




Question #1 of 29

Question ID: 1210407

Which of the following two securities are *most likely* used to calculate the term structure of credit spreads?

- A) A corporate issuer's senior debt and the same issuer's subordinated debt. 
- B) A corporate issuer's coupon paying bond and the same issuer's zero coupon bond. 
- C) A corporate issuer's zero coupon bond and a default free zero coupon bond. 

Explanation

If a zero coupon bond is not available an implied zero coupon bond price for the issuer can be derived from the coupon paying bond price.

(Study Session 13, Module 35.6, LOS 35.g)




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Question #2 of 29

Question ID: 1210415

Which of the following statements regarding financial institutions is *most likely* correct?

- A) The assets of most commercial banks consist of customer deposits which are often insured by the government to reduce the threat of a bank run. 
- B) All financial institutions are important to the economy, but only banks give rise to systemic risk. 
- C) Contagion is a fundamental to the definition of systemic risk. 

Explanation

Systemic risk is the risk of a disruption to financial services and has the potential to affect the economy as a whole via contagion. All financial institutions give rise to systemic risk. Deposits are the major liabilities for commercial banks (and are often insured by the government), the majority of assets are loans.

(Study Session 13, Module 35.7, LOS 35.h)

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Question #3 of 29

Question ID: 1210393

Credit scores are *most likely* to be used for:

- A) small businesses.
- B) ABS.
- C) sovereign bonds.



Explanation

Credit scores are used for individuals and small businesses. Credit ratings are used for corporate, quasi-government, and sovereign bonds as well as for secured debt (ABS).

(Study Session 13, Module 35.3, LOS 35.b)

Related Material

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Question #4 of 29

Question ID: 1210403

When assessing a company's credit risk using structural models, which of the following statements is *most* accurate?

- A) Owning equity is economically equivalent to owning a risk free bond and simultaneously selling a put option on the assets of the company.
- B) Owning debt is economically equivalent to owning a European call option on the company's assets.
- C) Structural models do not account for the impact of interest rate risk of the value of a company's assets.



Explanation

Owning equity is economically equivalent to owning a European call option on the assets of the company. Owning debt is economically equivalent to owning a risk free bond and simultaneously selling a put option on the assets of the company. The structural model assumes that risk-free rate is not stochastic (i.e., it assumes that risk-free rate is constant).

(Study Session 13, Module 35.4, LOS 35.d)

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Mihor Kotak is evaluating the impact of a ratings upgrade on 1Team bonds. The bonds have a modified duration of 5.88 and the current credit spread on the bonds is 60 bps. After the upgrade, Kotak expects that the spreads will narrow by 15bps. Based on Kotak's expectations, what will be the estimated change in the price of the bond if the upgrade occurs?

A) 0.38%



B) 8.82%



C) 0.88%



Explanation

Change in spread (given) = - 15 bps

$\Delta\%P = - (\text{modified duration of the bond}) \times (\Delta \text{ spread}) = -5.88 \times -0.0015 = -0.00882$ or 0.88%. Since spread narrows, price will increase (i.e., a positive price change).

(Study Session 13, Module 35.3, LOS 35.c)

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Question #6 of 29

Question ID: 1210390

If the annual hazard rate for a bond is 1.80%, the probability that the bond does not default over the next three years is *closest* to:

A) 96.30%



B) 95.20%



C) 94.70%



Explanation

Probability of survival = $(1 - 0.018)^3 = 0.9470$.

(Study Session 13, Module 35.1, LOS 35.a)

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Higher rated bonds have lower:

- A) price.
- B) returns.
- C) credit spreads.



Explanation

Higher rated bonds have lower spreads. Price and return depends on other factors (e.g., coupon rate, maturity, risk-free rate).

(Study Session 13, Module 35.3, LOS 35.b)

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Question #8 of 29

Question ID: 1210394

Credit scores and credit ratings are both:

- A) qualitative ratings.
- B) cardinal rankings.
- C) ordinal rankings.



