

Chapter 6-1

* The Risk Structure of Interest Rates:

Different bonds have different interest rates because of differences in liquidity, risk and tax considerations.

1. Given the following information, what is the risk premium on the corporate bond?

5-year Treasury bond 3.0%
10-year Treasury bond 5.0%
10-year ATT bond 6.5%

- (a) -3% (b) -1.5% (c) 1.5% (d) 3.5%

2. As a consequence of the Black Monday crash in 1987, the increase in default risk for junk bonds made them _____ desirable at any given interest rate and _____ the risk premium.

- (a) more; decreased (b) more; increased
(c) less; decreased (d) less; increased

3. Given the following information, under federal income tax rate of 20%, the after-tax yield on a 10-year T-bond is _____ and the after-tax risk premium on the municipal bond will be _____.

10-year Treasury bond 5.0%
10-year Municipal bond 4.5%

- (a) 4.0%; 1.4% (b) 4.0%; 0.5% (c) 3.6%; 1.4% (d) 3.6%; 0.5%

4. A decrease in the liquidity of corporate bonds will _____ the price of corporate bonds and _____ the yield of Treasury bonds.

- (a) increase; increase
(b) reduce; reduce
(c) increase; reduce
(d) reduce; increase
(e) reduce; not affect

5. The risk premium on corporate bond rises when:

- (a) Brokerage commissions on corporate bonds fall
(b) Treasury bonds become more liquid
(c) The economy slides into a recession
(d) All of the above
(e) Only (2) and (3)

6. If asymmetric information problems in the market become worse, other things equal, the demand curve for corporate bonds shifts to the _____ and the demand curve for the Treasury bonds shifts to the _____.

- (a) Right; right (b) right; left (c) left; right (d) left; left