Learning Module 1: Fixed Income Instrument Features

Q.55 Regarding fixed income, which of these statements is *least likely* a negative covenant?

A. Negative pledges.

B. Insure and maintain assets.

C. Restrictions on prior claims.

The correct answer is **B.**

Positive covenants refer to actions that the issuer of the bond is obligated to perform. These actions often include maintaining certain financial ratios, making regular interest payments, returning the principal at maturity, maintaining the underlying collateral, insuring assets, and providing the lender with regular financial statements. In this case, the requirement to 'insure and maintain assets' is a commitment that the issuer must fulfill, making it a positive covenant.

A is incorrect. Negative pledges are a type of negative covenant. Negative covenants are restrictions that limit what the issuer of the bond can do. They are designed to protect the interests of the bondholders by preventing the issuer from taking actions that could potentially harm the bondholders' investment. A negative pledge is a promise by the issuer not to use certain assets as security for future debts, which could potentially jeopardize the bondholders' claim on those assets.

C is incorrect. Restrictions on prior claims are also a type of negative covenant. These restrictions prevent the issuer from allowing other creditors to have a higher claim on the issuer's assets than the bondholders. This ensures that the bondholders' investment is protected and that they will be among the first to be repaid in the event of a default.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (b): Describe the contents of a bond indenture and contrast affirmative and negative covenants.

Q.2534 An asset-backed security is *most likely* different from a covered bond with respect to the fact that:

A. no special purpose entity (SPE) is created for a covered bond.

B. special legislation is created to protect the assets in the covered pool.

C. covered bonds do not have a provision of recourse to the issuing firm to replace or augment non-performing assets in the covered pool.

The correct answer is **A.**

An asset-backed security (ABS) and a covered bond differ primarily in the structure and legal framework surrounding the underlying assets. The key difference lies in the creation of a special purpose entity (SPE) for asset-backed securities, which is not a practice for covered bonds. In the case of ABS, the underlying assets are transferred to an SPE, which is a separate legal entity created specifically for the securitization process. This SPE holds the assets, thereby isolating them from the issuer's balance sheet.

B is incorrect. Both asset-backed securities and covered bonds are subject to specific legislation and regulatory frameworks that govern their creation, issuance, and the protection of the underlying assets. This legislation ensures that the interests of investors are safeguarded. For covered bonds, the legislation typically includes provisions that protect the cover pool and ensure its availability to meet bondholder claims, even in the event of the issuer's insolvency.

C is incorrect. The provision of recourse is another area where asset-backed securities and covered bonds differ, but not in the way suggested by this option. Covered bonds offer dual recourse, allowing investors to claim against both the issuer and the cover pool in case of default. This dual recourse provides an additional layer of security for investors. In contrast, asset-backed securities typically offer single recourse, with investors having a claim only against the pool of securitized assets.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.2536 Which of the following is *least likely* a method of external credit enhancement?

A. Surety bonds.

B. Bank guarantees.

C. Cash reserve fund.

The correct answer is **C.**

The cash reserve fund, is considered an internal credit enhancement method rather than an external one. Credit enhancement strategies are crucial for improving the creditworthiness of debt issuances, making them more attractive to investors by reducing the risk of default. Internal credit enhancements are mechanisms that are built within the structure of the debt issuance itself to provide additional security to investors.

A is incorrect. They involve a third party, typically an insurance company, which guarantees to pay the bondholders a specified amount if the issuer defaults. This guarantee reduces the risk to the bondholders since they have an additional source of repayment beyond the issuer's assets. Surety bonds do not rely on the issuer's internal resources but rather on the financial strength and promise of the external guarantor, making them a clear example of external credit enhancement.

B is incorrect. Bank guarantees serve as another form of external credit enhancement. In this arrangement, a bank or another financial institution promises to cover any missed payments on the debt issuance up to a certain amount. Similar to surety bonds, bank guarantees provide bondholders with an additional layer of security that is external to the issuer. This mechanism relies on the external support of the bank, distinguishing it from internal methods of credit enhancement.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (b): Describe the contents of a bond indenture and contrast affirmative and negative covenants.

Q.3887 Which of the following factors *least likely* distinguishes investment-grade from high-yield bond issues?

