

Zero Coupon Bond

[UPSC Notes]

What is a Zero Coupon Bond?

Also known as an accrual bond, a Zero Coupon Bond is a type of bond that does not pay periodic interest payments or make coupons but makes a one-time payment at maturity.

- These bonds are issued at a discount to their par value.
- The difference between the bondholder's amount at maturity, the price paid for the bond, and its face value is the return to the investors.
- Par is the amount of cash received when the bond's life expires.
- Zero Coupon Bonds are traded on exchanges including the American Stock Exchange, National Association of Securities Dealers Automated Quotation System (NASDAQ), Toronto Stock Exchange, London International Financial Futures and Options Exchange (LIFFE), Deutsche Börse, Euronext, and Chicago Board of Trade.

Type of Zero Coupon Bonds:

Various types of Zero Coupon Bonds are there-

Corporate Zero Coupon Bonds:

These are corporate bonds traded in zero bond styles. They are said to be the riskiest Zero Coupon Bonds as they are sold as the credit risk of the corporation.

STRIPS Zero Coupon Bonds:

STRIPS refers to separate trading of registered interest and principal of securities. These zero bonds have Government security, and some brokerage houses provide them.

Municipal Zero Coupon Bonds:

Municipal or state governments issue zero-Coupon Bonds as zero-coupon municipal bonds. These Zero Coupon Bonds are tax-free but usually have low return values.

Zero-Coupon Convertibles:

These Zero Coupon Bonds can be converted to other kinds of securities. For example, companies or governments issue zero-coupon bonds that can be changed into shares of common stock.

Recapitalization Bonds

Recapitalization refers to providing an equity price to cover an individual's debt. They are usually issued on behalf of the government to recapitalize the crisis struck Public Sector Banks.

Typically, the government issues the bonds subscribed by the PSBs, and the amount gathered is added to the bank as equity capital.

Special Zero Coupon Recapitalisation Bonds:

A Zero Coupon Bond is a type of security that pays interest but does not require payment on maturity.

- Special Zero Coupon Bonds have several advantages over regular Zero Coupon Bonds. For example, you can get your money back even if interest rates fall in the future and make it worth more than it was when you bought it. However, there are also some disadvantages to this type of investment:
- Special Zero-coupon bonds are more expensive than regular ones because they require no principal repayment until maturity (the end date). It means that you will have less total return after taxes when compared with other types such as regular coupons or Treasury bills (T-bills).
- The government has announced a new recapitalization bond for public sector banks, which will be in the form of special Zero Coupon Bonds. The bonds will have a maximum tenor of 10 years and be issued at a discount to face value. In addition, interest payments on the bonds will not be taxed.
- The scheme's objective is to provide a source of long-term funding for banks to boost their Tier-1 capital ratios. The government will subscribe to the bonds, and the banks themselves will issue them.
- The initial market response has been positive, with bank stocks rallying on the news. This is a welcome development as public sector banks have struggled to raise capital from private sources.

Difference Between Normal Zero Coupon Bonds and Special Zero Coupon Bonds

A few differences between normal and special Zero Coupon Bonds.

Interest Rate:

- The interest rate significantly differs between normal Zero Coupon Bonds and special Zero Coupon Bonds. The interest rate on a normal Zero Coupon Bond is generally fixed, while the interest rate on a special Zero Coupon Bond may be variable.
- This means that the return on investment for a holder of a special Zero Coupon Bond may be higher or lower than the return on investment for a normal Zero Coupon Bond, depending on market conditions.

Maturity Duration:

- Another difference between these two types of bonds is the length of time until maturity. Normal Zero Coupon Bonds typically have a more extended maturity date than special Zero Coupon Bonds.
- This means that normal Zero Coupon Bonds investors may have to wait longer to receive their entire investment back. Still, they will also likely experience less price fluctuation than those who invest in special Zero Coupon Bonds.

Investment and Risks:

- Finally, it's important to note that companies often issue special Zero Coupon Bonds with below-average credit ratings.
- This means there is a greater risk of default for these types of bonds than for normal Zero Coupon Bonds. However, special Zero Coupon Bonds may still be attractive for some investors because they offer higher returns.

