## Question #1 of 44

Question ID: 1458426

In the United States, debenture is defined as:

**A)** a bond secured by specific assets.

**B)** a short-term debt instrument.

**C)** an unsecured bond.

**Explanation**

In the U.S. a debenture is defined as unsecured debt. Debenture refers to a bond backed by firm assets in the United Kingdom.

(Module 42.1, LOS 42.d)

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## Question #2 of 44

Question ID: 1458442

The coupon rate of a fixed income security is stated as 90-day LIBOR plus 125 basis points. This security is *most accurately* described as a(n):

**A)** floating-rate note.

**B)** reference-rate note.

**C)** variable-rate note.

**Explanation**

A floating-rate note has a coupon rate based on a market-determined reference rate such as 90-day LIBOR. Typically the coupon rate will be stated as a margin above the reference rate. A variable-rate note has a margin above the reference rate that is not fixed over the life of the note. An index-linked bond has a coupon payment or principal amount that adjusts based on the value of a published index such as an equity market, commodity, or inflation index.

(Module 42.2, LOS 42.e)

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## Question #3 of 44

Question ID: 1458430

Which of the following issues is *most accurately* described as a eurobond?

**A)** Brazilian firm's U.S. dollar-denominated bonds sold to investors in Canada.

**B)** European Union firm's Japanese yen-denominated bonds sold to investors in Japan.

**C)** South Korean firm's euro-denominated bonds sold to investors in the European Union.

**Explanation**

Eurobonds are denominated in a currency other than that of the countries in which they are issued. The name "eurobond" does not imply that a bond is sold in Europe or by a European issuer, or denominated in the euro currency. A U.S. dollar-denominated bond sold to investors outside the United States is called a "eurodollar bond."

(Module 42.1, LOS 42.d)

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## Question #4 of 44

Question ID: 1458437

Consider a floating rate issue that has a coupon rate that is reset on January 1 of each year. The coupon rate is defined as one-year London Interbank Offered Rate (LIBOR) + 125 basis points and the coupons are paid semi-annually. If the one-year LIBOR is 6.5% on January 1, which of the following is the semi-annual coupon payment received by the holder of the issue in that year?

**A)** 3.250%.

**B)** 3.875%.

**C)** 7.750%.

**Explanation**

This value is computed as follows:

Semi-annual coupon = (LIBOR + 125 basis points) / 2 = 3.875%

(Module 42.2, LOS 42.e)

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## Question #5 of 44

Question ID: 1462912

A non-amortizing fixed income security is *most accurately* described as:

**A)** a bullet bond.

**B)** a balloon bond.

**C)** a mortgage bond.

**Explanation**

Bonds with a bullet structure are non-amortizing and return their entire principal to the bondholder at the maturity date. A non-amortizing bond makes a bullet *payment* at maturity.

(Module 42.2, LOS 42.e)

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## Question #6 of 44

Question ID: 1458429

To reduce the cost of long-term borrowing, a corporation with a below average credit rating could:

**A)** decrease credit enhancement.

**B)** issue commercial paper.

**C)** issue securitized bonds.

**Explanation**

Commercial paper is only issued by corporations with top credit ratings. Decreasing credit enhancements increase the cost of borrowing.

(Module 42.1, LOS 42.d)

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## Question #7 of 44

Question ID: 1458455

PRC International just completed a $234 million floating rate convertible bond offering. As stated in the indenture, the interest rate on the bond is the lesser of 90-day LIBOR or 10%. The indenture also requires PRC to retire $5.6 million per year with the option to retire as much as $10 million. Which of the following embedded options is *most likely* to benefit the investor? The:

**A)** 10% cap on the floating interest rate.

**B)** conversion option on the convertible bonds.

**C)** sinking fund provision for principal repayment.

**Explanation**

The conversion privilege is an option granted to the bondholder. The cap benefits the issuer. A sinking fund is not an embedded option; it is an obligation of the issuer.