A. Liquidity.

B. Maturity.

C. Credit quality.

The correct answer is **B.**

Maturity is the factor that least likely distinguishes investment-grade bonds from high-yield bonds. The maturity of a bond refers to the length of time until the principal amount of the bond is to be paid back to the bondholder. It is a characteristic that can vary widely within both investment-grade and high-yield bond categories. Bonds within these categories can have short, medium, or long-term maturities.

A is incorrect. Investment-grade bonds are issued by entities that are considered to have a lower risk of default, making them more attractive to a broader range of investors. As a result, these bonds tend to have a more active secondary market, which enhances their liquidity. On the other hand, high-yield bonds, also known as junk bonds, are issued by entities with a higher risk of default. This higher risk makes them less attractive to conservative investors, resulting in a less active secondary market and lower liquidity.

C is incorrect. Credit quality is a primary factor that distinguishes investment-grade bonds from high-yield bonds. Credit quality refers to the creditworthiness of the bond issuer and is an indication of the issuer's ability to meet its debt obligations. Investment-grade bonds are issued by entities that are deemed to have a relatively low risk of default. These bonds are rated BBB- or higher by Standard & Poor’s, or Baa3 or higher by Moody’s. High-yield bonds, on the other hand, are issued by entities with a higher risk of default and are rated below these thresholds.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4417 Which of the following *most likely* describes a bond's principal? The amount that:

A. fluctuates with market interest rates.

B. an issuer agrees to repay investors at maturity.

C. represents the total interest accrued over a bond's life.

The correct answer is **B.**

The bond's principal, also known as the face value or par value, is the fixed amount that the issuer of the bond agrees to repay the bondholder upon the bond's maturity. This amount is established at the time the bond is issued and is specified in the bond agreement or indenture. It is the principal amount on which interest payments, if any, are calculated during the life of the bond.

A is incorrect. The bond's principal is not affected by changes in market interest rates. While the market price of a bond may fluctuate based on changes in interest rates due to the inverse relationship between bond prices and interest rates, the principal amount remains unchanged. Market interest rates affect the bond's yield and its price in the secondary market, not the principal.

C is incorrect. The principal is not the sum of the interest accrued over the life of the bond. Interest payments are derived from the bond's coupon rate applied to the principal and are paid periodically to bondholders over the bond's term. The principal is distinct from these interest payments and represents the lump sum to be repaid at the end of the bond's term, not the accumulation of interest.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4421 Which type of bond is *most likely* to pay principal in equal or variable increments over time rather than in a lump sum at maturity?

A. Amortizing bond.

B. Floating-rate note.

C. Zero-coupon bond.

The correct answer is **A.**

An amortizing bond, such as a mortgage-backed security (MBS) or an asset-backed security (ABS), often structured similarly to a traditional mortgage loan, requires borrowers to make regular payments that include both interest and principal repayment. These payments reduce the principal balance over the life of the bond, unlike traditional bonds that typically pay back the entire principal at maturity.

B is incorrect. A floating-rate note (FRN) pays interest that fluctuates with market interest rates, typically by referencing a base rate such as LIBOR plus a spread. The principal of an FRN is usually repaid at maturity, not in increments over the life of the bond. However, there are some structured FRNs that may include provisions for principal amortization, but these are less common and not the defining characteristic of FRNs.

C is incorrect. A zero-coupon bond does not make periodic interest payments and pays the principal only at maturity. The bond is purchased at a discount to its face value, and the difference between the purchase price and the face value represents the bondholder's return.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4422 If a bond has a par value of USD 10,000 and a coupon rate of 4.5% with semiannual payments, the semiannual interest payment is *closest to*:

A. USD 90

B. USD 225

C. USD 450

The correct answer is **B.**

To calculate the semiannual interest payment for a bond, we use the formula:

$$\text{Semiannual interest payment} = \frac{\text{Bond par value} \times \text{Coupon rate}}{\text{Number of payments per year}}$$

In this case, the bond has a par value of USD 10,000 and a coupon rate of 4.5%, with payments made semiannually, which means there are 2 payments per year. Therefore, the calculation is as follows:

$$\text{Semiannual interest payment} = \text{USD}10,000 \times 0.0452 = \text{USD}225$$

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4423 A five-year bond trades at USD 980 per USD 1,000 in face value. If its annual coupon is 3.2%, its current yield is *closest to*:

A. 3.076%

B. 3.265%

C. 3.469%

The correct answer is **B.**

The current yield is a measure of the income (interest or dividends) that an investment provides relative to its current price. It is calculated as the annual income (interest or dividends) divided by the current price of the security.