Zero-Coupon Bonds are Issued By Private Firms:

- Private firms issue Zero Coupon Bonds with a maturity period of 10 years. These bonds are not listed on any stock exchange or traded in the open market.
- The investor must purchase these Zero Coupon Bonds through an underwriter who provides liquidity to the market and ensures that there is enough demand for them by investors.
- While government-issued Zero Coupon Bonds are relatively common, private companies also issue Zero Coupon Bonds from time to time.
- These bonds offer the potential for higher returns than other types of bonds. This is because investors are lending money to the issuing firm for a longer time, thus taking more risks.
- Another reason why Zero Coupon Bonds issued by private firms can be attractive is that they can provide diversification benefits. This is because the performance of these bonds is often not correlated with other asset classes such as stocks and real estate.

- This means that they can help to reduce overall portfolio risk.

Advantages & Disadvantages Of Zero Coupon Bond

The Zero Coupon Bond's value depends on its maturity date and original issue price, which an interest rate or redemption premium may adjust.

Advantages of Zero Coupon Bond

- Zero-Coupon Bonds contain less risk than any other bonds since they're issued by governments, private firms, banks, and financial institutions; therefore, investors can expect higher returns on these securities compared with other types of bonds because there are fewer chances of defaulting on payments due to missed payments/late payments (as opposed to commercial paper).
- Zero Coupon Bonds allow you to get high returns without paying much interest; this makes them ideal for people who want to save money over time but don't have enough cash or liquidity (or both).

Disadvantages of Zero Coupon Bond

- Inflationary pressure from inflation could cause investors holding these Zero Coupon Bonds in their portfolios over time to eventually lose money because prices increase faster than expected earnings over time due to both supply & demand pressures in global markets, increasing demand and driving up prices more quickly than how much it costs producers/manufacturers, etc.
- Zero Coupon Bonds have no cash flow, so they do not pay dividends and cannot be used as income investments. Therefore, when you buy a Zero Coupon Bond, you are taking on all of the risks associated with owning stocks or bonds without having access to any income until maturity.
- Zero Coupon Bonds are not as liquid as other bonds, so selling them may take longer if you need cash immediately (e.g., in an emergency).

Cautions To Take While Investing In Zero Coupon Bonds:

Despite these risks, Zero Coupon Bonds can still be attractive to investors because of their simplicity and the potential for capital appreciation. For example, a \$100 Zero Coupon Bond with 10 years remaining to maturity may be sold for \$50. If held to maturity, the bond will be worth \$100, and the investor will realize a 100% return on their investment.

Before investing in Zero Coupon Bonds, investors should carefully weigh the risks and rewards. However, for those looking for a simple way to invest in bonds with the potential for high returns, Zero Coupon Bonds may be worth considering. What are the risks associated with Zero Coupon Bonds?

These types of securities can be risky, especially for investors who don't have much experience with them. They're also subject to changes in interest rates and market fluctuations; if there's a significant change in interest rates, the value of your Zero Coupon Bond might go down.

Risks Associated with Zero Coupon Bonds

- Compared to other types of investments, Zero Coupon Bonds have the potential to yield higher returns. In this case, the investor does not receive any interest during the bond's life. Instead, they are simply investing money and waiting for it to mature.
- One of the most notable is inflation risk. If inflation increases over the bond's life, the real return on the investment will be lower than it would have been if the investor had invested in a different type of investment.
- Investors also need to be aware of liquidity risks. For example, Zero Coupon Bonds are difficult to sell before maturity. As a result, investors may not be able to access their money when needed. Finally, Zero Coupon Bonds can be subject to default risk.

Current Issued Bonds:

Current-issued bonds have been issued in the last 10 years. These bonds can be used for buying property, cars, or other campus facilities. In addition, the interest on these bonds is tax-free as it is not considered income under Section 80C of the IT Act.

- The government has recently launched the bond scheme to offer investors a higher yield rate than bank fixed deposits (FDs).
- The scheme provides attractive returns for investors wishing to park their money with banks at lower rates than FDs available on similar maturity periods.
- An investor can avail of this benefit only if they invest at least Rs 1 lakh per annum in a single year under this scheme.
- The scheme also offers a tax-free interest rate for the first five years. This means that an investor can park their money in such bonds for five years at a low-interest rate and then avail of tax-free income from the bonds after five years.

- The current bond scheme is open only to individuals and not institutions as it is exempt from taxation under Section 80C of the IT Act.

