How well do you know your debt instruments?

There are different kinds of debt instruments. Some are riskier than others. Here's what you need to know

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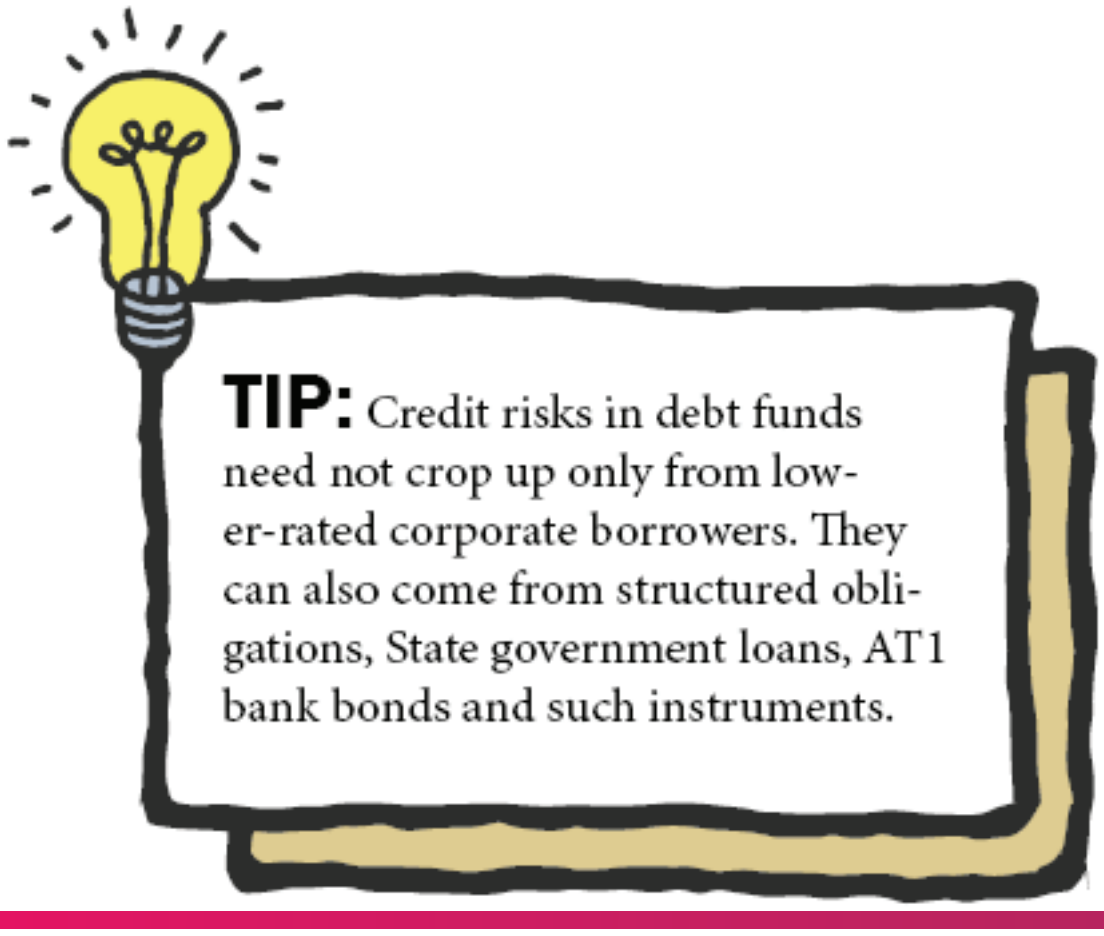
Habitual investors may be familiar with conventional debt instruments - NCDs, commercial paper, G-secs, treasury bills and the like. Of these, Government of India bonds are obviously the safest, while all corporate instruments carry credit risks in some measure.

But the world of debt is lately getting more complicated, with some new-fangled instruments cropping up. Watch out for the acronym 'SO' or 'structured obligation' against debt instruments in your fund's portfolio. This indicates that the rating agency has rated the instrument not on the strength of the issuer alone but on a guarantee provided by a reputed company/government/financial institution to meet this obligation in case the issuer fails to cough up. In SO ratings, the creditworthiness of the guarantor matters more than that of the issuer of the bond.

Similar risks exist with securitised vehicles such as pass-through certificates (PTCs), where lenders bundle a pool of loans and sell them to third-party buyers. PTCs pose challenges even for rating agencies because they need to make judgement calls about multiple borrowers and their aggregate credit worthiness, while assessing these securities.

For long, Indian investors have treated state government loans (SGLs) as 'sovereign' loans on par with G-secs issued by the Centre. But with the financial position of many state governments in a far more precarious state than the Centre, in recent years, smart investors have begun to make distinctions between sovereign bonds from the central government and those from the states. Lenders now demand a significant risk premium over the G-sec rate from individual states with shaky finances or high deficits.

Saddled with bad loans, many public-sector banks are now flooding the debt market with AT1 bonds offering attractive yields of 8-9 per cent and debt funds are investing in them. What can go wrong with a bond from a public-sector bank, you may ask. But AT1 bonds, intended to shore up the capital base of banks, allow the bank to skip interest payments, write down the bonds or convert them into equity shares. In short, they are akin to equity and can subject debt investors to a capital loss if the bank has big write-offs. They can be pretty illiquid, too, as apart from mutual funds, few other debt market participants have the wherewithal to take them on.



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