Learning Module 5: Fixed Income Market for Government Issuers

Q.63 Which of these following statements regarding bond issuance is/are inaccurate?
I. Municipal bonds often return the lower tax-free rate as opposed to the market rate.
II. 'Developed bond markets' is an example of a bond classification by geography.
III. The interbank funds market trades mostly long-term loans.

A. Municipal bonds often return the lower tax-free rate as opposed to the market rate.

B. Developed bond markets' is an example of a bond classification by geography.

C. The interbank funds market trades mostly long-term loans.

The correct answer is **C.**

Most interbank loans are for maturities of one week or less, the majority being overnight.

A is incorrect. Municipal bonds provide investors with interest that is exempt from federal and state taxes. As such, the rate of interest on such bonds is generally lower than the market rate earned on otherwise taxable bonds.

B is incorrect. Based on the geographical location, we have domestic bond markets, foreign bond markets, and the Eurobond market. But they can also be classified further as either developed bond markets (which are well established) or emerging bond markets (which are in an earlier stage of development).

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (b): Contrast the issuance and trading of government and corporate fixed-income instruments.

Q.67 A particularly risk-averse American investor wants your opinion on the bond market. All things being equal, which of these bonds would you *most likely* recommend a buy?

A. Euro bonds.

B. Domestic bonds.

C. Emerging market bonds.

The correct answer is **B.**

A risk-averse investor is an investor who prefers lower returns with known risks to higher returns with unknown risks. A particularly risk-averse American investor will prefer a domestic bond that will give him no currency rate risk since domestic bonds are issued and traded in the currency of the market they are traded.

A is incorrect. Eurobonds will expose the investor to currency rate risk since they are issued in a currency not native to the country they are traded. Eurobonds are also riskier since they are unsecured and less regulated. In particular, they do not fall under the jurisdiction of any one country or regulatory body.

C is incorrect. Emerging market bonds have a lower credit quality than those of developed markets; they offer high returns but then pose a higher default risk, a characteristic that is best suited for a risk-taker, not a risk-averse investor.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (b): Contrast the issuance and trading of government and corporate fixed-income instruments.

Q.843 Bonds issued by the World Bank are *most likely* classified as:

A. Supranational bonds.

B. Non-sovereign bonds.

C. Quasi-government bonds.

The correct answer is **A.**

The World Bank is a supranational agency (An organization formed by a group of countries) and bonds issued by such agencies are called supranational bonds.

B is incorrect. Non-sovereign bonds are bonds issued by governments below the national level, for example, bonds issued by counties.

C is incorrect. Quasi-government bonds are bonds issued by quasi-government organizations. Quasi-government organizations are organizations established to perform some functions for the government.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (a): Describe funding choices by sovereign and non-sovereign governments, quasi-government entities, and supranational agencies.

Q.2212 Which of the following institutions has debt that is *most likely* backed by the full faith and credit of the U.S. Government?

A. Federal National Mortgage Association (Fannie Mae).

B. Federal Home Loan Mortgage Association (Freddie Mac).

C. Government National Mortgage Association (Ginnie Mae).

The correct answer is **C.**

Ginnie Mae securities are issued and guaranteed by the Government National Mortgage Association (GNMA) and are considered to be backed by the full faith and credit of the U.S. government with respect to timely payment of interest and repayment of principal. The Government National Mortgage Association (GNMA) is a federally related institution because it is part of the US Department of Housing and Urban Development.

A is incorrect. Securities issued by Federal National Mortgage Association (Fannie Mae) a quasi-government entity, do not carry the full faith and credit of the US government.

B is incorrect. Federal Home Loan Mortgage Corporation (Freddie Mac) is a quasi-government entity whose securities do not carry full faith and credit of the US government.

CFA Level I, Fixed Income, Learning Module 5: Fixed-Income Markets for Government Issuers, LOS (a) Describe funding choices by sovereign and non-sovereign governments, quasi-government entities, and supranational agencies.

Q.2479 Inflation-linked bonds are *most likely* issued primarily by:

A. Corporates with high and low credit quality.

B. Municipalities and corporations of low credit quality.

C. Governments and corporations of high credit quality.

The correct answer is **C.**

Inflation-linked bonds are issued primarily by governments but also by some corporations of high credit quality. The financial stability enjoyed by the government and top corporations implies that they are in a position to offset inflation by increasing the principal amount without succumbing to the associated financial cost. The same cannot be said about corporations and municipalities with unstable financials and low creditworthiness.

Inflation-linked bonds (ILBs) are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation.

A is incorrect. While it is true that corporations, regardless of their credit quality, can issue bonds, the issuance of inflation-linked bonds is typically not favored by corporates with low credit quality.

