c2

Student: ____

1. _____ are contracts containing a promise to pay a future stream of cash to investors who hold the contracts.
A. Debt instruments
B. Futures
C. Option contracts
D. Swap contracts

2. Which of the following is true of a line of credit?
A. It is a short-term, zero-coupon note issued by major corporations.
B. It is an arrangement in which the firm is allowed to pay down the loan and then subsequently increase the amount of borrowing.
C. It is an arrangement where the bank will lend up to a maximum pre-specified loan amount at a pre-specified interest rate, as long as the firm meets the requirements established initially.
D. It is an arrangement with a bank whereby the bank authorizes the maximum loan amount, but not the interest rate, when commitment was drawn up.

3. Treasury bonds are:
A. the zero-coupon Treasury issues, with maturities that range from one month to one year at issue.
B. the coupon-paying issues with maturities from one year to 10 years at their initial issue date.
C. the coupon-paying issues with maturities from one year to 5 years at their initial issue date.
D. the coupon-paying issues with maturities greater than 10 years at their issue date.

4. Which of the following is defined in the lease contract between the lessor and the lessee?
A. Whether the lease should be expensed or capitalized
B. Time period for which the lessee can use the asset
C. Depreciation method of the leased asset.
D. Retention ratio of the firm.

5. Operating leases are more complicated to value than financial leases because _____.
A. the lessee cannot return the asset except with substantial penalties
B. it is difficult to find the appropriate discount rate
C. of the uncertainty about the length of the lease
D. it is difficult to predict the cash flows.

6. _____ of a bond is the maximum length of time the borrower has to pay off the bond principal in full.
A. Maturity
B. Duration
C. Covenant
D. Convexity

7. Financing covenants:
A. are beneficial in preventing a manager from leaving bondholders penniless by liquidating the firm and paying out the proceeds to themselves and shareholders.
B. prevent the firm from promiscuously issuing new debt, which would dilute the claims of existing bondholders to the firm?s assets.
C. are beneficial to bondholders as they require that a certain portion of the bonds be retired before maturity.
D. give the bondholder the option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.

8. Which of the following is an unsecured bond?
A. Mortgage bond
B. Equipment trust certificate
C. Debenture
D. Collateral trust bond

9. Which of the following is true of the convertible type of bond option?
A. It gives the bondholder the option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.
B. It gives the issuing firm an option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.
C. It mandates a conversion of the regular bonds into another security, typically the ordinary equity of the firm issuing the convertible bond, on maturity.
D. It is similar to a perpetuity and mandates a conversion of the regular bonds into another bond subsequently issued by the firm immediately after maturity.

10. A bond is said to be issued at premium when:
A. the coupon rate is set lower than the coupon rate of par bonds of same maturity and credit risk.
B. the quoted price exceeds the face value of the bond.
C. the quoted price equals the face value of the bond.
D. the face value exceeds the quoted price of the bond.

11. An investment-grade rating on a bond is a rating of _____.
A. Aa3 and above by Moody's, and AA- and above for S&P and Fitch ratings.
B. A1 and above by Moody's, and A- and above for S&P and Fitch ratings.
C. Baa and above by Moody's, and CCC and above for S&P and Fitch ratings.
D. Baa and above by Moody's, and BBB and above for S&P and Fitch ratings.

12. The process of packaging tiny investments into a larger portfolio and selling a security backed by the portfolio's cash flows is called _____.
A. securitization
B. portfolio management
C. amortization
D. collateralization

13. Which of the following is true of Eurobonds?
A. They are zero-coupon bonds issued by the European Central Bank.
B. They are sold outside the country in whose currency it is denominated.
C. They are sovereign bonds issued by European countries.
D. They are Euro-denominated bonds issued by corporations.

14. Which of the following means the discount rate that makes the discounted value of the promised future bond payments equal to the market price of the bond?
A. Cash flow yield
B. Current yield
C. Yield to maturity
D. Bond-equivalent yield

15. The ex-coupon date is:
A. the date on which the bondholder becomes entitled to the coupon.
B. the last day on which a bond can be traded on the secondary market.
C. is the preceding day of the first principal payment to the bondholder.
D. is the date of legal exchange of cash for bonds.