For a bond with an annual coupon of 3.2% and trading at USD 980 per USD 1,000 in face value, the calculation is as follows:

$$
\begin{aligned}
\text{Current Yield (CY)} &= \frac{\text{Annual coupon}}{\text{Bond price}} \\
&= \frac{3.2\% \times \text{USD } 1,000}{\text{USD } 980} = \frac{\text{USD } 32}{\text{USD } 980} \\
&= 3.265\%
\end{aligned}
$$

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4424 Which of the following *best* describes a negative covenant in a bond indenture?

A. A clause that signifies a default if the issuer defaults on any other debt obligation.

B. An action that the borrower promises to perform, such as providing timely financial reports.

C. A restriction placed on the issuer to prevent actions that might increase the risk of default, such as limitations on further borrowings.

The correct answer is **C.**

Negative covenants in a bond indenture are designed to protect the interests of the bondholders by imposing restrictions on the issuer's actions that could potentially increase the risk of default. These covenants are crucial in maintaining the financial stability and creditworthiness of the issuer by preventing them from engaging in risky financial activities. By restricting certain actions of the issuer, negative covenants help in preserving the value of the bond and safeguarding the investment made by the bondholders.

A is incorrect. A clause that signifies a default if the issuer defaults on any other debt obligation is known as a cross-default clause. This type of clause is not a negative covenant but rather a mechanism that provides bondholders with additional security by linking the issuer's default on any debt to the default on the bond in question. It ensures that bondholders have a claim or can take action if the issuer defaults on other financial obligations, thereby offering a layer of protection.

B is incorrect. An action that the borrower promises to perform, such as providing timely financial reports, falls under the category of affirmative covenants rather than negative covenants. Affirmative covenants require the issuer to undertake certain actions or meet specific conditions, which can include maintaining certain financial ratios, providing regular financial statements, or ensuring the maintenance of the issuer's assets.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (b): Describe the contents of a bond indenture and contrast affirmative and negative covenants.

Q.4425 Which of the following covenants is *most likely* to commit the borrower to adhere to relevant laws and regulations?

A. Negative Covenant

B. Cross-default Clause

C. Affirmative Covenant

The correct answer is **C.**

Affirmative covenants, also known as positive covenants, are commitments that the borrower agrees to perform, such as maintaining certain financial ratios, providing financial statements, and adhering to relevant laws and regulations. Compliance with legal and regulatory requirements is a fundamental aspect of affirmative covenants.
A is incorrect. Negative covenants impose restrictions on the borrower's actions, aiming to protect the lender’s interest by preserving the borrower's operational and financial status quo, rather than actively ensuring compliance with laws and regulations.

B is incorrect. The cross-default clause is a contractual provision that defines a default event through the borrower's failure to meet obligations on other debts. It is a mechanism to protect lenders by broadening the conditions under which a borrower can be considered in default, rather than directly enforcing legal and regulatory adherence.

Q.4426 A corporation issues a bond with a covenant that restricts the sale of significant assets without the approval of bondholders. Which type of covenant does this *most likely* define?

A. Pari passu clause.

B. Negative Covenant.

C. Cross-default Clause.

The correct answer is **B.**

A covenant that restricts the sale of significant assets without the approval of bondholders is a prime example of a negative covenant. Negative covenants are contractual agreements embedded within the bond's indenture that limit or prohibit certain actions by the issuer unless agreed upon by the bondholders.

These covenants are designed to protect the interests of the bondholders by preserving the company's assets and financial stability, which in turn, ensures the issuer's ability to meet its debt obligations. The covenant aims to prevent the issuer from potentially compromising its financial position and the collateral value backing the bond, which could adversely affect the bondholders.

A is incorrect. The pari passu clause is related to the equal treatment of all parties in the same class of debt, ensuring that no single creditor receives preferential treatment over others. This clause is typically involved in the ranking of debts and does not directly relate to the restrictions on the sale of assets or other specific actions by the issuer.

C is incorrect. The cross-default clause is a provision that triggers a default on a bond if the issuer defaults on another financial obligation. This clause is designed to protect bondholders by providing an early warning mechanism and additional security in case the issuer faces financial difficulties. It is not directly related to the restrictions on the issuer's actions, such as the sale of significant assets, but rather focuses on the issuer's performance on its broader financial obligations.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (b): Describe the contents of a bond indenture and contrast affirmative and negative covenants.