(Module 42.2, LOS 42.f)

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## Question #8 of 44

Question ID: 1462914

An investor most concerned with reinvestment risk would be *least likely* to:

**A)** prefer a lower coupon bond to a higher coupon bond.

**B)** prefer a noncallable bond to a callable bond.

**C)** eliminate reinvestment risk by holding a coupon bond until maturity.

**Explanation**

The key term here is *coupon bond*. While an investor in a fixed-coupon bond can usually eliminate interest rate risk by holding a bond until maturity, the same is not true for reinvestment risk. The receipt of periodic coupon payments exposes the investor to reinvestment risk. A noncallable bond reduces reinvestment risk by reducing the risk of repayment. Thus, an investor most concerned with reinvestment risk would prefer a noncallable bond to a callable bond. Since lower coupon bonds have lower reinvestment risk, this same investor would prefer a lower coupon bond to a higher coupon bond.

(Module 42.2, LOS 42.f)

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## Question #9 of 44

Question ID: 1458434

A company desiring to issue a fixed-income security has placed $10 million worth of loan receivables in a special purpose entity (SPE) that is independent of the issuer. The credit rating agencies suggest the company secure a third-party guarantee in order to have the security rated AAA. After completing the transfer of assets to the SPE and obtaining a letter of credit from a national bank, the company issues the AAA rated security. The securities are *most likely*:

**A)** global bonds.

**B)** asset-backed securities.

**C)** commercial paper.

**Explanation**

Special purpose entities relate to asset-backed securities.

(Module 42.1, LOS 42.d)

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## Question #10 of 44

Question ID: 1462915

What effects will an increase in yield volatility have on the values of a putable bond and a callable bond?

**A)** One bond will increase in value and the other will decrease.

**B)** Both bonds will decrease in value.

**C)** Both bonds will increase in value.

**Explanation**

A callable bond is made up of a straight bond and a written call option. An increase in volatility increases the value of the call option and decreases the value of the callable bond. On the other hand, a putable bond is made up of an option-free (or straight) bond and a long put option. An increase in volatility increases the value of the put option and therefore increases the value of the putable bond.

(Module 42.2, LOS 42.f)

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## Question #11 of 44

Question ID: 1458427

Which of the following entities play a critical role in the ability to create a securitized bond with a higher credit rating than the corporation?

**A)** Special purpose entities.

**B)** Rating agencies.

**C)** Investment banks.

**Explanation**

Special purpose entities (SPEs), buy the assets from the corporation. The SPE separates the assets used as collateral from the corporation that is seeking financing. This shields the assets from other creditors.

(Module 42.1, LOS 42.d)

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## Question #12 of 44

Question ID: 1458441

A bond whose periodic payments are all equal is said to have a(n):

**A)** bullet structure. ✗

**B)** balloon structure. ✗

**C)** amortizing structure. ✓

**Explanation**

Only a fully amortizing structure features payments that are all equal. A bullet structure pays a series of equal coupons but the final coupon is paid at the same time as the bond's principal. A final payment that includes a lump sum in addition to the last interest payment is referred to as a balloon payment.

(Module 42.2, LOS 42.e)

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## Question #13 of 44

Question ID: 1458419

An analyst observes a 5-year, 10% coupon bond with semiannual payments. The face value is £1,000. How much is each coupon payment?

**A)** £100. ✗

**B)** £50. ✓

**C)** £25. ✗

**Explanation**

The coupon rate is the percentage of par value paid annually. With semiannual coupons, half of the annual coupon rate is paid every six months. For a 5-year, 10% coupon bond with semiannual payments and a face value of £1,000, each coupon payment is half of 10% times £1,000, or £50.

(Module 42.1, LOS 42.a)

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## Question #14 of 44

Question ID: 1458443

Consider $1,000,000 par value, 10-year, 6.5% coupon bonds issued on January 1, 20X5. The market rate for similar bonds is currently 5.7%. A sinking fund provision requires the company to redeem $100,000 of the principal each year. Bonds called under the terms of the sinking fund provision will be redeemed at par. A bondholder would:

**A)** be indifferent between having her bonds called under the sinking fund provision or not called. ✗

**B)** prefer not to have her bonds called under the sinking fund provision. ✓

**C)** prefer to have her bonds called under the sinking fund provision. ✗

**Explanation**

With the market rate currently below the coupon rate, the bonds will be trading at a premium to par value. Thus, a bondholder would prefer not to have her bonds called under the sinking fund provision.

(Module 42.2, LOS 42.e)

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## Question #15 of 44

Question ID: 1458453

Which of the following embedded options in a fixed income security can be exercised by the issuer?