16. Write a short note about bond covenants.

17. What are asset-backed securities?

18. What are the features that characterize long-term Eurocurrency loans?

19. Comment on the growth of the Eurobond Market.

20. Comment on the borrower-lender distance effect.

c2 Key

1. _____ are contracts containing a promise to pay a future stream of cash to investors who hold the contracts.

A. Debt instruments
B. Futures
C. Option contracts
D. Swap contracts

Debt instruments, also called fixed-income investments, are contracts containing a promise to pay a future stream of cash to investors who hold the contracts.

Hillier - Chapter 02 #1
Level of Difficulty: Easy
Topic: Bank Loans

2. Which of the following is true of a line of credit?

A. It is a short-term, zero-coupon note issued by major corporations.
B. It is an arrangement in which the firm is allowed to pay down the loan and then subsequently increase the amount of borrowing.
C. It is an arrangement where the bank will lend up to a maximum pre-specified loan amount at a pre-specified interest rate, as long as the firm meets the requirements established initially.
D. It is an arrangement with a bank whereby the bank authorizes the maximum loan amount, but not the interest rate, when commitment was drawn up.

Line of credit is an arrangement between a bank and a firm, typically for a short-term loan, whereby the bank authorizes the maximum loan amount, but not the interest rate, when setting up the line of credit.

Hillier - Chapter 02 #2
Level of Difficulty: Medium
Topic: Bank Loans

3. Treasury bonds are:
A. the zero-coupon Treasury issues, with maturities that range from one month to one year at issue.
B. the coupon-paying issues with maturities from one year to 10 years at their initial issue date.
C. the coupon-paying issues with maturities from one year to 5 years at their initial issue date.
D. the coupon-paying issues with maturities greater than 10 years at their issue date.

Treasury bonds are the coupon-paying issues with maturities greater than 10 years at their issue date.

Hillier - Chapter 02 #3
Level of Difficulty: Easy
Topic: Types of Bank Loans

4. Which of the following is defined in the lease contract between the lessor and the lessee?
A. Whether the lease should be expensed or capitalized
B. Time period for which the lessee can use the asset
C. Depreciation method of the leased asset.
D. Retention ratio of the firm.

The contract between the lessor and the lessee defines: (1) the length of time for which the lessee can or must use the asset, (2) the party responsible for maintenance of the asset and (3) whether the lessee has the right to buy the asset at the end of the leasing period and, if so, at what purchase price.

Hillier - Chapter 02 #4
Level of Difficulty: Easy
Topic: Leases

5. Operating leases are more complicated to value than financial leases because _____.
A. the lessee cannot return the asset except with substantial penalties
B. it is difficult to find the appropriate discount rate
C. of the uncertainty about the length of the lease
D. it is difficult to predict the cash flows.

Operating leases are more complicated to value than financial leases because of the uncertainty about the length of the lease.

Hillier - Chapter 02 #5
Level of Difficulty: Easy
Topic: Leases

6. _____ of a bond is the maximum length of time the borrower has to pay off the bond principal in full.
A. Maturity
B. Duration
C. Covenant
D. Convexity

Maturity of a bond is the maximum length of time the borrower has to pay off the bond principal in full.

Hillier - Chapter 02 #6
Level of Difficulty: Easy
Topic: Corporate Bonds

7. Financing covenants:
A. are beneficial in preventing a manager from leaving bondholders penniless by liquidating the firm and paying out the proceeds to themselves and shareholders.
B. prevent the firm from promiscuously issuing new debt, which would dilute the claims of existing bondholders to the firm?s assets.
C. are beneficial to bondholders as they require that a certain portion of the bonds be retired before maturity.
D. give the bondholder the option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.

Financing covenants prevent the firm from promiscuously issuing new debt, which would dilute the claims of existing bondholders to the firm's assets.

Hillier - Chapter 02 #7
Level of Difficulty: Easy
Topic: Corporate Bonds

8. Which of the following is an unsecured bond?
A. Mortgage bond
B. Equipment trust certificate
C. Debenture
D. Collateral trust bond

A debenture is a type of unsecured bond. In the event of default, debenture holders are unsecured creditors, meaning that they have a claim on all the firm's assets not already pledged.

