Reading 52

FIXED-INCOME MARKETS FOR CORPORATE ISSUERS

1. (A) central bank funds rate.

Explanation

Required reserves are deposits with a country's central bank. Banks that deposit more than the required amount with the central bank are said to have excess reserves and may lend these to other banks. This lending is said to take place in the central bank funds market and the interest rates on such loans are known as central bank funds rates.

(Module 52.1, LOS 52.a)

2. (C) A cap of $20 million on total debt outstanding.

Explanation

Debt covenants are put in place to protect debt investors. A cap on the total amount of debt a company can have outstanding will protect current debt investors from the company borrowing more money and putting current obligation interest and principal payments at risk. The debt-to-equity ratio debt covenant will likely be a maximum (not a minimum) threshold. Dividend payments are likely to be maximum amounts not to be exceeded, rather than minimum amounts.

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(Module 52.1, LOS 52.c)

3. (A) take out leveraged loans with prepayment options.

Explanation

A company with a low credit rating will have to issue high-yield debt until the company is able to turn things around financially and can borrow at lower rates. Given the situation Redding is in, its best courses of action are either to issue callable debt (where the issuer has the right to call in the debt issuance before maturity) or take out leveraged loans with prepayment options. Shorter-maturity instruments are better, as the company may be able to borrow at lower rates later when its situation improves.

(Module 52.1, LOS 52.c)

4. (C) a high-yield bond.

Explanation

For high-yield bonds, credit spreads are likely to be a larger proportion of yield than they are for investment-grade bonds and government bonds.

(Module 52.1, LOS 52.c)

5. (B) **Investment grade.**

Explanation

Investment-grade issues are standardized (similar across different issues) and typically issued across multiple maturities, which reduces rollover risk (the risk that maturing debt will have to be replaced with new debt at higher interest rates). High-yield debt is not standardized and often matures earlier than investment-grade debt. Short-term debt will carry more rollover risk.

(Module 52.1, LOS 52.c)

6. (C) **lower repo rate and repo margin.**

Explanation

Both the repo rate and the repo margin tend to be higher for longer repo terms. Therefore an overnight repo should have a lower repo rate and a lower repo margin than a term (i.e., longer than overnight) repo.

(Module 52.1, LOS 52.b)

7. (C) **investment grade or high yield.**

Explanation

In a normal yield curve environment where bond yields are higher for longer-dated bond maturities, both investment-grade and high-yield corporate issuers need to offer higher yields on bonds with longer maturities.

(Module 52.1, LOS 52.c)

8. (C) **unsecured short-term loans from one bank to another.**

Explanation

The interbank funds market refers to short-term unsecured loans between banks. It does not refer to trading of negotiable certificates of deposit. Borrowing from the central bank is said to occur in the central bank funds market.

(Module 52.1, LOS 52.a)

9. (A) **Greater demand for the underlying security results in a lower repo margin.**

Explanation

Other things equal, the repo margin (percent difference between the market value of the collateral and the loan amount) is lower if the collateral is in greater demand. The repo margin and repo rate (the annualized percent difference between the sale price and repurchase price of the collateral) are inversely related to the credit quality of the collateral.

(Module 52.1, LOS 52.b)

10. (A) **a bond dealer is the lender.**

Explanation

Bond dealers frequently use repurchase agreements as sources of funding. When a bond dealer enters a repo as the lender instead of the borrower, the agreement is referred to as a reverse repo.

(Module 52.1, LOS 52.b)