Learning Module 15: Credit Analysis for Government Issuers

Q.2018 In the event of default, who would have the lowest priority of claims?

A. Senior Secured

B. Senior Subordinated

C. Senior Unsecured

The correct answer is **B.**

Priority of claim:
First Lien Loan
Senior Secured
Senior Unsecured
Senior Subordinated
Subordinated
Junior Subordinated.
Based on this priority of claims option A & C are incorrect.

CFA Level I, Fixed Income, Learning Module 15: Credit Analysis for Government Issuers, LOS 15a: explain special considerations when evaluating the credit of sovereign and non-sovereign government debt issuers and issues.

Q.2021 Skyworks Global defaults on one of its several outstanding bonds. Provisions in Skyworks Global bond indentures may trigger default on the remaining issues as well. Such a provision is called:

A. strategic default provision.

B. cross-default provision.

C. trigger-default provision.

The correct answer is **B.**

Bond indentures if too restrictive can trigger cross default.
A in incorrect: Strategic default is when a borrower stops making payments on a debt issue, despite having the financial ability to make his payments. It is typically associated with mortgage loans. When house prices fall substantially, the debt owed is greater than the house value so the borrower is inclined to default and buy a new property at the new market price.

C is incorrect: There is no such term as trigger default.

CFA Level I, Fixed Income, Learning Module 15: Credit Analysis for Government Issuers, LOS 15a: explain special considerations when evaluating the credit of sovereign and non-sovereign government debt issuers and issues.

Q.2022 The practice by rating agencies of assigning different ratings to bonds of the same issuer is called:

A. notching.

B. Pari-Passu.

C. tranches.

The correct answer is **A.**

Notching is the practice by rating agencies to give different credit ratings to the bonds of a single entity.
Option B is incorrect. Pari-Passu is a principle that describes a situation where two or more securities are managed in the same manner (without preferential treatment)

Option C is incorrect. A tranche is a segment that is created from a pool of securities. Tranches are created to increase the marketability of securities to an investor

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Q.2033 In the event of bankruptcy, which of the following is most accurate?

A. Junior subordinated loans are subordinate to senior subordinated loans.

B. Senior subordinated loans are subordinate to junior subordinated loans.

C. Senior secured loans are subordinate to subordinated loans.

The correct answer is **A.**

Priority of claim:
1) First Lien Loan
2) Senior Secured
3) Senior Unsecured
4) Senior Subordinated
5) Subordinated
6) Junior Subordinated.
Based on this priority of claims option B & C are incorrect.

CFA Level I, Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers, LOS 16c: Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.2034 Higher coverage ratios *most likely* indicate:

A. higher credit risk.

B. lower credit risk.

C. no credit risk.

The correct answer is **B.**

''EBITDA/Interest expense'' and ''EBIT/Interest expense'' are the two types of coverage ratios. Higher coverage ratios indicate lower credit risk.
CFA Level I, Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers, LOS 16b: Calculate and interpret financial ratios used in credit analysis.

Q.2036 A company that has a high proportion of the capital structure financed with secured bank debt is said to be:

A. top-heavy.

B. in a liquidity trap.

C. unliquid.

The correct answer is **A.**

A company that has a high proportion of the capital structure financed with secured bank debt is said to be Top-heavy.
B is incorrect. A liquidity trap is a situation described in Keynesian economics; a situation that arises when monetary policy becomes ineffective due to low-interest rates that make consumers want to save and not to spend.
C is incorrect. A company that has a high proportion of the capital structure financed with secured bank debt could still be liquid.

CFA Level I, Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers, LOS 16c: Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.2037 Which of the following is *most likely* a coverage ratio?

A. Debt/EBITDA

B. FFO/Debt

C. EBITDA/Interest expense

The correct answer is **C.**

EBITDA/Interest expense is a coverage ratio.
Options A) and B) are leverage ratios.

