Question #1 of 12

Question ID: 1210426

Which of the following strategies would be *most appropriate* use of CDS given an expectation of credit curve steepening?

A) A curve flattening trade.

B) Engage in a naked CDS.

C) A curve steepening trade.

Explanation

A credit curve steepening expectation would entail the credit spread for longer maturities increasing relative to the change in credit spread for shorter maturities. In such a scenario, one would buy protection for longer maturities and sell protection for shorter maturity (i.e., a curve steepening trade).

(Study Session 13, Module 36.3, LOS 36.d)

Related Material

SchweserNotes - Book 4

Question #2 of 12

Question ID: 1210424

It is *most accurate* to state that the upfront payment associated with a credit default swap (CDS) is:

A) greater when the reference obligation is high-yield debt rather than investment-grade debt.

B) sometimes made by the credit protection seller to the credit protection buyer.

C) always zero due to the way CDS are priced at origination.

Explanation

The CDS upfront payment may either be from the protection buyer to the seller, or vice-versa. If the credit spread is equal to the coupon rate, the upfront payment can be zero. CDS are valued by calculating the difference between the present value of the protection leg, versus the present value of the payment leg. The amount of upfront payment depends on the difference between the credit spread on the reference obligation and the CDS coupon rate, and hence need not be higher for a high-yield bond compared to an investment grade bond.

(Study Session 13, Module 36.2, LOS 36.c)

Related Material

Question #3 of 12

Question ID: 1210416

Gill Westmore is the fixed income portfolio manager for Allied Insurance. Westmore has bought protection using a 2-year CDS on CDX-IG (125 constituent) index. The notional is $200 million. Company X, an index constituent defaults and trades at 25% of par.

The payoff on the CDS on account of default of X and the notional principal of the CDS after default are *closest* to:

	Payoff	Notional	
A)	$1.5 million	$198 million	✗
B)	$1.6 million	$200 million	✗
C)	$1.2 million	$198.4 million	✓

Explanation

Notional principal attributable to bonds of company X = $200 million/125 = $1.6 million.

Payoff on the CDS = $1.6 million − (0.25)($1.6 million) = $1.2 million.

After default, the CDS continues with (200-1.6) $198.4 million of notional principal.

(Study Session 13, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 4

Question #4 of 12

Question ID: 1210423

A credit default swap (CDS) will change in value:

A) whenever the credit quality of the reference entity changes. ✓

B) only when default occurs. ✗

C) only when a failure to pay, a bankruptcy, or a restructuring occurs. ✗

Explanation

CDS change in value over their lives as the credit quality of the reference entity changes; this leads to gains and losses for the CDS counterparties. This change in value will happen even though default may not have occurred – and even if it may never occur.

(Study Session 13, Module 36.2, LOS 36.c)

Related Material

SchweserNotes - Book 4

Question #5 of 12

Question ID: 1210421

5-year, 5% Zillon Corp. bonds currently trade at $980 reflecting credit spread of 3%. A 5-year CDS for Zillon bonds has a coupon rate of 5%. The duration of the CDS = 4.

The upfront payment made/received by the protection buyer on a $4 million notional CDS is *closest* to:

A) $320,000 received by the protection buyer. ✓

B) $300,000 paid by the protection buyer. ✗

C) $400,000 received by the protection buyer. ✗

Explanation

Upfront payment	= (CDS spread − CDS coupon) × duration × notional principal
	= (0.03 − 0.05) × 4 × 4,000,000 = −$320,000

The protection buyer will receive an upfront premium of $320,000.

(Study Session 13, Module 36.2, LOS 36.c)

Related Material

SchweserNotes - Book 4

Question #6 of 12

Question ID: 1210422

Credit default swap (CDS) fixed payments are *most* likely to:

A) be made by the protection seller to the protection buyer . ✗

B) be set at 1% for investment-grade debt and 5% for high-yield debt. ✓

C) be made until the maturity of the CDS whether a credit event occurs or not. ✗

Explanation

CDS fixed payments are customarily set at a fixed annual rate of 1% for investment-grade debt or 5% for high-yield debt. Fixed payments are made by the CDS buyer to the CDS seller. The protection buyer is obligated to make regular payments until maturity of the CDS or until default (whichever occurs first).

