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Question 1

Question Type: MultipleChoice

If two bonds with identical credit ratings, coupon and maturity but from different issuers trade at different spreads to treasury rates, which of the following is a possible

1. The bonds differ in liquidity
2. Events have happened that have changed investor perceptions but these are not yet reflected in the ratings
3. The bonds carry different market risk
4. The bonds differ in their convexity

Options:

A- 1, 2 and 4

B- 2 and 4

C- 1 and 2

D- 3 and 4

Answer:

C

Explanation:

When two bonds that appear identical in every respect trade at different prices, the difference is often due to differences in liquidity between the two bonds (the less liquid bond will be cheaper and yield higher), and also due to the fact that ratings from the major rating agencies do not generally react to day to day changes in the market. The market's perception of the differences in the two credits will cause a divergence in the prices. This has been an extremely visible phenomenon during the credit crisis of 2007-2009, where fixed income security prices have changed sharply for many securities without any changes in external credit ratings.

Bonds carrying 'different market risk' is meaningless, and so is the difference in convexity (because the calculated convexity would be identical for similar bonds).

Therefore Choice 'c' is the correct answer.

Question 2

Question Type: MultipleChoice

A portfolio has two loans, A and B, each worth \$1m. The probability of default of loan A is 10% and that of loan B is 15%. The probability of both loans defaulting together is 1%. Calculate the expected loss on the portfolio.

Options:

A- 500000

B- 250000

C- 1000000

D- 240000

Answer:

B

Explanation:

The easiest way to answer this question is to ignore the joint probability of default as that is irrelevant to expected losses. The joint probability of default impacts the volatility of the losses, but not the expected amount. One way to think about it is to think of asset portfolios, where diversification reduces risk (ie standard deviation) but the expected returns are nothing but the average of the expected returns in the portfolio. Just as the expected returns of the portfolio are not affected by the volatility or correlations (these affect standard deviation), in the same way the joint probability of default does not affect the expected losses. Therefore the expected losses for this portfolio are simply $\$1\text{m} \times 10\% + \$1\text{m} \times 15\% = \$250,000$.

This can also be seen from the lens of a joint probability distribution as follows:

	Loan A defaults	Loan A survives	
Loan B defaults	1%	14%	15%
Loan B survives	9%	76%	85%
	10%	90%	

There are four possibilities for this portfolio:

- Only loan A defaults: loss of \$1m: 9% probability
- Only loan B defaults: loss of \$1m: 14% probability
- Both loan A and B default: loss of \$2m: 1% probability
- Neither A nor B default: loss of \$0m: 76% probability

Therefore the expected losses on the portfolio are $(\$1m \times 9\%) + (\$1m \times 14\%) + (\$2m \times 1\%) + (\$0m \times 76\%) = \$250,000$.

(Notes: How is the above table calculated? The totals (10%, 90%, 15% and 85%) are filled in first. The top left cell (both A & B default) is given as 1%. We can now calculate the rest of the cells as the totals are known.)

Question 3

Question Type: MultipleChoice

Which of the following is the best description of the spread premium puzzle:

Options:

- A-** The spread premium puzzle refers to observed default rates being much less than implied default rates, leading to lower credit bonds being relatively cheap when compared to their actual default probabilities
- B-** The spread premium puzzle refers to dollar denominated non-US sovereign bonds being priced a at significant discount to other similar USD denominated assets
- C-** The spread premium puzzle refers to AAA corporate bonds being priced at almost the same prices as equivalent treasury bonds without offering the same liquidity or guarantee as treasury bonds
- D-** The spread premium puzzle refers to the moral hazard implicit in the monoline insurance market

Answer:

A

Explanation:

Choice 'a' is the correct answer. The other choices represent non-sensical statements.

Question 4

Question Type: MultipleChoice

The CDS quote for the bonds of Bank X is 200 bps. Assuming a recovery rate of 40%, calculate the default hazard rate priced in the CDS quote.

Options:

A- 0.80%

B- 5.00%

C- 3.33%

D- 2.00%

Answer:

C

Explanation:

Hazard rate x Loss given default = CDS quote. In other words, Hazard rate x (1 - recovery rate) = CDS quote. We can therefore calculate the hazard rate for this problem as $200 \text{ bps} / (1 - 40\%) = 3.33\%$.

Question 5

Question Type: MultipleChoice

For a corporate bond, which of the following statements is true:

1. The credit spread is equal to the default rate times the recovery rate
2. The spread widens when the ratings of the corporate experience an upgrade
3. Both recovery rates and probabilities of default are related to the business cycle and move in opposite directions to each other
4. Corporate bond spreads are affected by both the risk of default and the liquidity of the particular issue

Options:

A- 1,2 and 4

B- 3 and 4

C- 3 only

D- 4 only

Answer:

B

Explanation:

The credit spread is equal to the default rate times the loss given default, or stated another way, default rate times $(1 - \text{recovery rate})$. It is not equal to the default rate times the recovery rate. Therefore statement I is not correct.

When ratings are upgraded by rating agencies, the spread contracts and not widens. Therefore statement II is not correct.

Both recovery rates and probabilities of default are related to the business cycle, and they move in opposite directions. Economic recessions witness an increase in the default rate and a decrease in the recovery rate, and economic expansions result in a decrease in the default rate and an increase in the recovery rates when default does happen. Therefore statement III is correct.

Bond spreads incorporate both the risk of default, but also considerations of liquidity in the case of corporate bonds. Hence statement IV is correct.

Question 6

Question Type: MultipleChoice

The CDS rate on a defaultable bond is approximated by which of the following expressions:

Options:

- A- Hazard rate / (1 - Recovery rate)
- B- Loss given default x Default hazard rate
- C- Credit spread x Loss given default
- D- Hazard rate x Recovery rate

Answer:

B

Explanation:

The CDS rate is approximated by the [Loss given default x Default hazard rate]. Thus Choice 'b' is the correct answer.

Note that this is also equal to the credit spread on the reference bond over the risk free rate. Therefore credit spreads and CDS rates are generally the same. Also, 'loss given default' is nothing but (1 - Recovery rate). This can be substituted in the formula for the credit spread to get an alternative expression that directly refers to the recovery rate. Therefore all other choices are incorrect.

Question 7

Question Type: MultipleChoice

A long position in a credit sensitive bond can be synthetically replicated using:

Options:

- A-** a long position in a treasury bond and a short position in a CDS
- B-** a long position in a treasury bond and a long position in a CDS
- C-** a short position in a treasury bond and a short position in a CDS
- D-** a short position in a treasury bond and a long position in a CDS

Answer:

A

Explanation:

The correct answer is choice 'a'

A long position in a credit sensitive bond is equivalent to earning the risk free rate and the spread on the bond. The risk free rate can be earned through a long position in a treasury bond, and the spread can be earned in the form of premiums on a CDS, which are received by the protection seller, ie the party short a CDS contract. Therefore we can get the same results as a long bond position using a combination of a long treasury bond and a short position in a CDS. Choice 'a' is the correct answer.

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