Learning Module 4: Fixed Income Market for Corporate Issuers

Q.64 Which of these bonds is *most likely* to have a higher yield?

A. Junk bond.

B. Government bond.

C. Investment-grade bond.

The correct answer is **A.**

Junk bonds are more speculative and carry more risk, thus, have to pay a higher yield for investors to be interested in them.

B is incorrect. They are backed by the full faith and credit of the government that issues them. As a result, they typically offer lower yields compared to riskier types of bonds.

C is incorrect. Investment-grade bonds are issued by companies with high credit ratings, indicating a low risk of default.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (c): Contrast the long-term funding of investment-grade versus high-yield corporate issuers.

Q.65 All things being equal, which of these is *most likely* to have a higher yield?

A. 2-year bond.

B. 5-year bond.

C. 10-year bond.

The correct answer is **C.**

All things being equal, investors take more interest rate risk for a longer maturity bond and, thus, will want a higher yield.

A is incorrect. A 2-year bond is less likely to have a higher yield than a 10-year bond, all else being equal. As a result, investors typically demand a lower yield for holding a bond with a shorter maturity.

B is incorrect. A 5-year bond is also less likely to have a higher yield than a 10-year bond, all else being equal. While a 5-year bond has more interest rate risk than a 2-year bond, it still has less interest rate risk than a 10-year bond.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (c): Contrast the long-term funding of investment-grade versus high-yield corporate issuers.

Q.844 Which of the following is *most likely* a form of bridge financing?

A. Bilateral loan.

B. Accounts payable.

C. Commercial Paper.

The correct answer is **C.**

Bridge financing is the Interim financing that provides funds until permanent financing can be arranged. Commercial paper is a form of bridge financing that provides funds for meeting short-term liquidity requirements until permanent financing can be arranged.

A is incorrect. A bilateral loan is a loan from a single lender to a single borrower. Companies routinely use bilateral loans from their banks, and these bank loans are governed by bank loan documents. Bank loans are the primary source of debt financing in countries where bond markets are under-developed.

B is incorrect. Accounts payable are amounts that a business owes to its vendors for goods and services that were purchased from them, but which have not yet been paid.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.845 Which of the following is *most likely* accurate with respect to U.S. commercial paper and Euro commercial paper?

A. Both can be sold to another party.

B. In both, the settlement time is T+2.

C. Both are discount-based securities that do not bear any interest.

The correct answer is **A.**

Both the US commercial paper and Euro commercial paper can be sold to another party.

B is incorrect. U.S. commercial paper settles after T + 0 days (i.e., on the trade date) but Euro commercial paper settles after T + 2 days (2 days after the trade date).

C is incorrect . U.S. commercial paper is always issued at a discount, but Euro commercial paper can be issued either as interest-bearing instruments or as discount instruments.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.847 Which of the following *most likely* plays a role in determining the repo margin?

A. The quality of the collateral.

B. The length of the repurchase agreement.

C. The quality of collateral and length of the repurchase agreement.

The correct answer is **C.**

A repo margin is the difference between the market value of the security used as collateral and the value of the loan. Also called *haircut.*

The level of margin is a function of the following factors:

- The length of the repurchase agreement
- The quality of the collateral
- The credit quality of the counterparty
- The supply and demand conditions of the collateral

A is incorrect. While the quality of the collateral is a critical factor in determining the repo margin, considering it in isolation overlooks the importance of the length of the repurchase agreement. The term of the agreement significantly impacts the risk profile of the transaction and, consequently, the size of the haircut.

B is incorrect. Similarly, focusing only on the length of the repurchase agreement while ignoring the quality of the collateral does not provide a full picture of the factors that influence the repo margin.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (b): Describe repurchase agreements (repos), their uses, and their benefits and risks.

Q.850 Which of the following classes of commercial paper requires registration with the SEC in the United States?