Q.4427 Which of the following *most likely* describes the source of repayment for asset-backed securities (ABS)?

A. Firm's operating cash flows.

B. Taxation power of the issuing government.

C. Cash flows generated from a collection of loans or receivables held by a designated special purpose issuer.

The correct answer is **C.**

Asset-backed securities are a type of financial instrument that are secured by a pool of assets, typically consisting of loans like auto loans, credit card receivables, or mortgages. These securities allow the issuer to generate liquidity by selling interests in the pool of assets to investors.

The cash flows from the underlying assets, such as payments of principal and interest made by the borrowers, are used to pay the investors. This structure provides a mechanism for financial institutions to finance a large array of consumer and business credit without using their own balance sheets directly.

A is incorrect. It suggests that the firm's operating cash flows are the source of repayment for asset-backed securities. This is not accurate. While corporate bonds and other types of debt financing might rely on the issuing firm's operating cash flows for repayment, ABS are distinct in that they are secured by and repaid through the cash flows generated from a specific pool of assets, not the general cash flows of the issuing firm.

B is incorrect. It indicates that the taxation power of the issuing government is the source of repayment for asset-backed securities. This description more accurately applies to government bonds or municipal securities, where the government's ability to levy taxes can be used to repay investors.

Asset-backed securities, on the other hand, do not rely on the taxation power of any government entity. Instead, they are backed by the cash flows from the underlying assets within the pool managed by the special purpose issuer.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4428 Which of the following issuers *most likely* has the lowest credit risk within a specific region?

A. Corporate Issuers

B. Local Governments

C. National or Sovereign Governments

The correct answer is **C.**

National or Sovereign Governments typically have the lowest credit risk within a specific region. This is primarily due to their unique financial capabilities and responsibilities, including the power to levy taxes and, in many cases, to print money. These governments have a broader range of tools at their disposal to manage debt obligations compared to other issuers. Furthermore, sovereign governments often have a vested interest in maintaining a strong reputation in international financial markets to facilitate future borrowing at favorable rates.

A is incorrect. Corporate issuers are typically subject to a higher level of credit risk compared to sovereign and local government issuers. This increased risk stems from their exposure to market competition, operational risks, regulatory changes, and economic cycles that can adversely affect their financial performance and, consequently, their ability to service debt. Unlike sovereign governments, corporations cannot levy taxes or print money, which limits their financial flexibility in managing debt obligations.

B is incorrect. Local Governments, while generally having lower credit risk than corporate issuers, still face a higher credit risk compared to national or sovereign governments. This is due to their more limited revenue-generating capabilities and their susceptibility to regional economic conditions. Local governments may rely on property taxes, sales taxes, and other revenue sources that can fluctuate significantly with the local economy's health.

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.4429 Which type of issuer *best* describes entities created to own specific assets like loans and finance them by issuing securities to investors?

A. Special Purpose Entities

B. Quasi-Government Entities

C. Supranational Organizations

The correct answer is **A.**

Special Purpose Entities (SPEs)are entities specifically established with the narrow mandate of owning assets such as loans and financing their purchase through the issuance of securities to investors. They are instrumental in securitization transactions that seek to isolate and mitigate financial risk, benefiting from a legal structure that typically segregates their operations from the parent company for the protection of investors.

B is incorrect. Quasi-Government Entities, while often involved in public financing activities, are not commonly created to own distinct assets such as loans for securitization purposes. These entities are more involved with functions that support governmental objectives rather than the direct issuance of securities backed by specific asset pools.

C is incorrect. Supranational Organizations transcend national boundaries and are usually established through international treaties to pursue collaborative international objectives, rather than to engage in the ownership and securitization of discrete asset classes like loans.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4430 Which type of securities is *best* described as providing short-term liquidity and being considered low risk?

A. Perpetual Bonds.

B. Money Market Securities.

C. Capital Market Securities.

The correct answer is **B.**

Money Market Securities are designed for short-term investments, typically with maturities of less than one year. These instruments are sought after for their low risk profile and high liquidity, making them an ideal choice for investors looking to maintain cash flow or to park funds in a low-risk, easily accessible vehicle.

A is incorrect. Perpetual Bonds, also known as consols, have no maturity date, meaning they pay interest indefinitely. They are not generally considered low-risk due to their perpetual nature and interest rate sensitivity, and they do not provide short-term liquidity due to their long-term, indefinite structure.

