other funds with much better conditions.

Interest step-up option (not always): Some perpetual securities have a step-up feature where the issuer is obligated to pay a higher rate of interest after a certain number of years. This feature is not common but can be used by the issuers to attract potential bondholders. It is also used to mitigate the risk of price fluctuations and infliction.

THE BENEFITS AND RISKS

Benefits

What makes a Perp a desirable "quasi" debt instrument?

The one party that benefits the most from this kind of arrangement is the bond issuer, because it allows them to raise money without ever paying back the nominal value since these bonds never mature. Moreover, it lets the issuer involve the bond in its additional capital as it is done in case of subordinated loans. Indeed, somehow Perps are similar to subordinated loans (hereinafter referred to as the "Sub Loan'') and perhaps the regulations that will apply to sub loans can also be applicable to Perps, as unsecured and secondary debt. That is why the Perp is considered a good instrument especially for the issuers who need to show large capital (e.g. financial institutions).

From the perspective of a bondholder, Perps are generally considered as steady, predictable and scheduled interest payments.[6] Furthermore, some Perps are endowed with the "step-up" feature, which increases interest payments at predetermined points in the future. This feature can be quite profitable for the bondholder. Perps with this feature are also called "growing perpetuity".

Perps are also considered to be transferable securities with some exceptions of course. The bondholder can sell it anytime on the secondary market.

As it has already been mentioned, Perps are often considered as equity instruments, yet due to its specific characteristics they have several advantages over them, such as: priority over equity in the hierarchy of claims; the interest payment is not based on the income of the company, it is fixed; for the payment of the bonds, the company shall have a separate reserved fund[7]; the bondholder doesn't participate in the management of the company and therefore will not bear the risk of default; etc.

Risks

At the same time, there are several risks associated with Perps. Namely, Perps have currency risk in cases where the bonds are issued in foreign currency. They might also collide with the risk of being unable to be sold, as these kinds of bonds are traded only on a limited market (at least in some countries). The callable feature of the Perp is also a risk for the bondholder because the issuer will exercise the call if they see an opportunity to obtain finances at a better price (if there is no agreed redemption schedule).

[6] https://www.investopedia.com/terms/p/perpetualbond.asp

[7] RA Law on "Joint Stock Companies" Article 43(1), Code N ՀՕ–232, dated 06.12.2001, amended as of 04 December 2019.

In case of inflation, the longer the investor holds on to the bond, the value of the yearly payout will diminish. In addition, fluctuations can also be very significant. This is why, in terms of risk profiles, Perps are compared to shares, as both have higher yield than other debt instruments.

Their future value is not guaranteed and the return is uncertain during difficult financial periods. Although, there can be some mechanisms that might mitigate such risks (e.g. step-up features).

There can also be risks concerning the interest rate of the bond. Since there is no maturity date for the bond, its value is considerably dependent on the evolution of the market interest rate. If the interest rate rises, a bond's value falls; and if the interest rate falls, the bond's value rises. The longer the term of the bond, the more the value will rise or fall if there is a change in the market interest rate. The interest rate risk special to Perps is therefore greater than those in classic bonds.

Most importantly, Perps bear a risk specific to its nature. When Perps are issued by financial institutions (e.g. banks), they generally contain an additional risk because these bonds can be written off, either wholly, in part, or converted into shares at the request of the regulator if the institution is no longer viable or is involved in bankruptcy. This means that anyone buying Perps runs the risk of eventually receiving shares[8].

Finally, there is a huge credit and default risk for Perps. Taking into consideration that in many cases Perps are issued by those who are in bad financial situations, where the default or insolvency risk is high, the Perp may encounter big challenges. As Perps are often very strongly subordinated bonds, in the event of bankruptcy, they will be paid back after all the creditors[9]. Therefore, it is always recommended to assess the credit quality of the issuer of the Perp carefully when buying Perps. Further, it is crucial to constantly review and assess this information throughout the time of holding the Perp[10].

PERPS IN ARMENIA

Is it possible to issue a Perp in Armenia?

In order to answer this question, it is essential to understand the nature of bonds under Armenian legislation and regulations. According to Article 154 (1) of the RA Civil Code, the bond is characterized as a security certifying the right of its holder to receive from the issuer of the bond within the term specified therein the nominal value of the bond or any other property equivalent.

A bond also gives its holder the right to receive interest on the nominal value of the bond or other property rights. Moreover, in accordance with the Article 40 (2) of the RA Law on "Joint Stock Companies": "A bond is a security paper, which verifies the right of the possessor to receive from the bond issuing company the nominal value of the bond or a property equivalent thereof in the time period mentioned in the bond (…)"

From the general definition of the bond under Armenian legislation, it can be stated that the term or the time period of the bond is an essential condition. This term stipulates the exact time period when the issuer shall pay back the nominal value. Furthermore, according to another point of the same

[8] https://www.bnpparibasfortis.be/rsc/contrib/document/1-Website/5-Docserver/BNP/F04824E.pdf

[9] However, from the perspective of the issuer this subordination is more beneficial.

[10] https://www.moneysense.gov.sg/articles/2018/10/understanding-perpetual-securities

article, “A decision on bond issuance shall define the method of repayment, the deadlines, and conditions.”

HOW CAN WE HELP?

Though these legal definitions may suggest that Preps cannot be issued in Armenia, our team has come up with innovative solutions to bypass the archaic limitations.

NOTE: This material is for general information only and is not intended to provide legal advice

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