Reading 62

CREDIT RISK

1. (C) **market liquidity risk.**

   Explanation

   Market liquidity risk is the risk of receiving less than market value when selling a bond and is reflected in the size of the bid-ask spreads. Market liquidity risk is greater for the bonds of less creditworthy issuers and for the bonds of smaller issuers with relatively little publicly traded debt. Loss severity and recovery rate refer to defaults.

   (Module 62.1, LOS 62.a).

2. (A) **Capacity.**

   Explanation

   Analyzing a corporate borrower's capacity to repay its debt obligations is similar to the top-down process used in equity analysis. Collateral analysis is evaluating the issuer's assets. Analyzing covenants involves reviewing the terms and conditions of lending agreements.

   (Module 62.1, LOS 62.a)

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3. (A) **capacity and character.**

   Explanation

   The "four Cs" of credit analysis are capacity, collateral, covenants, and character.

   (Module 62.1, LOS 62.a)

4. (B) **character.**

   Explanation

   Character refers to the quality of management. Character analysis includes soundness of strategy, management's track record, accounting policies and tax strategies, fraud and malfeasance record, and prior treatment of bondholders. Capacity refers to the ability of the borrower to make its debt payments on time. Covenants are the terms and conditions of lending agreements with which the issuer must comply.

   (Module 62.1, LOS 62.a)

5. (A) **Purchase corporate bonds and sell Treasury bonds.**

Explanation

During periods of economic expansion corporate yield spreads generally narrow, reflecting decreased credit risk. If yield spreads narrow, the prices of corporate bonds increase relative to the prices of Treasuries. Selling lower-rated bonds and buying higherrated bonds is an appropriate strategy if an economic contraction is anticipated.

(Module 62.1, LOS 62.c)

6. (A) **The economy is going to contract.**

Explanation

If economic conditions are expected to get worse, then the probability that corporations may default increases and causes credit spreads to widen.

(Module 62.1, LOS 62.c)

7. (B) **Collateral.**

Explanation

These items are part of analyzing a borrower's collateral. Analyzing depreciation expense and equity market capitalization can provide insight into the quality of a firm's fixed assets. Intellectual capital and intangible assets can potentially be used as collateral if they can be separated from the firm and sold. Capacity refers to a borrower's ability to repay its obligations. Analysis of capacity focuses on industry structure and company fundamentals. Covenants are terms and conditions of a bond issue.

(Module 62.1, LOS 62.a)

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8. (A) **amount a bondholder will lose if the issuer defaults.**

Explanation

Loss severity is the money amount or percentage of a bond's value a bondholder will lose if the issuer defaults. The percentage of a bond's value a bondholder will receive if the issuer defaults is the recovery rate.

(Module 62.1, LOS 62.a)

9. (A) **investors increase their estimates of the recovery rate on the corporate bonds.**

Explanation

Yield spreads reflect the credit quality of bond issuers and the liquidity of the market for their bonds. Narrowing (decreasing) yield spreads reflect improving credit quality or more liquidity. Widening (increasing) yield spreads reflect deteriorating credit quality or less liquidity. Increased estimates of the recovery rate in the event of default represent an improvement in investors' assessment of the issuer's credit quality and are likely to narrow yield spreads on the issuer's bonds.

(Module 62.1, LOS 62.a)

10. (B) Yield spreads are likely to narrow.

Explanation

Credit spreads tend to narrow in times of high demand for bonds and widen in times of low demand for bonds. Credit spreads tend to widen under excess supply conditions, such as large issuance in a short period of time, and narrow when supply is low.

(Module 62.1, LOS 62.c)

11. (A) weak.

Explanation

Conditions that cause equity markets to weaken, such as poor economic growth, also tend to widen yield spreads in the bond market. Likewise, strong equity market performance tends to coincide with narrowing yield spreads. Yield spreads tend to narrow when equity markets are stable because investors "reaching for yield" increase their demand for bonds.

(Module 62.1, LOS 62.c).

12. (A) only the bond rating and the recovery rate.

Explanation

Credit risk is calculated with the probability of default (estimated from the bond rating) and the estimated recovery value should the bond default. Yield volatility is combined with duration to estimate the price risk of a bond.

(Module 62.1, LOS 62.a)

13. (C) 5% liquidity risk and 95% credit risk.

Explanation

Yield at the bid price: N = 5; PMT = 8; FV = 100; PV = –98.25; CPT I/Y = 8.4434

Yield at the offer price: PV = –98.75; CPT I/Y = 8.3157

Liquidity spread = 8.4434 – 8.3157 = 0.1277 = 12.77 basis points

The proportion of the yield spread attributable to liquidity risk is 12.77 / 275 = 4.64%. The remaining 95.36% of the spread is attributable to credit risk.

(Module 62.1, LOS 62.c)

14. (B) widen.

Explanation

With greater uncertainty, investors require a higher return for taking on more risk. Therefore, credit spreads will widen.

(Module 62.1, LOS 62.c)