

50**FIXED-INCOME CASH
FLOWS & TYPES**

1. 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) commercial paper.
 - (B) asset-backed securities.
 - (C) global bonds.

2. 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.

3. An investor most concerned with reinvestment risk would be least likely to:
 - (A) eliminate reinvestment risk by holding a coupon bond until maturity.
 - (B) prefer a lower coupon bond to a higher coupon bond.
 - (C) prefer a noncallable bond to a callable bond.

4. Which of the following statements about U.S. Treasury Inflation Protection Securities (TIPS) is most accurate?
 - (A) The coupon rate is fixed for the life of the issue.
 - (B) Adjustments to principal values are made annually.
 - (C) The inflation-adjusted principal value cannot be less than par.

5. 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.

6. 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.
7. 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%.
8. What effects will an increase in yield volatility have on the values of a puttable bond and a callable bond?
- (A) One bond will increase in value and the other will decrease.
 - (B) Both bonds will increase in value.
 - (C) Both bonds will decrease in value.
9. 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.
10. 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.
11. A bond initially does not make periodic payments but instead accrues them over a predetermined 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.

12. 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.
13. Securitized bonds are most likely to be issued by:
- (A) banking institutions.
 - (B) special purpose entities.
 - (C) supranational entities.
14. As compared to an equivalent noncallable bond, a callable bond's yield should be:
- (A) higher.
 - (B) lower.
 - (C) the same.
15. As compared to an equivalent nonputtable bond, a puttable bond's yield should be:
- (A) higher.
 - (B) lower.
 - (C) the same.
16. 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.
17. 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.
18. A step-up coupon bond is structured such that its coupon rate increases:
- (A) on a predetermined schedule.
 - (B) if a reference interest rate increases.
 - (C) if the issuer's credit rating decreases.

19. 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.
20. A bond whose periodic payments are all equal is said to have a(n):
- (A) bullet structure.
 - (B) amortizing structure.
 - (C) balloon structure.
21. 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.
22. 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) Rating agencies.
 - (B) Special purpose entities.
 - (C) Investment banks.
23. A non-amortizing fixed income security is most accurately described as:
- (A) a balloon bond.
 - (B) a bullet bond.
 - (C) a mortgage bond.
24. 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) The bond's coupon rate is linked to the price of aluminum.
 - (B) Payment structure helps protect Allcan's credit rating.
 - (C) Allows Allcans to set coupon payments based on business results.

25. Which of the following is least likely an example of an external credit enhancement?
- (A) Letter of credit.
 - (B) An excess spread account.
 - (C) Bank guarantee.
26. 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.
27. 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.
28. 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.
29. 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.
30. Which of the following statements about the call feature of a bond is most accurate? An embedded call option:
- (A) stipulates whether and under what circumstances the issuer can redeem the bond prior to maturity.
 - (B) stipulates whether and under what circumstances the bondholders can request an earlier repayment of the principal amount prior to maturity.
 - (C) describes the maturity date of the bond.

31. 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.
32. Which of the following embedded bond options tends to benefit the borrower?
- (A) Conversion option.
 - (B) Interest rate cap.
 - (C) Put option.
33. 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.

