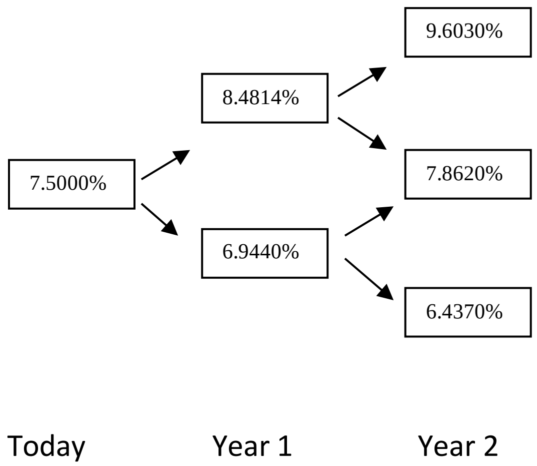
Session 3
Questions

Question 1

Explain why a callable bond's price would be expected to decline less than an otherwise comparable option-free bond when interest rates rise. If necessary use a numeric example.

Question 2

Use the following arbitrage-free binomial interest rate tree to answer the questions that follow:



a. What is the value of a 3-year Treasury bond with a 9% coupon rate?

b. What is the value of a 2-year call option on a bond that currently has three years to maturity and coupon rate of 9% if the strike price is 98? Assume in this calculation that the current price of the 3-year Treasury bond is the value found in part a).