

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

1. (B) **asset-backed securities.**

Explanation

Special purpose entities relate to asset-backed securities.

(Module 50.1, LOS 50.b)

2. (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.

(Module 50.1, LOS 50.a)

3. (A) **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 50.1, LOS 50.a)

4. (A) **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).

(Module 50.1, LOS 50.a)

5. (C) **\$212.50.**

Explanation

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

$$\text{Coupon in \$} = \$5,000 \times 0.085 / 2 = \$212.50$$

(Module 50.1, LOS 50.a)

6. (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.

(Module 50.1, LOS 50.a)

7. (B) **3.875%.**

Explanation

This value is computed as follows:

$$\text{Semi-annual coupon} = (\text{LIBOR} + 125 \text{ basis points}) / 2 = 3.875\%$$

(Module 50.1, LOS 50.a)

8. (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 puttable 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 puttable bond.

(Module 50.1, LOS 50.a)

9. (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."

(Module 50.1, LOS 50.b)

10. (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.

(Module 50.1, LOS 50.b)

11. (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 deferral 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 50.1, LOS 50.a)

12. (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.

(Module 50.1, LOS 50.b)

13. (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.

(Module 50.1, LOS 50.b)

14. (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.

(Module 50.1, LOS 50.a)

15. (B) lower.

Explanation

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

(Module 50.1, LOS 50.a)

16. (B) a partially amortizing 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 50.1, LOS 50.a)

17. (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 50.1, LOS 50.b)

18. (A) 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.

(Module 50.1, LOS 50.a)

19. (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.

(Module 50.1, LOS 50.a)

20. (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.

(Module 50.1, LOS 50.a)

21. (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.

(Module 50.1, LOS 50.a)

22. (B) 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.

(Module 50.1, LOS 50.b)

23. (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.

(Module 50.1, LOS 50.a)

24. (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 50.1, LOS 50.a)

25. (B) 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.

(Module 50.1, LOS 50.b)

26. (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.

(Module 50.1, LOS 50.a)

27. (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.

(Module 50.1, LOS 50.a)

28. (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 50.1, LOS 50.b)

29. (B) \$2,025.**Explanation**

This coupon payment is computed as follows:

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

(Module 50.1, LOS 50.a)

30. (A) 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.

(Module 50.1, LOS 50.a)

31. (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.

(Module 50.1, LOS 50.a)

32. (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.

(Module 50.1, LOS 50.a)

33. (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.

(Module 50.1, LOS 50.a)