**A)** Call option. ✓

**B)** Conversion option. ✗

**C)** Put option. ✗

**Explanation**

Securities with embedded call options may be called by the issuer. An embedded put option gives the bondholder the right to sell (put) the security back to the issuer. A conversion option gives the bondholder the right to exchange the security for the issuer's common stock.

(Module 42.2, LOS 42.f)

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## Question #16 of 44

## Question #16 of 44

Question ID: 1458451

As compared to an equivalent noncallable bond, a callable bond's yield should be:

**A)** higher.

**B)** lower.

**C)** the same.

**Explanation**

A callable bond favors the issuer. Hence, the value of the bond is discounted by the value of the option, which means the yield will be higher.

(Module 42.2, LOS 42.f)

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## Question #17 of 44

Question ID: 1458428

Which of the following is *least likely* an example of an external credit enhancement?

**A)** Bank guarantee.

**B)** An excess spread account.

**C)** Letter of credit.

**Explanation**

Internal credit enhancements are built into the structure of a bond issue. An excess spread account is an example of an internal credit enhancement. An excess spread account involves setting aside amounts to protect against losses.

External credit enhancements are essentially backing from third parties, such as letters of credit or bank guarantees.

(Module 42.1, LOS 42.d)

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## Question #18 of 44

Question ID: 1458439

Which of the following statements regarding a sinking fund provision is *most accurate*?

**A)** It permits the issuer to retire more than the stipulated amount if they choose.

**B)** It requires that the issuer retire a portion of the principal through a series of principal payments over the life of the bond.

**C)** It requires that the issuer set aside money based on a predefined schedule to accumulate the cash to retire the bonds at maturity.

**Explanation**

A sinking fund actually retires the bonds based on a schedule. This can be accomplished through either payment of cash or through the delivery of securities. A sinking fund provision may allow the issuer to retire more than is stipulated in the indenture, but not all sinking fund provisions allow this.

(Module 42.2, LOS 42.e)

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## Question #19 of 44

Question ID: 1458425

Restrictions on asset sales and additional borrowings by a bond issuer are *best* characterized as:

**A)** affirmative covenants.

**B)** positive covenants.

**C)** negative covenants.

**Explanation**

Negative covenants are prohibitive in nature, such as restrictions on asset sales and additional borrowings.

Affirmative or positive covenants are actions a borrower is required to take and are often administrative in nature, for example to comply with relevant laws and regulations or to insure and maintain assets.

(Module 42.1, LOS 42.c)

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## Question #20 of 44

Question ID: 1458456

Which of the following embedded bond options tends to benefit the borrower?

**A)** Conversion option.

**B)** Interest rate cap.

**C)** Put option.

**Explanation**

The interest rate cap benefits the borrower who issues a floating rate bond. The cap places a restriction on how high the coupon rate can become during a rising interest rate environment. Therefore, the floating rate borrower is protected against ever-rising interest rates.

(Module 42.2, LOS 42.f)

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## Question #21 of 44

Question ID: 1458433

Which of the following securities is *least likely* classified as a eurobond? A bond that is denominated in:

**A)** euros and issued in Germany.

**B)** euros and issued in the United States.

**C)** U.S. dollars and issued in Japan.

**Explanation**

Bonds denominated in the currency of the country or region where they are issued are domestic bonds. Eurobonds are denominated in a currency other than those of the countries in which they are sold.

(Module 42.1, LOS 42.d)

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## Question #22 of 44

Question ID: 1458444

An investor holds $100,000 (par value) worth of TIPS currently trading at par. The coupon rate of 4% is paid semiannually, and the annual inflation rate is 2.5%. What coupon payment will the investor receive at the end of the first six months?

**A)** $2,000.

**B)** $2,025.

**C)** $2,050.

**Explanation**

This coupon payment is computed as follows:

$$\text{coupon payment} = (\$100,000 \times 1.0125)\left(\frac{0.04}{2}\right) = \$2,025$$

(Module 42.2, LOS 42.e)

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## Question #23 of 44

Question ID: 1458449

A corporation has borrowed $10 million. It will repay this by making payments of $1.3 million each year for 9 years and a payment of $8 million at the end of the 10th year. This type of bond is referred to as:

**A)** a balloon bond.

**B)** a partially amortizing bond.

**C)** a bullet bond.

**Explanation**

The bond is most appropriately termed a partially amortizing bond because some of the principal is repaid before maturity, but there is still a principal amount due at maturity ($8 million – the final interest payment). This payment is called a balloon payment. A bullet bond pays only interest until maturity, when the full principal amount is due.

