

STUDY SESSION

13

Fixed Income (2)

This study session continues use of the binomial valuation method to value bonds with embedded options. Sensitivity to interest rates and interest rate volatility are key considerations. Option-adjusted spreads are introduced for the evaluation of risky bonds. Credit analysis concepts, tools, and applications are then discussed along with the term structure of credit spreads. The study session concludes with credit default swaps and their use in managing credit exposure.

READING ASSIGNMENTS

Reading 36	Valuation and Analysis: Bonds with Embedded Options by Leslie Abreo, MFE, Ioannis Georgiou, CFA, and Andrew Kalotay, PhD
Reading 37	Credit Analysis Models by James F. Adams, PhD, CFA, and Donald J. Smith, PhD
Reading 38	Credit Default Swaps by Brian Rose and Don M. Chance, PhD, CFA

LEARNING OUTCOMES

READING 36. VALUATION AND ANALYSIS: BONDS WITH EMBEDDED OPTIONS

The candidate should be able to:

- a** describe fixed-income securities with embedded options;
- b** explain the relationships between the values of a callable or puttable bond, the underlying option-free (straight) bond, and the embedded option;

- c describe how the arbitrage-free framework can be used to value a bond with embedded options;
- d explain how interest rate volatility affects the value of a callable or puttable bond;
- e explain how changes in the level and shape of the yield curve affect the value of a callable or puttable bond;
- f calculate the value of a callable or puttable bond from an interest rate tree;
- g explain the calculation and use of option-adjusted spreads;
- h explain how interest rate volatility affects option-adjusted spreads;
- i calculate and interpret effective duration of a callable or puttable bond;
- j compare effective durations of callable, puttable, and straight bonds;
- k describe the use of one-sided durations and key rate durations to evaluate the interest rate sensitivity of bonds with embedded options;
- l compare effective convexities of callable, puttable, and straight bonds;
- m calculate the value of a capped or floored floating-rate bond;
- n describe defining features of a convertible bond;
- o calculate and interpret the components of a convertible bond's value;
- p describe how a convertible bond is valued in an arbitrage-free framework;
- q compare the risk–return characteristics of a convertible bond with the risk–return characteristics of a straight bond and of the underlying common stock.

READING 37. CREDIT ANALYSIS MODELS

The candidate should be able to:

- a explain expected exposure, the loss given default, the probability of default, and the credit valuation adjustment;
- b explain credit scores and credit ratings;
- c calculate the expected return on a bond given transition in its credit rating;
- d explain structural and reduced-form models of corporate credit risk, including assumptions, strengths, and weaknesses;
- e calculate the value of a bond and its credit spread, given assumptions about the credit risk parameters;
- f interpret changes in a credit spread;
- g explain the determinants of the term structure of credit spreads and interpret a term structure of credit spreads;
- h compare the credit analysis required for securitized debt to the credit analysis of corporate debt.

READING 38. CREDIT DEFAULT SWAPS

The candidate should be able to:

- a describe credit default swaps (CDS), single-name and index CDS, and the parameters that define a given CDS product;
- b describe credit events and settlement protocols with respect to CDS;
- c explain the principles underlying, and factors that influence, the market's pricing of CDS;

- d** describe the use of CDS to manage credit exposures and to express views regarding changes in shape and/or level of the credit curve;
- e** describe the use of CDS to take advantage of valuation disparities among separate markets, such as bonds, loans, equities, and equity-linked instruments.