Explanation

Credit scores and credit ratings are both ordinal rankings.

(Study Session 13, Module 35.3, LOS 35.b)

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Question #9 of 29

Question ID: 1210399

Under the structural model, owning risky debt is equivalent to a long position in a similar risk-free bond and a:

- A) short position in a put option on the assets of the company.
- B) long position in a call option on the assets of the company.
- C) long position in a put option on the assets of the company.

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Explanation

Risky debt ownership is economically equivalent to a long position in risk-free bond and a short position in a put option on the assets of the company.

(Study Session 13, Module 35.4, LOS 35.d)




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Question #10 of 29

Question ID: 1210405

Zack Ma is evaluating a 10-year, 4% Tesa bond. Ma has calculated the CVA on the bond to be \$1.19 per \$100 par. Ma is considering the impact of a new patent granted to Tesa. After careful analysis, Ma concludes that the probability of default would most likely decrease on the bond. After incorporating the revised probability in his analysis, Ma will *most likely* conclude that:

- A) both the CVA and the credit spread will be lower. 
- B) only the credit spread will be lower; the impact on CVA will depend on changes in benchmark rates. 
- C) both the CVA and the credit spread will be higher. 

Explanation

CVA and credit spreads are positively related to probability of default.

(Study Session 13, Module 35.6, LOS 35.f)

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Question #11 of 29

Question ID: 1210396

Fico scores are inversely related to the:

- A) number of 'hard' inquiries.
- B) length of credit history.
- C) variety of credit types used.

Explanation

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FICO scores are higher for those with: (a) longer credit histories (age of oldest account), (b) absence of delinquencies, (c) lower utilization (outstanding balance divided by available line), (d) fewer credit inquiries, and (e) a variety of types of credit used.

(Study Session 13, Module 35.3, LOS 35.b)

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Question #12 of 29

Question ID: 1210404

Zack Ma is evaluating a five-year, 4% Zem bond. Ma has calculated the CVA on the bond to be \$2.12 per \$100 par. Current benchmark rates are flat at 3%. The credit spread on the bond is *closest* to:

A) 0.21%



B) 0.97%



C) 0.46%



Explanation

First calculate the VND: $N=5$, $PMT = 4$, $FV = 100$, $I/Y = 3$. $PV = 104.58 = VND$.

Value of risky bond = $VND - CVA = 104.58 - 2.12 = 102.46$

YTM on risky bond: $N=5$, $PV = -102.46$, $PMT = 4$, $FV = 100$, $I/Y = 3.46\%$

Credit spread = $YTM(\text{risky}) - YTM(\text{risk-free}) = 3.46\% - 3\% = 0.46\%$.

(Study Session 13, Module 35.5, LOS 35.e)

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Question #13 of 29

Question ID: 1210412

An ABS security backed by a highly granular collateral pool composed of hundreds of clearly defined loans, analysis of collateral pool can be done using:

A) examination of individual loans.

B) summary statistics for analyzing credit risk.

C) distribution waterfall analysis.

Explanation

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A highly granular pool would have hundreds of clearly defined loans, allowing for use of summary statistics as opposed to investigating each borrower. A more-discrete pool of few loans would warrant examination of each obligation separately. Distribution waterfall analysis is part of evaluation of the ABS structure (and not collateral pool).

(Study Session 13, Module 35.7, LOS 35.h)




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Question #14 of 29

Question ID: 1210400

Using the structural model, the value of the put option on the assets of the company is equal to:

- A) credit valuation adjustment of the bond. 
- B) value of the risky bond minus value of the risk-free bond. 
- C) the value of the call option on assets of the company. 

Explanation

Under structural model the put option value = value of risk-free bond – value of the risky bond = CVA.

(Study Session 13, Module 35.4, LOS 35.d)




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Question #15 of 29

Question ID: 1210388

Credit valuation adjustment is *most likely*:

- A) the sum of present values of expected losses. 
- B) higher when the recovery rate is higher. 
- C) higher when the probability of survival is higher. 