C is incorrect. Capital Market Securities include longer-term debt and equity instruments, which are usually held for investment purposes rather than short-term liquidity management. They can exhibit a higher risk profile compared to money market instruments.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4431 Which term *best* describes a loan repayment method involving monthly payments consisting of both principal repayment and interest, resulting in a gradual reduction of the outstanding balance over the loan's term?

A. Perpetual Repayment Method.

B. Incremental Repayment Method.

C. Lump Sum Repayment at Maturity.

The correct answer is **B.**

The term that best describes a loan repayment method involving monthly payments consisting of both principal repayment and interest, resulting in a gradual reduction of the outstanding balance over the loan's term, is the Incremental Repayment Method. This method is characterized by a structured approach where each payment made by the borrower includes a portion that goes towards paying off the principal amount borrowed and a portion that covers the interest on the outstanding balance. As a result, with each successive payment, the remaining balance of the loan decreases.

A is incorrect. The Perpetual Repayment Method does not accurately describe the loan repayment structure in question. In finance, a "perpetual" structure typically refers to financial instruments with no maturity date, such as perpetual bonds, which pay interest indefinitely without principal repayment. This concept is fundamentally different from the scenario described, where the loan involves regular payments that reduce the principal amount over a specified term until the loan is fully repaid.

C is incorrect. Lump Sum Repayment at Maturity refers to a repayment strategy where the borrower is required to pay the entire principal amount in one single payment at the end of the loan term. This method does not involve regular monthly payments that include both principal and interest. Instead, the borrower may pay periodic interest payments during the term of the loan but defers the repayment of the principal amount until the loan's maturity.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4432 Which feature of the bond indenture is *most likely* used by an issuer to limit certain activities that could jeopardize the position of the bondholders?

A. Covenants

B. Maturity date clauses

C. Interest rate stipulations

The correct answer is **A.**

Covenants within a bond indenture are specific agreements or clauses designed to protect bondholders by placing restrictions on the actions of the issuer. These covenants can range from maintaining certain financial ratios to restrictions on further debt issuance or asset sales.

The primary purpose of these covenants is to ensure that the issuer does not engage in activities that might undermine the bond's value or the bondholders' interests. By limiting certain risky activities, covenants help maintain the issuer's creditworthiness and the bond's value, thereby protecting the investment made by the bondholders.

B is incorrect. Maturity date clauses denote the date on which the bond will mature and the principal is due to be paid back to the bondholders. While important for defining the term of the bond, these clauses do not directly limit the issuer's operational or financial activities. The maturity date is a fundamental characteristic of a bond that informs investors about the time horizon of their investment, but it does not impose restrictions on the issuer's behavior beyond the obligation to repay the principal at the specified time.

C is incorrect. Interest rate stipulations relate to the terms concerning the coupon payments of a bond. These stipulations define the interest rate that the issuer agrees to pay to the bondholders, usually expressed as a percentage of the bond's face value. While the interest rate is a critical component of a bond's terms, affecting its yield and market value, it does not limit the issuer's operational decisions or financial policies.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (b): Describe the contents of a bond indenture and contrast affirmative and negative covenants.

Q.4433 Which underlying factor *most likely* describes the reason U.S. Treasury bonds are considered suitable for a client's risk-free asset allocation?

A. The bonds' high liquidity in global markets.

B. The full faith and credit of the U.S. government.

C. The bonds' historical performance and returns.

The correct answer is **B.**

The primary reason U.S. Treasury bonds are considered suitable for a client's risk-free asset allocation is the full faith and credit of the U.S. government. This term signifies the government's unwavering commitment to fulfilling its debt obligations, which in turn minimizes the risk of default to an almost negligible level. The U.S. government's ability to raise taxes and print currency as a means to ensure the repayment of its debts is a cornerstone of the perceived safety of these bonds.

A is incorrect. While the high liquidity of U.S. Treasury bonds is indeed a significant advantage, it is not the primary factor that renders them suitable for risk-free asset allocation. Liquidity refers to the ease with which an asset can be bought or sold in the market without affecting its price. Although this characteristic is highly beneficial, especially for investors who may need to quickly convert their investments into cash, it does not inherently reduce the risk of the investment.