(Module 42.2, LOS 42.e)

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## Question #24 of 44

Question ID: 1458417

Every six months a bond pays coupon interest equal to 3% of its par value. This bond is a:

**A)** 3% semiannual coupon bond.

**B)** 6% annual coupon bond.

**C)** 6% semiannual coupon bond.

**Explanation**

The coupon rate on a bond is the percentage of its par value that it pays in interest each year. The coupon frequency states how often the bond will pay interest. A 6% semiannual coupon bond pays interest twice per year with each coupon equaling half of 6%, or 3%, of par value.

(Module 42.1, LOS 42.a)

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## Question #25 of 44

Question ID: 1458435

Which of the following statements with regard to floating rate notes that have caps and floors is *most* accurate?

**A)** A floor is a disadvantage to both the issuer and the bondholder while a cap is an advantage to both the issuer and the bondholder. ✗

**B)** A cap is a disadvantage to the bondholder while a floor is a disadvantage to the issuer. ✓

**C)** A cap is an advantage to the bondholder while a floor is an advantage to the issuer. ✗

**Explanation**

A cap limits the upside potential of the coupon rate paid on the floating rate bond and is therefore a disadvantage to the bondholder. A floor limits the downside potential of the coupon rate and is therefore a disadvantage to the bond issuer.

(Module 42.2, LOS 42.e)

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## Question #26 of 44

Question ID: 1458416

A bond is trading at a premium if its:

**A)** price is greater than its par value. ✓

**B)** redemption value is greater than its face value. ✗

**C)** yield is greater than its coupon rate. ✗

**Explanation**

If a bond's price is greater than its par value, the bond is trading at a premium. If a bond's yield is greater than its coupon rate, its price is less than par value and the bond is trading at a discount. Face value and redemption value both refer to par value.

(Module 42.1, LOS 42.a)

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## Question #27 of 44

Question ID: 1458436

Allcans, an aluminum producer, needs to issue some debt to finance expansion plans, but wants to hedge its bond interest payments against fluctuations in aluminum prices. Jerrod Price, the company's investment banker, suggests a commodity index floater. This type of bond is *least likely* to provide which of the following advantages?

**A)** Payment structure helps protect Allcan's credit rating. ✗

**B)** The bond's coupon rate is linked to the price of aluminum. ✗

**C)** Allows Allcans to set coupon payments based on business results. ✓

**Explanation**

The coupon rate is set in the bond agreement (indenture) and cannot be changed unilaterally. Non-interest rate indexed floaters are indexed to a commodity price such as oil or aluminum. Business results could be impacted by numerous factors other than aluminum prices.

Both of the other choices are true. By linking the coupon payments directly to the price of aluminum (meaning that when aluminum prices increase, the coupon rate increases and vice versa), the non-interest index floater allows Allcans to protect its credit rating during adverse circumstances.

(Module 42.2, LOS 42.e)

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## Question #28 of 44

Question ID: 1458424

A covenant that requires the issuer not to let the insurance coverage lapse on assets pledged as collateral is an example of a(n):

**A)** affirmative covenant. ✓

**B)** inhibiting covenant. ✗

**C)** negative covenant. ✗

**Explanation**

Covenants are classified as negative or affirmative. Affirmative covenants specify administrative actions a bond issuer is required to take, such as maintaining insurance coverage on assets pledged as collateral. Negative covenants are restrictions on a bond issuer's actions, such as preventing an issuer from selling any assets that have been pledged as collateral or pledging them again as collateral for additional debt.

(Module 42.1, LOS 42.c)

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## Question #29 of 44

Question ID: 1458445

Treasury Inflation Protected Securities, which provide investors with protection against inflation by adjusting the par value and keeping the coupon rate fixed, are *best* described as:

**A)** capital-indexed bonds. ✓

**B)** indexed-annuity bonds. ✗

**C)** interest-indexed bonds. ✗

**Explanation**

Indexed bonds that adjust the principal value while keeping the coupon rate fixed are best described as capital-indexed bonds. Interest-indexed bonds adjust the coupon rate. Indexed-annuity bonds are fully amortizing with the payments adjusted.