Explanation

Credit valuation adjustment (CVA) is the sum of present values of expected losses. CVA is positively related to the probability of default and negatively related to probability of survival and recovery rate.

(Study Session 13, Module 35.1, LOS 35.a)

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Question #16 of 29

Question ID: 1210409

Upward sloping credit curve is *most likely* an indication of:

- A) expectations of an economic expansion.
- B) expectations of a recession.
- C) upward sloping benchmark curve.



Explanation

Upward sloping credit curve indicates widening of spread as debt maturity increases. This would be consistent with expectations of higher probability of default (or lower recovery rate) in the longer-term, which would be consistent with expectations of a recession.

(Study Session 13, Module 35.6, LOS 35.g)

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Question #17 of 29

Question ID: 1210413

An investor in an ABS would face which risks on account of the ABS servicer?

- A) Credit and concentration risk.
- B) Operational and counterparty risk.
- C) Operational and concentration risk.



Explanation

After origination, investors in secured debt face the operational and counterparty risk of the servicer.

(Study Session 13, Module 35.7, LOS 35.h)

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Question #18 of 29

Question ID: 1210391

Perez Zinta has collected the following information on a 3-year, 3% corporate bond.

Year	Exposure	LGD	PD	PS	Expected Loss	DF	PV of Expected Loss
1	103.96	41.585	1.80%	98.200%	0.749	0.9756	0.73
2	103.49	41.395	1.77%	96.432%	0.732	0.9518	0.70
3	103.00	41.200	1.74%	94.697%	0.715	0.9286	0.66
CVA							2.091

Given a 3-year risk-free rate of 1.50%, Calculate the IRR of the bond assuming that default occurs in year 2.

A) -13.37%



B) -20.60%



C) -25.48%



Explanation

First calculate the VND: $N=3$, $PMT = 3$, $FV = 100$, $I/Y = 1.50$, $PV = 104.37 = \text{VND}$.

Price of the corporate bond = $\text{VND} - \text{CVA} = 104.37 - 2.09 = 102.28$

Cash flow in year 0 = -102.28, cash flow in year 1 = \$3 (coupon, no default).

If the bond defaults in year 2, recovery = Exposure - LGD = $103.49 - 41.40 = 62.09$ = cash flow in year 2.

Enter the cash flows and calculate IRR = -20.60%.

(Study Session 13, Module 35.1, LOS 35.a)

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Question #19 of 29

Question ID: 1210406

If investors are expecting an impending recession, credit spreads would *most likely*:

A) widen.



B) remain unchanged.



C) narrow.



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Explanation

Credit spreads change based on market's expectations. Impending recessions would lead to upward revision in probability of default and lower recovery rate. Combined, these revisions would lead to widening of credit spreads.

(Study Session 13, Module 35.6, LOS 35.f)

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Question #20 of 29

Question ID: 1210408

Which of the following factors is *least likely* a determinant of term structure of credit spreads?

- A) Financial conditions in the market.
- B) Equity market volatility.
- C) Existence of off-balance sheet liabilities.



Explanation

Term structure of credit spread is influenced by credit quality, financial conditions, market demand and supply, and equity market volatility.

(Study Session 13, Module 35.6, LOS 35.g)

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Question #21 of 29

Question ID: 1210410

Which of the following statements regarding evaluating credit risk of Asset Backed Securities (ABS) is *least* accurate?

- A) Credit rating agencies use the same credit ratings for ABS as for corporate debt.
- B) The analysis should entail consideration of the composition of the collateral pool and the cash flow waterfall.
- C) Unlike for corporate debt, structural and reduced form models are not appropriate.



Explanation

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Reduced form and structural models can be used as long as they take into account the complex structure of the ABS.