C is incorrect. The historical performance and returns of U.S. Treasury bonds, while indicative of their stability and reliability, do not constitute the basis for their classification as risk-free assets. Historical data can provide insights into the bonds' past behavior under various economic conditions, but it is not a guarantee of future performance. The risk-free perception of U.S. Treasury bonds is fundamentally linked to the backing of the U.S. government, not to their historical returns.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4434 For a municipal bond issued to finance a specific project like a toll bridge, which source of repayment should investors primarily focus on to evaluate the bond's credit risk?

A. General tax revenues of the city.

B. Toll revenues generated by the bridge.

C. Federal government subsidies for infrastructure.

The correct answer is **B.**

For a municipal bond issued to finance a specific project like a toll bridge, the primary source of repayment that investors should focus on is the toll revenues generated by the bridge. This approach is crucial for evaluating the bond's credit risk because the bond is a revenue bond, meaning its repayment is secured by the revenue streams generated by the project it finances. In this case, the tolls collected from the bridge users directly impact the issuer's ability to meet its financial obligations.

A is incorrect. General tax revenues of the city are not the dedicated repayment source for a revenue bond issued for a specific project like a toll bridge. While general obligation bonds are backed by the full faith and credit of the issuing municipality and are repaid through general tax revenues, revenue bonds are different. They are secured by specific revenue sources, in this case, the tolls from the bridge.

C is incorrect. Their availability can be influenced by changes in political priorities, budget constraints, and legislative processes. Therefore, focusing on federal government subsidies does not provide a reliable basis for evaluating the credit risk of a municipal bond that is supposed to be repaid through project-specific revenues, such as tolls from a bridge.

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.4435 Which type of bond is a financially distressed airline *most likely* to issue in order to assure investors of repayment and what would be the primary source of security for the bondholders?

A. Unsecured bond, relying on operating cash flows.

B. Secured bond, using its fleet of airplanes as collateral.

C. Government-backed bond, using federal guarantees.

The correct answer is **B.**

A financially distressed airline is more likely to issue a secured bond, using its fleet of airplanes as collateral. This approach provides a tangible asset as security to the bondholders, which significantly increases the bond's appeal, especially in situations where the issuer's financial stability is in question. The use of tangible assets as collateral is a common practice in securing bonds, as it offers a form of assurance to investors that they will recover their investment in the event of a default.

A is incorrect. Issuing an unsecured bond, which relies solely on the airline's operating cash flows for repayment, would be an unattractive option for investors given the airline's financial distress. Operating cash flows are a measure of the cash that a company generates from its normal business operations. Investors typically seek higher levels of security in their investments, especially when the issuer is facing financial challenges. An unsecured bond in such a scenario would likely be perceived as too risky, as it does not provide any collateral that can be used to recover the investment in the event of a default.

C is incorrect. While a government-backed bond could indeed offer a high level of assurance to investors due to federal guarantees, it is not a common or easily accessible option for most privately operated airlines. Government backing for bonds is typically reserved for specific projects or entities that align with national interests or during extraordinary economic circumstances. For a financially distressed airline, obtaining such guarantees would require special arrangements and may not be feasible.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (a): Describe the features of a fixed-income security.

Q.4436 Which strategy would a technology company *most likely* employ to secure lower interest rates on its bonds without significantly hampering its operating flexibility, and what might be the trade-off involved?

A. Increasing the maturity date, potentially increasing interest rate risk.

B. Offering its patents as collateral, potentially reducing operating flexibility.

C. Issuing bonds through a third-party guarantor, potentially increasing counterparty risk.

The correct answer is **C.**

A technology company may opt to secure lower interest rates through a third-party guarantor, which can vouch for the bond's repayment, leading to more favorable borrowing terms. The trade-off here is the introduction of counterparty risk, which is the risk that the guarantor may fail to fulfill its obligation.

A is incorrect. Using patents as collateral can indeed lower interest rates due to the added security, but this can significantly limit the company's ability to operate freely as these patents cannot be utilized elsewhere without affecting the bond terms.

B is incorrect: Lengthening the maturity date of the bonds might reduce annual interest costs, but it doesn't necessarily preserve operating flexibility. Moreover, a longer maturity can increase the bond's exposure to interest rate risk, which is the risk that rising interest rates will negatively affect the bond's value.

CFA Level I, Topic 7 - Fixed Income, Learning Module 1: Fixed Income Instrument Features. LOS (b): Describe the contents of a bond indenture and contrast affirmative and negative covenants.