A. Securities with an original maturity in excess of 1 year.

B. Securities with an original maturity in excess of 180 days.

C. Securities with an original maturity in excess of 270 days.

The correct answer is **C.**

In the United States, securities with original maturities in excess of 270 days have to be registered with the Securities and Exchange Commission (SEC). To avoid the time and expense associated with a SEC registration, issuers of US commercial paper rarely offer maturities longer than 270 days.

A is incorrect. Securities with an original maturity in excess of 1 year are not the specific threshold for SEC registration requirements in the context of commercial paper.

B is incorrect. Securities with an original maturity in excess of 180 days do not meet the specific criteria for SEC registration in the context of commercial paper. Although securities with maturities longer than 180 days are less common in the commercial paper market, the critical threshold for SEC registration is set at maturities exceeding 270 days.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.2486 The repo rate is increased by all the following factors, except:

A. A longer repo term.

B. A lower credit quality of the borrower.

C. Lower interest rates for alternative sources of funds.

The correct answer is **C.**

Lower interest rates for alternative sources of funds lead to lower repo rates. If the rate of interest on funds from alternative sources decreases, there will be an increase in the supply of credit which will reduce the demand for funds on the repo market. Lower demand for credit will translate to a lower repo rate.

A and B are incorrect. A longer repo term and lower credit quality of the borrower increase default risk and credit risk, respectively, leading to a higher repo rate.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (b): Describe repurchase agreements (repos), their uses, and their benefits and risks.

Q.2487 Which of the following is *most likey* correct?

A. Firms use commercial paper as a permanent source of funds.

B. For larger creditworthy corporations, funding costs can be reduced by issuing short-term debt securities referred to as commercial paper.

C. Commercial paper has yields less than short-term sovereign debt because commercial paper has, on average, less credit risk and less liquidity.

The correct answer is **B.**

For larger, more creditworthy corporations, funding costs can be reduced by issuing short-term debt securities referred to as commercial paper. For these firms, the interest cost of commercial paper is less than the interest cost on a bank loan.

A is incorrect. Firms use commercial paper as a source of working capital. It's a temporary source of funds prior to issuing longer-term debt.

C is incorrect. Commercial paper yields more than short-term sovereign debt because it has, on average, more credit risk, and less liquidity.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.2489 The risk that a company will not be able to sell new commercial paper to replace maturing paper is *most likely* known as:

A. Credit risk.

B. Default risk.

C. Rollover risk.

The correct answer is **C.**

Commercial paper is a rolling form of debt where new issues generally fund the retirement (and settlement) of old issues. While that happens, the main risk is that the issuer will not be able to issue new commercial paper, possibly because of a general decline in the availability of credit on the market or a deterioration of the issuer’s creditworthiness. This is called rollover risk.

A is incorrect. Credit risk is the risk of loss arising from a borrower’s inability to repay the principal and/or make interest payments as agreed.

B is incorrect. Default risk arises when a borrower cannot make complete and timely payments to the lender.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.2492 Which of these is NOT a feature of negotiable certificates of deposit?

A. They can be sold before maturity.

B. They trade in domestic bond markets only.

C. They typically have maturities of one year or less.

The correct answer is **B.**

Negotiable certificates of deposit can be sold before maturity. They typically have maturities of one year or less and are traded in domestic bond markets as well as in the Eurobond market.

A is incorrect. The ability to sell negotiable CDs before maturity is one of their defining features. This liquidity is particularly attractive to investors who may need access to their funds before the CD matures or who wish to take advantage of movements in interest rates.

C is incorrect. It is true that negotiable CDs typically have maturities of one year or less. This short-term nature is one of their characteristics, making them suitable for investors looking for investment opportunities with a relatively quick return.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.4458 Which of the following *best* describes a provisional credit arrangement where there's no obligation for the bank to lend the specified amount and is useful for immediate liquidity needs?

A. Uncommitted Lines of Credit.

B. Regular (Committed) Lines of Credit.

C. Revolvers (Revolving Credit Agreements).

The correct answer is **A.**

Uncommitted Lines of Credit are provisional credit arrangements where there's no obligation for the bank to lend the specified amount. They are beneficial for immediate liquidity needs and are cost-efficient.