B is incorrect. Municipalities and corporations of low credit quality are less likely to issue inflation-linked bonds for similar reasons mentioned above. Municipalities, although they can issue debt, may not have the financial flexibility or the need to issue ILBs, as their funding requirements and investor base can differ significantly from those of sovereign governments.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (a): Describe funding choices by sovereign and non-sovereign governments, quasi-government entities, and supranational agencies.

Q.2480 Is the following statement correct?
''Tax-exempt bonds are sold with lower yields than taxable bonds of similar risk and maturity.''

A. Correct.

B. Incorrect, because tax-exempt bonds are sold with higher yields than taxable bonds.

C. Incorrect, because tax-exempt bonds are sold with the same yields as taxable bonds.

The correct answer is **A.**

The coupon rate (and yield) on a tax-exempt municipal bond is typically lower than that on an otherwise similar taxable bond to reflect the implied income tax rate. Investors are willing to accept a lower coupon rate on a tax-exempt municipal bond compared with an otherwise similar taxable bond because the income received from municipal bonds is not taxable. To attract taxable investors, bonds that are subject to income taxes must offer higher yields than those that are tax exempt.

B is incorrect. This option incorrectly suggests that tax-exempt bonds are sold with higher yields than taxable bonds.

C is incorrect. Suggesting that tax-exempt bonds are sold with the same yields as taxable bonds disregards the impact of taxation on investment returns. The primary appeal of tax-exempt bonds is their tax advantage, which allows them to be issued with lower yields while still offering competitive after-tax returns to investors.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (b): Contrast the issuance and trading of government and corporate fixed-income instruments.

Q.2496 Bonds issued by multilateral agencies are *most likely* called:

A. Supranational bonds.

B. Quasi-governmental bonds.

C. Non-sovereign government bonds.

The correct answer is **A.**

Supranational bonds are issued by supranational agencies, also known as multilateral agencies. Supranational bonds are issued by international organizations, often multinational or quasi-government organizations, with the purpose of promoting economic development. Examples include the World Bank and the Asian Development Bank. Similar to semi-government bonds, these often have a higher yield than government bonds.

B is incorrect. Quasi-government bonds are issued by quasi-government organizations established by the national governments like Fannie Mae (Federal Mortgage Association), Freddie Mac in the US, and Hydro-Quebec in Canada.

C is incorrect. Non-sovereign bonds are issued by provinces, regions, states and cities to finance schools, hospitals, highways, bridges, etc.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (a): Describe funding choices by sovereign and non-sovereign governments, quasi-government entities, and supranational agencies.

Q.2523 Which of the following statements is/are *most likely* correct?
Statement 1: For fixed-coupon bonds, on-the-run government bond yields for the same or nearest maturity are frequently used as benchmarks.

Statement 2: The benchmark remains fixed during a bond's life.

A. Both statements are correct.

B. Statement II is correct, whereas statement I is incorrect.

C. Statement I is correct, whereas statement II is incorrect.

The correct answer is **C.**

Statement 1 is correct. For fixed-coupon bonds, on-the-run government bond yields for the same or nearest maturity are frequently used as benchmarks.
Statement 2 is incorrect. The benchmark may change during a bond's life.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (a): Describe funding choices by sovereign and non-sovereign governments, quasi-government entities, and supranational agencies.

Q.4463 Which of the following *best* describes the primary advantage national or sovereign government issuers have over private sector issuers in terms of debt repayment?

A. They can sell their assets for repayment.

B. They rely on revenues from government-owned enterprises only.

C. They derive tax cash flows from economic activities within their jurisdiction.

The correct answer is **C.**

Sovereign governments have the sovereign authority to derive tax cash flows from economic activities within their jurisdiction for debt repayment.

A is incorrect. Both private and public sectors can utilize asset sales for repayment, but it isn't their primary advantage.

B is incorrect. While revenues from government-owned enterprises might be a source, it's not the only one.

CFA Level I, Fixed Income, Learning Module 5: Fixed Income Market for Government Issuers. LOS (b): Contrast the issuance and trading of government and corporate fixed-income instruments.

Q.4464 Which of the following is *most likely* a feature of revenue bonds issued by local and regional government authorities?

A. They are used to finance the general objectives of the region.

B. They are backed by the commitments of multiple national governments.

C. Their repayment is often tied to user fees from specific projects they finance.

The correct answer is **C.**

Revenue bonds issued by local and regional government authorities are often tied to user fees from specific projects they finance.

A is incorrect. General objectives are usually financed by General Obligation bonds.

B is incorrect. Backing by multiple national governments is a feature of supranational agencies.

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.
