CHAPTER 39

# FIXED-INCOME SECURITIES DEFINING ELEMENTS

1. (A) higher.

**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.

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

SchweserNotes - Book 4

2. (A) Covering the bond issue via a surety bond.

**Explanation**

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

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

3 (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.

(Study Session 13, Module 39.1, LOS 39.a)

**Related Material**

Schweser Notes - Book 4

4. (B) asset-backed securities.

**Explanation**

Special purpose entities relate to asset-backed securities.

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

5. (A) **price is greater than its par value.**

**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.

(Study Session 13, Module 39.1, LOS 39.a)

**Related Material**

Schweser Notes - Book 4

6. (C) **issue securitized bonds.**

**Explanation**

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

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

7. (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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

8. (A) **Newly issued security 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.

(Study Session 13, Module 39.1, LOS 39.a)

**Related Material**

Schweser Notes - Book 4

9. (C) **stipulates whether and under what circumstances the issuer can redeem the bond 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.

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

Schweser Notes - Book 4

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

**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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

11. (B) **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.

(Study Session 13, Module 39.1, LOS 39.c)

**Related Material**

Schweser Notes - Book 4

12. (A) **floating-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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

13. (B) **lower.**

**Explanation**

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

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

Schweser Notes - Book 4

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

**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.

(Study Session 13, Module 39.1, LOS 39.a)

**Related Material**

Schweser Notes - Book 4

15. (A) **Special purpose entities.**

**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.

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

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

**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.

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

Schweser Notes - Book 4

17. (B) No additional debt.

Explanation

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

(Study Session 13, Module 39.1, LOS 39.c)

**Related Material**

Schweser Notes - Book 4

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

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."

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

19. (B) issuer and rating.

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.

(Study Session 13, Module 39.1, LOS 39.b)

**Related Material**

Schweser Notes - Book 4

20. (C) on a predetermined schedule.

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.

**For Further Reference:**

(Study Session 13, Module 39.2, LOS 39.e)

CFA® Program Curriculum, Volume 4, page 437

**Related Material**

Schweser Notes - Book 4

21. (A) **Call 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.

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

Schweser Notes - Book 4

22. (A) **affirmative 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.

(Study Session 13, Module 39.1, LOS 39.c)

**Related Material**

Schweser Notes - Book 4

23. (B) **special purpose 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.

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

24. (C) **An excess spread account.**

**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.

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

Schweser Notes - Book 4

25. (A) identity of the lender.

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.

(Study Session 13, Module 39.1, LOS 39.b)

**Related Material**

Schweser Notes - Book 4

26. (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.

**Related Material**

Schweser Notes - Book 4

27. (B) 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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

28. (B) a bullet 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.

**For Further Reference:**

(Study Session 13, Module 39.2, LOS 39.e)

CFA® Program Curriculum, Volume 4, page 437

**Related Material**

Schweser Notes - Book 4

29. (B) $212.50.

Explanation

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

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

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

30. (A) capital-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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

31. (A) deferred-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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

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

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.

**For Further Reference:**

(Study Session 13, Module 39.2, LOS 39.f)

CFA® Program Curriculum, Volume 4, page 448

CFA® Program Curriculum, Volume 5, page 248

**Related Material**

Schweser Notes - Book 4

33. (B) **Interest rate cap.**

**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.

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

Schweser Notes - Book 4

34. (B) **A cap is a disadvantage to the bondholder while a floor is a disadvantage 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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

SchweserNotes - Book 4

35. (B) **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.

**For Further Reference:**

(Study Session 13, Module 39.2, LOS 39.f)

CFA® Program Curriculum, Volume 4, page 448

CFA® Program Curriculum, Volume 5, page 7

**Related Material**

Schweser Notes - Book 4

36. (B) **3.875%.**

**Explanation**

This value is computed as follows:

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

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

37. (B) **Indenture.**

**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.

(Study Session 13, Module 39.1, LOS 39.b)

**Related Material**

Schweser Notes - Book 4

38. (B) **Bermuda 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.

(Study Session 13, Module 39.2, LOS 39.f)

**Related Material**

Schweser Notes - Book 4



39. (C) **£50.**

**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.

(Study Session 13, Module 39.1, LOS 39.a)

**Related Material**

Schweser Notes - Book 4

40. (B) **$2,025.**

**Explanation**

This coupon payment is computed as follows:

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

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

41. (B) **prefer not 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.

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4

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

**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.

(Study Session 13, Module 39.1, LOS 39.d)

**Related Material**

SchweserNotes - Book 4

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

**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).

(Study Session 13, Module 39.2, LOS 39.e)

**Related Material**

Schweser Notes - Book 4