Hillier - Chapter 02 #8
Level of Difficulty: Easy
Topic: Corporate Bonds

9. Which of the following is true of the convertible type of bond option?
A. It gives the bondholder the option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.
B. It gives the issuing firm an option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.
C. It mandates a conversion of the regular bonds into another security, typically the ordinary equity of the firm issuing the convertible bond, on maturity.
D. It is similar to a perpetuity and mandates a conversion of the regular bonds into another bond subsequently issued by the firm immediately after maturity.

Convertibility if a bond option gives the bondholder the option to convert the bond into another security, typically the ordinary equity of the firm issuing the convertible bond.

Hillier - Chapter 02 #9
Level of Difficulty: Easy
Topic: Corporate Bonds

10. A bond is said to be issued at premium when:
A. the coupon rate is set lower than the coupon rate of par bonds of same maturity and credit risk.
B. the quoted price exceeds the face value of the bond.
C. the quoted price equals the face value of the bond.
D. the face value exceeds the quoted price of the bond.

Premium bond is a bond in which the quoted price exceeds the face value of the bond.

Hillier - Chapter 02 #10
Level of Difficulty: Easy
Topic: Corporate Bonds

11. An investment-grade rating on a bond is a rating of _____.
A. Aa3 and above by Moody's, and AA- and above for S&P and Fitch ratings.
B. A1 and above by Moody's, and A- and above for S&P and Fitch ratings.
C. Baa and above by Moody's, and CCC and above for S&P and Fitch ratings.
D. Baa and above by Moody's, and BBB and above for S&P and Fitch ratings.

An investment-grade rating on a bond is a rating of Baa and above by Moody's, and BBB and above for S&P and Fitch ratings.

Hillier - Chapter 02 #11
Level of Difficulty: Easy
Topic: Corporate Bonds

12. The process of packaging tiny investments into a larger portfolio and selling a security backed by the portfolio's cash flows is called _____.
A. securitization
B. portfolio management
C. amortization
D. collateralization

The process of packaging tiny investments into a larger portfolio and selling a security backed by the portfolio’s cash flows is called securitization.

Hillier - Chapter 02 #12
Level of Difficulty: Easy
Topic: Asset-Backed Securities

13. Which of the following is true of Eurobonds?
A. They are zero-coupon bonds issued by the European Central Bank.
B. They are sold outside the country in whose currency it is denominated.
C. They are sovereign bonds issued by European countries.
D. They are Euro-denominated bonds issued by corporations.

Eurobonds are sold outside the country in whose currency it is denominated.

Hillier - Chapter 02 #13
Level of Difficulty: Easy
Topic: Raising Debt Capital in the Euromarkets

14. Which of the following means the discount rate that makes the discounted value of the promised future bond payments equal to the market price of the bond?
A. Cash flow yield
B. Current yield
C. Yield to maturity
D. Bond-equivalent yield

Yield to maturity is the discount rate that makes the discounted value of the promised future bond payments equal to the market price of the bond.

Hillier - Chapter 02 #14
Level of Difficulty: Easy
Topic: Bond Prices, Yields to Maturity and Bond Market Conventions

15. The ex-coupon date is:
A. the date on which the bondholder becomes entitled to the coupon.
B. the last day on which a bond can be traded on the secondary market.
C. is the preceding day of the first principal payment to the bondholder.
D. is the date of legal exchange of cash for bonds.

The ex-coupon date is the date on which the bondholder becomes entitled to the coupon.

