7.14 Credit Risk

Question 1
An analyst has compiled the following data on a corporate bond:

Selected Data	
Maturity (years)	12
Coupon (%)	5
Price	100
Modified duration	8.94
Convexity	90

The price impact from an instantaneous 80 basis points of spread narrowing is *closest* to (%):
A. 6.86
B. 7.15
C. 7.44

Question 2
All else being equal, in which of the following situations would a rating agency's bond rating be *least likely* to reflect the true risk of default?
A. The issuer paid the rating agency's fee.
B. The issuer may have to pay significant penalties for environmental damage.
C. The bond is issued by a subsidiary of a holding company that issues its own bonds.

Question 3
An analyst has compiled the following information on three new bond issues:

Issuer	Industry	Moody's Issuer Rating	Standard & Poor's Issuer Rating	Bond Seniority
Bond X	Pharmaceutical	Aa1	AA+	Senior subordinated
Bond Y	Utility	Baa1	A−	Senior unsecured
Bond Z	Industrial machinery	B2	B	Senior subordinated

Which bond would have the *greatest* notching adjustment?
A. Bond X
B. Bond Y
C. Bond Z

Question 4
If a debt security has a higher credit rating than its issuer, it is *most likely* due to:

A. a bond indenture that includes few covenants restricting issuer operating flexibility.
B. an indenture provision that grants a second lien claim on company-owned property.
C. market expectations that rating agencies intend to upgrade the issuer's credit rating.

Question 5
In credit analysis, the size of the notching adjustment for the rating on a corporate bond issue is *most likely*:
A. unrelated to the issuer's reference credit rating.
B. directly related to the issuer's reference credit rating.
C. inversely related to the issuer's reference credit rating.

Question 6
The process for assigning different credit ratings for individual bond issues versus the issuer's credit rating is *best* described as:
A. notching.
B. credit migration.
C. spread widening.

Question 7
The type of debt security *most likely* to have a credit rating the same as the issuer's is:
A. secured.
B. senior unsecured.
C. senior subordinated.

Question 8
Which of the following factors is *most likely* to result in a narrowing of corporate bond yield spreads?
A. Falling government bond yields
B. Strengthening economic conditions
C. Increasing supply of new-issue corporate debt

Question 9
When analyzing the credit risk of a bond issue, the expected loss can *most likely* be estimated knowing only the bond's:
A. spread risk and loss severity.
B. downgrade risk and recovery rate.
C. default probability and loss severity.

Question 10
Analysts evaluating the credit risk of AA/Aa2-rated issuers tend to place *most emphasis* on:
A. asset values.
B. probability of default.
C. severity of loss in default.

Question 11
In the event of a default, a bondholder's expected loss is *most appropriately* expressed as:
A. Par value [Probability of default (1 − Recovery rate)]
B. Par value [Probability of default (1 − Recovery rate)]
C. Market value [Probability of default (1 − Recovery rate)]

Question 12
Which of the following risks is *least likely* to impact yield spreads between corporate and government bonds?
A. Credit risk
B. Inflation risk
C. Liquidity risk

Question 13
Which of the following *best* describes loss severity for a debt instrument?
A. Loss given default
B. One default rate
C. Par value × default probability

Question 14
A company's bonds are currently trading at a lower YTM than bonds with similar maturities but have the same credit rating as those other bonds. Based only on this information, the *most appropriate* conclusion by market participants is that rating agencies are:
A. underestimating the company's probability of default.
B. overestimating the bonds' recovery rate in event of default.
C. slower to recognize the company's improving credit quality.

Question 15
The *best* reason to avoid overreliance on credit ratings is that ratings:
A. tend to be static.
B. usually lead market prices.
C. do not capture all types of risk.

Question 16
If a company issued a senior subordinated bond with a B2 rating, which of the following is *most likely* to be its issuer rating?
A. Ba3
B. B2
C. B3

Question 17
The risk that a bond's credit rating might decline is *best* described as:

A. credit spread risk.
B. credit duration risk.
C. credit migration risk.

Question 18
All else being equal, if an issuer has less publicly traded debt outstanding than other comparable companies, then *most likely* the company's bonds will have:
A. more interest rate risk.
B. less market liquidity risk.
C. a greater market liquidity premium.

Question 19
Credit spreads are *most likely* to widen if:
A. equity markets are declining.
B. the economy is strengthening.
C. corporate bond issuance is declining.

Question 20
Bond market price adjustments reflecting a company's deteriorating credit quality are *most likely* to:
A. lag credit rating downgrades.
B. coincide with credit rating downgrades.
C. precede credit rating downgrades.