CFA Level I, Fixed Income, Learning Module 15: Credit Analysis for Government Issuers, LOS 15a: explain special considerations when evaluating the credit of sovereign and non-sovereign government debt issuers and issues.

Q.2043 All senior secured debt holders are treated alike in case of corporate bankruptcy because of:

A. the seniority ranking.

B. the principle of Pari-passu.

C. the priority of claim.

The correct answer is **B.**

All senior secured debt holders are treated alike in case of corporate bankruptcy. This is because of the principle of Pari-passu.
Note: Pari-passu is a Latin phrase meaning "equal footing" that describes situations where two or more assets, securities, creditors, or obligations are equally managed without any display of preference.

A and C are incorrect. There is preferential treatment (senior bondholders are paid off before junior bondholders) in seniority ranking and priority of claims.

CFA Level I, Fixed Income, Learning Module 14: Credit Risk, LOS 14c: Describe macroeconomic, market, and issuer-specific factors that influence the level and volatility of yield spreads.

Q.2044 Credit Rating agencies base their ratings of the issuer on the basis of:

A. senior secured debt.

B. senior subordinated debt.

C. senior unsecured debt.

The correct answer is **C.**

Credit Rating agencies base their ratings of the issuer on the basis of senior unsecured debt.
CFA Level I, Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers, LOS 16a: describe the qualitative and quantitative factors used to evaluate a corporate borrower’s creditworthiness

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Q.2046 Which of the following statements is/are *least likely* accurate?
I. Notching is the practice by which rating agencies reduce their ratings on structured financial collateral based on rating the collateral themselves.
II. The practice by which rating agencies reduce their ratings on structured financial collateral based on ratings from another agency without rating the collateral themselves is called structural subordination.

A. I only

B. II only

C. Both I & II

The correct answer is **C.**

Both statements are incorrect.
The practice of adjusting an issue credit rating upward or downward from the issuer credit rating to reflect the seniority and other provisions of the debt issue is called 'notching'. In other words, 'notching' is when rating agencies reduce their ratings on structured financial collateral based on ratings from another agency **without** rating the collateral themselves.

Structural subordination is the concept that a lender to a company will not have access to the assets of the company's subsidiary until after all of the subsidiary's creditors have been paid and the remaining assets have been distributed up to the company as an equity holder.

CFA Level I, Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers, LOS 16c: Describe the seniority rankings of debt, secured versus unsecured debt and the priority of claims in bankruptcy, and their impact on credit ratings.

Q.2051 The two primary categories of ratios used for credit analysis are:

A. leverage and coverage ratios.

B. operating and financial ratios.

C. profitability and liquidity ratios.

The correct answer is **A.**

The two primary categories of ratios used for credit analysis are leverage and coverage ratios.
A leverage ratio is any one of several financial measurements that look at how much capital comes in the form of debt (loans) or assesses the ability of a company to meet financial obligations.
A coverage ratio is a measure of a company's ability to meet its financial obligations. In broad terms, the higher the coverage ratio, the better the ability of the enterprise to fulfill its obligations to its lenders.

CFA Level I, Fixed Income, Learning Module 16: Credit Analysis for Corporate Issuers, LOS 16b: Calculate and interpret financial ratios used in credit analysis

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Learning Module 16: Credit Analysis for Corporate Issuers

Q.94 ABC Corp has just filed for bankruptcy. Which debt is *least likely* to be recovered by creditors?

A. Second lien debt

B. Senior secured

C. Senior subordinated

The correct answer is **C.**

The senior subordinated debt is least likely to be recovered by creditors.
Here is the list of seniority ranking for debt: (In the case of bankruptcy, debt will be cleared according to the seniority order, i.e., first-lien debt will be cleared before second lien debt, and if the proceeds from the sale of assets won't be enough to cover both debts, then only the highest-ranking debts will be settled.)

- First lien debt
- Second lien debt
- Senior secured
- Senior unsecured
- Senior subordinated
- Subordinated
- Junior subordinated