(Module 42.2, LOS 42.e)

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## Question #30 of 44

Question ID: 1458450

Which of the following statements about the call feature of a bond is *most* accurate? An embedded call option:

**A)** describes the maturity date of the bond. ✗

**B)** stipulates whether and under what circumstances the issuer can redeem the bond prior to maturity. ✓

**C)** stipulates whether and under what circumstances the bondholders can request an earlier repayment of the principal amount prior to maturity. ✗

**Explanation**

Call provisions give the issuer the right (but not the obligation) to retire all or a part of an issue prior to maturity. If the bonds are "called," the bondholder has no choice but to turn in his bonds. Call features give the issuer the opportunity to get rid of expensive (high coupon) bonds and replace them with lower coupon issues in the event that market interest rates decline during the life of the issue.

Call provisions do not pertain to maturity. A put provision gives the *bondholders* certain rights regarding early payment of principal.

(Module 42.2, LOS 42.f)

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## Question #31 of 44

Question ID: 1458422

Features specified in a bond indenture *least likely* include the bond's:

**A)** coupon rate and maturity date. ✗

**B)** issuer and rating. ✓

**C)** par value and currency. ✗

**Explanation**

Bond ratings are assigned by third-party credit rating agencies and may change during the life of a bond. Features that are specified in the indenture for a fixed income security include its issuer, maturity date, par value, coupon rate and frequency, and currency.

(Module 42.1, LOS 42.b)

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## Question #32 of 44

Question ID: 1458454

The indenture of a callable bond states that the bond may be called on the first business day of any month after the first call date. The call option embedded in this bond is a(n):

**A)** American style call option. ✗

**B)** Bermuda style call option. ✓

**C)** European style call option. ✗

**Explanation**

A bond with a Bermuda style embedded call option may be called on prespecified dates after the first call date. A European style embedded call option specifies a single date on which a bond may be called. With an American style embedded call option, a bond may be called any time after its first call date.

(Module 42.2, LOS 42.f)

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## Question #33 of 44

Question ID: 1458440

Which of the following statements about U.S. Treasury Inflation Protection Securities (TIPS) is *most* accurate?

**A)** The inflation-adjusted principal value cannot be less than par.

**B)** The coupon rate is fixed for the life of the issue.

**C)** Adjustments to principal values are made annually.

**Explanation**

For U.S. Treasury TIPS, the coupon rate is set at a fixed rate determined via auction. The principal that serves as the basis of the coupon payment and the maturity value is adjusted semiannually. Because of the possibility of deflation, the adjusted principal value may be less than par. (However, at maturity, the Treasury redeems the bonds at the greater of the inflation-adjusted principal or the initial par value).

(Module 42.2, LOS 42.e)

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## Question #34 of 44

Question ID: 1458431

Securitized bonds are *most likely* to be issued by:

**A)** banking institutions.

**B)** special purpose entities.

**C)** supranational entities.

**Explanation**

The issuer of a securitized bond is typically a special purpose entity (SPE), also known as a special purpose vehicle (SPV) or special purpose company (SPC). An SPE is formed specifically to purchase and administer assets that will provide the cash flows to pay interest and principal on bonds the entity issues. These bonds are called securitized bonds.

(Module 42.1, LOS 42.d)

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## Question #35 of 44

Question ID: 1458423

Which of the following bond covenants is considered negative?

**A)** Maintenance of collateral. ✗

**B)** No additional debt. ✓

**C)** Payment of taxes. ✗

**Explanation**

Negative covenants set forth limitations and restrictions, whereas affirmative covenants primarily set forth administrative activities that the borrower promises to do.

(Module 42.1, LOS 42.c)

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## Question #36 of 44

Question ID: 1462913

A step-up coupon bond is structured such that its coupon rate increases:

**A)** on a predetermined schedule. ✓

**B)** if the issuer's credit rating decreases. ✗

**C)** if a reference interest rate increases. ✗

**Explanation**

Step-up coupon bonds feature a coupon rate that increases on a predetermined schedule. Credit linked coupon bonds have a coupon rate that changes inversely with the issuer's credit rating. Floating-rate notes have coupon rates that are based on a reference interest rate.