(Study Session 13, Module 36.2, LOS 36.c)

Related Material

SchweserNotes - Book 4

Question #7 of 12

Question ID: 1210425

Suppose that an investment-grade bond's five-year credit spread is 175 bps, and the duration of the associated CDS is four years. Assuming a 1% CDS coupon, the upfront premium (expressed as a percentage of the notional) required to purchase five-year CDS protection on the company's debt will be *closest* to:

A) 4% ✗

B) 3% ✓

C) 8% ✗

Explanation

To buy 5-year CDS protection, an investor would have to pay upfront the present value of the difference between the 100bps coupon and the current market spread of 175 bps. In this case, the upfront premium would be: Upfront premium ≈ (Credit spread – Fixed coupon) × Duration = (175bps – 100bps) × 4 = 3% of the notional.

(Study Session 13, Module 36.2, LOS 36.c)

Related Material

SchweserNotes - Book 4

Question #8 of 12

Question ID: 1210418

Considering the two parties to a credit default swaps (CDS), the protection buyer is *most likely* to be:

A) said to be long the reference entity's credit risk. ✗

B) exposed to the credit risk of the protection seller. ✓

C) bullish on the financial condition of the reference entity.

Explanation

The credit protection buyer is exposed to the credit risk of the CDS seller. (Note that a CDS does not entirely eliminate credit risk; it eliminates the credit risk of the reference entity but substitutes it with the credit risk of the CDS seller.) The protection buyer is said to be *short* the reference entity's credit risk and is *bearish* on the financial condition of the reference entity.

(Study Session 13, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 4

Question #9 of 12

Question ID: 1210419

Which of the following statements regarding settlement protocols with respect to CDS is *least* accurate?

A) When a credit event has occurred, with physical settlement, the protection seller receives the reference obligation and the protection buyer receives the market

B) A super majority vote of the declarations committee of ISDA is needed for a credit event to be declared.

C) When there is a credit event, the swap will be settled in cash or by physical delivery.

Explanation

In case of physical settlement, the protection buyer receives the notional principal and not the market value of the bond prior to the credit event.

(Study Session 13, Module 36.2, LOS 36.b)

Related Material

SchweserNotes - Book 4

Question #10 of 12

Question ID: 1210420

Regarding CDS credit events, a CDS is *least* likely to pay off upon occurrence of a:

A) restructuring.

B) bankruptcy

C) failure to pay

Explanation

CDS pay off upon occurrence of a credit event, which includes failure to pay, and bankruptcy. Restructuring is not considered a credit event in some countries (such as the United States, where bankruptcy is the preferred route.) Restructuring refers to events such as: reduction or deferral of principal or interest, change in the currency in which principal or interest will be paid, or change in an obligation's seniority or priority.

(Study Session 13, Module 36.2, LOS 36.b)

Related Material

SchweserNotes - Book 4

Question #11 of 12

Question ID: 1210417

Which of the following statements about credit default swaps (CDS) is *least* accurate? A credit default swap's reference obligation is:

A) the only obligation of the reference entity covered by a single-name CDS.

B) typically a senior unsecured bond.

C) delivered by the protection buyer to the protection seller, upon default, in the case of physical settlement.

Explanation

The reference obligation is not the only instrument covered by the CDS: any debt obligation issued by the borrower that is ranked equivalently ("pari passu") in priority of claims, or higher, relative to the reference obligation, is covered. A CDS's reference obligation is typically a senior unsecured bond. In the case of physical settlement, the reference obligation is delivered by the protection buyer to the protection seller, in exchange for the CDS notional.

(Study Session 13, Module 36.1, LOS 36.a)

Related Material

SchweserNotes - Book 4

Question #12 of 12

Question ID: 1210427

In anticipation of an announcement of leveraged buyout of a publicly traded company, which of the following actions would be *most appropriate*?

A) Buy both the stock and the bonds of the company.

B) Sell protection of the company's bond and buy put options on the company's stock.

C) Buy the stock of the company and buy CDS protection on company's debt.

Explanation

In the case of a leveraged buyout (LBO), the firm will issue a great amount of debt in order to repurchase all of the company's publicly traded equity. This additional debt will increase the CDS spread because default is now more likely. An investor who anticipates an LBO might purchase both the stock and CDS protection, both of which will increase in value when the LBO happens.

(Study Session 13, Module 36.3, LOS 36.e)

Related Material

SchweserNotes - Book 4