(Study Session 13, Module 35.7, LOS 35.h)

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Question #22 of 29

Question ID: 1210392

Alan Barding is a bank analyst currently reviewing data on the credit scores of 3 individuals who have applied for a bank loan. The credit scores for the 3 individuals are shown below:

Individual	Credit score
A	700
B	440
C	350

Which of the following conclusions is Barding *least likely* to draw?

- A) Individual A has a lower credit risk than individual B.
- B) Individual B is less likely to default than individual C.
- C) Individual C is twice as likely to default as individual A.



Explanation

Credit scores are ordinal rankings. Individual C is more likely to default than individual A, but it cannot be concluded that A is twice as likely.

(Study Session 13, Module 35.3, LOS 35.b)

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Question #23 of 29

Question ID: 1210387

A corporate bond has one year to maturity with a probability of default of 2.05% and a recovery rate of \$32.00 per \$100 par value. If an investor holds \$100,000 of par value, what is the expected loss?

- A) \$2,050.



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B) \$656.



C) \$1,394.



Explanation

Expected loss	= Probability of default × expected loss per \$ × par value
	= $0.0205 \times (1 - 0.32) \times \$100,000$
	= \$1,394

(Study Session 13, Module 35.1, LOS 35.a)

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Question #24 of 29

Question ID: 1210398

Under the structural model, owning equity in a company is equivalent to:

A) long position in a call option on the firm's debt.



B) short position in a put option on the assets of the company.



C) long position in a call option on the assets of the company.



Explanation

Equity investors have economic position equivalent to a long position in a call option on the assets of the company with a strike price equal to the face value of debt.

(Study Session 13, Module 35.4, LOS 35.d)

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Question #25 of 29

Question ID: 1210411

As compared to otherwise identical corporate debt, securitized debt is *least likely* to have:

A) higher leverage for the issuer.



B) lower cost for the issuer.



C) the same risk premium.



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Explanation

The isolated structure of securitized assets allows for higher leverage and lower cost to the issuer. Investors also benefit from greater diversification, more stable cash flows and a *higher* risk premium relative to similar rated general obligation bonds (due to higher complexity associated with collateralized debt).

(Study Session 13, Module 35.7, LOS 35.h)

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Question #26 of 29

Question ID: 1210389

Calculate the CVA on a 1.75%, 1-year, \$100 par annual pay bond with recovery rate of 70% and probability of default of 2%. Assume that the 1-year risk-free rate is 2%.

A) \$1.89



B) \$1.12



C) \$0.60



Explanation

Year	Exposure	LGD	PD	Expected Loss	DF	PV of Expected Loss
1	101.75	30.525	2.00%	0.611	0.9804	0.60

DF = PV of \$1 using risk-free rate = $1 / 1.02 = 0.9804$. LCD = Exposure \times (1 – recovery rate) = 101.75×0.30 . Expected loss = LGD \times PD = 30.525×0.02 .

(Study Session 13, Module 35.1, LOS 35.a)

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Question #27 of 29

Question ID: 1210402

Which key input into a reduced form model can be estimated using a regression model?

A) Recovery rate.

B) Default intensity.

C) Loss intensity.



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Explanation

Default intensity is the probability of default over the next time period and can be estimated using regression models.

(Study Session 13, Module 35.4, LOS 35.d)

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Question #28 of 29

Question ID: 1210414

As compared to other secured debt, investors in a covered bond have:

- A) recourse rights.
- B) an embedded put option.
- C) an embedded conversion option.



Explanation

Covered bonds are backed by the collateral pool as well as by the issuer; investors in covered bonds have recourse rights.

(Study Session 13, Module 35.7, LOS 35.h)

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Question #29 of 29

Question ID: 1210401

To analyze the credit risk of a company with significant off-balance sheet liabilities, which credit model is *most appropriate*?

- A) Reduced form model.
- B) Structural model.
- C) Econometric model.



Explanation

Structural models are not suitable when the company has complex balance sheets or when there are significant off-balance sheet liabilities. Reduced form models would be appropriate in such a situation.

(Study Session 13, Module 35.4, LOS 35.d)

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