B is incorrect. Regular (Committed) Lines of credit involve a formal contractual obligation by the bank to provide the funds up to the agreed limit.

C is incorrect. Revolvers are long-term credit arrangements that can span several years and may come with specific covenants.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.4459 Which of the following is *most likely* a form of external, security-based financing predominantly issued by large, high-credit corporations and generally matures in under three months?

A. Secured Loans.

B. Commercial Paper (CP).

C. Eurocommercial Papers (ECPs).

The correct answer is **B.**

Commercial Paper (CP) is predominantly issued by large, high-credit corporations and is a short-term, unsecured note that generally matures in under three months.

A is incorrect. Secured Loans demand collateral and are not typically short-term, unsecured notes.

C is incorrect. Eurocommercial Papers (ECPs) are similar to CPs but are issued internationally and generally involve smaller transaction sizes.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.4460 When considering the short-term funding sources for financial institutions, which option is closest to a non-transactional deposit that may have defined terms?

A. Saving Deposits.

B. Demand Deposits.

C. Unsecured Loans in the Interbank Market.

The correct answer is **A.**

Saving Deposits are typically non-transactional accounts that may come with defined terms such as minimum balances or limited withdrawal capabilities. They can offer interest to the depositor and often have specific conditions regarding the notice period for withdrawal, making them a more stable source of funds for financial institutions.

B is incorrect. Demand Deposits are accounts that allow depositors to withdraw funds without advance notice, and they can be used for transactions such as payments and transfers. They are highly liquid and do not have defined terms concerning maturity or interest in many cases.

C is incorrect. Unsecured Loans in the Interbank Market refer to loans between banks for short-term needs, which do not have collateral backing and are not considered deposits. These are typically used for very short-term financing, often overnight, and not structured as deposits with defined terms.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (a): Compare short-term funding alternatives available to corporations and financial institutions.

Q.4461 A financial institution has decided to obtain a short-term loan that's collateralized by a US Treasury note, which involves a sale of a security and ends with its repurchase. This is *most likely* described as:

A. A General CP

B. A Repurchase Agreement (Repo)

C. An Asset-Backed Commercial Paper (ABCP)

The correct answer is **B.**

A Repurchase Agreement, commonly known as a repo, is a form of short-term borrowing for dealers in government securities. In the case of a repo, a dealer sells government securities to investors, usually on an overnight basis, and buys them back the following day at a slightly higher price. The difference in price represents the interest on the loan. The security serves as collateral, which protects the lender in case the borrower does not repurchase the securities.

A is incorrect: Commercial Paper (CP) is an unsecured form of short-term debt issued by corporations without any collateral backing, hence it does not match the description of a secured borrowing backed by US Treasury notes.

C is incorrect: Asset-Backed Commercial Paper (ABCP) is a form of commercial paper that is collateralized by other financial assets, not specifically by a repurchase agreement involving US Treasury notes.

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (b): Describe repurchase agreements (repos), their uses, and their benefits and risks.

Q.4462 Which of the following *best* describes a "fallen angel" in the bond universe?

A. A high-yield bond upgraded to an investment-grade bond.

B. An investment-grade bond that has always maintained its status.

C. An investment-grade bond that has been downgraded to high-yield status.

The correct answer is **C.**

A "fallen angel" refers to a bond that was once considered investment-grade but has been downgraded to high-yield status due to a deterioration in the issuer's credit quality. This change reflects a perceived higher risk of default by the issuer and affects the bond's pricing, yield, and investment mandates of the funds holding it.

A is incorrect. A bond that has always maintained its investment-grade status doesn't fit the definition of a "fallen angel."

B is incorrect. A bond upgraded from high-yield to investment-grade isn't referred to as a "fallen angel."

CFA Level I, Fixed Income, Learning Module 4: Fixed Income Market for Corporate Issuers. LOS (c): Contrast the long-term funding of investment-grade versus high-yield corporate issuers.