Hillier - Chapter 02 #15
Level of Difficulty: Easy
Topic: Bond Prices, Yields to Maturity and Bond Market Conventions

16. Write a short note about bond covenants.

Virtually all debt contracts contain covenants to restrict equity holders who control the firm from putting the bondholders' funds at risk. In the absence of such covenants, the incentives of equity holders to expropriate bondholder wealth would be reflected in the bond's coupon or price, resulting in higher borrowing rates.
Asset covenants: Asset covenants specify what rights the bondholder has to the firm's assets in case of default. Some bonds are senior bonds that give investors the rights to satisfy their claims before the junior bonds holders. Other bonds are secured bonds, which means the firm has pledged specific assets to the bondholders in case of default.
Dividend covenants: Dividend covenants prevent managers simply liquidating the firm and paying out the liquidation proceeds as a dividend to shareholders and leaving bondholders penniless by.
Financing covenants: Financing covenants prevent firms from promiscuously issuing new debt, which would dilute the claims of existing bondholders. Such covenants could specify that any new debt has to have a subordinated claim to the assets.**Financial ratio covenants**: Both asset covenants and financing covenants are embedded in covenants that require the firm to maintain certain financial ratios. For instance, a covenant may specify a minimum value for net working capital or for net worth, as noted earlier. When the firm cannot meet the financial ratio conditions, it is technically in default, even when it has made the promised payments to bondholders.
Sinking fund covenants: It requires that a certain portion of the bonds be retired before maturity. The firm makes payments to the trustee, who then repurchases randomly chosen bonds.

Hillier - Chapter 02 #16
Level of Difficulty: Hard
Topic: Corporate Bonds

17. What are asset-backed securities?

Hillier - Chapter 02 #17
Level of Difficulty: Medium
Topic: Asset-Backed Securities

18. What are the features that characterize long-term Eurocurrency loans?

Firms can also raise funds in the Euromarkets through a Eurocurrency loan. A Eurocurrency is a major currency on deposit in a bank outside the country of origin for the currency. For example, when an American company deposits dollars into a London-based bank, its deposits become Eurodollar deposits. The following features characterize long-term Eurocurrency loans:

1.They are issued on a floating-rate basis, usually at a fixed spread above LIBOR or EURIBOR.

2. The margin varies between about 50 and 300 basis points, depending on the credit risk of the borrowing firm or bank, with the benchmark LIBOR or EURIBOR rate generally reset every six months.

3. They have a maturity of 3–10 years.

4. They are issued by a syndicate of banks, which charge fixed fees of 0.25–1 per cent of loan value. The syndicate allows great flexibility in the timing of takedowns of the loan commitment.

Hillier - Chapter 02 #18
Level of Difficulty: Medium
Topic: Raising Debt Capital in the Euromarkets

19. Comment on the growth of the Eurobond Market.

The Eurobond market has seen spectacular growth. This has been driven in part by the growth in the currency swap market.Swaps enable firms to issue bonds in whatever currency they choose, and to swap the proceeds into whatever currency they need. They allow multinational firms to take full advantage of global capital markets to obtain the lowest borrowing rate, and then to hedge the currency risk of their global operations and their financing with a series of swap agreements.

Hillier - Chapter 02 #19
Level of Difficulty: Medium
Topic: Raising Debt Capital in the Euromarkets

20. Comment on the borrower-lender distance effect.

With the changing environment regarding debt, there has been a resurgence of interest in debt financing and the factors that drive pricing and availability. Agarwal and Hauswald (2010) report that the physical distance between the borrower and the lending bank is a factor in the debt financing decision. Banks must undertake an extended analysis of the credit applicant when making their lending decision, and a component of the information gathered is soft and proprietary. The quality of such information gets worse as the borrowing firm becomes less local. The borrower–lender distance effect has also been found in the municipal bond market by Butler (2008), and could explain why banks exhibit a significant home-country bias in the loan portfolios (Carey and Nini, 2007).

The distance effect can be mitigated partially by having strong covenants that are regularly monitored and enforced. Covenants affect corporate decision-making and strategy, especially when the terms are in danger of being violated.

Hillier - Chapter 02 #20
Level of Difficulty: Easy
Topic: Bond Prices, Yields to Maturity and Bond Market Conventions

c2 Summary

Category	*# of Questions*
Hillier - Chapter 02	20
Level of Difficulty: Easy	15
Level of Difficulty: Hard	1
Level of Difficulty: Medium	4
Topic: Asset-Backed Securities	2
Topic: Bank Loans	2
Topic: Bond Prices, Yields to Maturity and Bond Market Conventions	3
Topic: Corporate Bonds	7
Topic: Leases	2
Topic: Raising Debt Capital in the Euromarkets	3
Topic: Types of Bank Loans	1