(Module 42.2, LOS 42.e)

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## Question #37 of 44

Question ID: 1458420

Which of the following contains the overall rights of the bondholders?

**A)** Covenant.

**B)** Indenture.

**C)** Rights offering.

**Explanation**

An indenture specifies the rights of bondholders and the obligations of the issuer. Covenants are specific provisions within the indenture. A rights offering is typically associated with an equity security.

(Module 42.1, LOS 42.b)

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## Question #38 of 44

Question ID: 1458438

A bond has a par value of $5,000 and a coupon rate of 8.5% payable semi-annually. The bond is currently trading at 112.16. What is the dollar amount of the semi-annual coupon payment?

**A)** $238.33.

**B)** $425.00.

**C)** $212.50.

**Explanation**

The dollar amount of the coupon payment is computed as follows:

Coupon in $ = $5,000 × 0.085 / 2 = $212.50

(Module 42.2, LOS 42.e)

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## Question #39 of 44

Question ID: 1458432

Which of the following is *least likely* a form of internal credit enhancement for a bond issue?

**A)** Covering the bond issue via a surety bond.

**B)** Including a tranche system to identify priority of claims.

**C)** Structuring the asset pool such that it has an excess spread.

**Explanation**

A surety bond is issued by a third party and hence is an external form of credit enhancement.

(Module 42.1, LOS 42.d)

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## Question #40 of 44

Question ID: 1458418

Which of the following fixed income securities is classified as a money market security?

**A)** Newly issued security that will mature in one year.

**B)** Security issued 18 months ago that will mature in six months.

**C)** Security issued six months ago that will mature in one year.

**Explanation**

Money market securities have original maturities of one year or less. Fixed income securities originally issued with maturities longer than one year are classified as capital market securities.

(Module 42.1, LOS 42.a)

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## Question #41 of 44

Question ID: 1458415

Assuming bond yields are greater than zero, which of the following statements about zero-coupon bonds is *least* accurate?

**A)** A zero coupon bond may sell at a premium to par when interest rates decline.

**B)** All interest is earned at maturity.

**C)** The lower the price, the greater the return for a given maturity.

**Explanation**

Zero coupon bonds always sell below their par value, or at a discount prior to maturity. The amount of the discount may change as interest rates change, but a zero coupon bond will always be priced less than par if it has a positive yield.

(Module 42.1, LOS 42.a)

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## Question #42 of 44

Question ID: 1458452

As compared to an equivalent nonputable bond, a putable bond's yield should be:

**A)** higher.

**B)** lower.

**C)** the same.

**Explanation**

A putable bond favors the buyer (investor). Hence, a premium will be paid for the option, which means the yield will be lower.

(Module 42.2, LOS 42.f)

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## Question #43 of 44

Question ID: 1458446

A bond initially does not make periodic payments but instead accrues them over a pre-determined period and then pays a lump sum at the end of that period. The bond subsequently makes regular periodic payments until maturity. Such a bond is *best* described as a:

**A)** deferred-coupon bond.

**B)** step-up note.

**C)** zero-coupon bond.

**Explanation**

Deferred-coupon bonds carry coupons, but the initial coupon payments are deferred for some period. The coupon payments accrue, at a compound rate, over the deferral period and are paid as a lump sum at the end of that period. After the initial deferment period has passed, these bonds pay regular coupon interest for the rest of the life of the issue (i.e., until the maturity date). Zero coupon bonds do not pay periodic interest. A step-up note has a coupon rate that increases on one or more specified dates during the note's life.

(Module 42.2, LOS 42.e)

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## Question #44 of 44

Question ID: 1458421

A bond's indenture *least likely* specifies the:

**A)** identity of the lender.

**B)** source of funds for repayment.

**C)** covenants that apply to the issuer.

**Explanation**

The identity of the lender (i.e., the bondholder) is not specified in a bond's indenture because a bond may be traded during its life. An indenture or trust deed is a legal contract that specifies a bond issuer's obligations and restrictions. The indenture may include covenants that require the issuer to take or refrain from taking certain actions and may specify the source of funds for repayment, such as a project to be funded or the taxing power of a government.

(Module 42.1, LOS 42.b)