Learning Module 18: Asset Backed Security (ABS) Instrument and Market Features

Q.71 Which one of these is *least likely* a type of Collateral Debt Obligations (CDOs)?

A. Arbitrage CDOs.

B. Balance sheet CDOs.

C. Weighted-average CDOs.

The correct answer is **C.**

Collateralized debt obligation (CDO) is a term used to describe a security backed by a diversified pool of one or more debt obligations. The two types of Collateral Debt Obligations (CDOs) are Arbitrage CDOs and Balance sheet CDOs.Weighted-Average CDOs are not a recognized type of CDOs. The term "weighted-average" might be used in various financial contexts, such as weighted-average life or weighted-average maturity, but it is not a specific category of CDOs.

A is incorrect. Arbitrage CDOs are typically structured to exploit the spread between the income generated by the pooled assets and the cost of funding these assets. Arbitrage CDOs aim to achieve returns through the careful selection and management of a diversified portfolio of debt obligations, leveraging differences in credit risk and return. This strategy is common in the CDO market and is designed to benefit from the inefficiencies in the pricing of credit risk.

B is incorrect. Balance Sheet CDOs are primarily used by financial institutions to remove assets from their balance sheets, thereby achieving regulatory capital relief and managing risk exposure. By pooling these assets and issuing securities backed by the pool, institutions can transfer the credit risk associated with these assets to investors. Balance Sheet CDOs serve as a tool for financial institutions to optimize their capital structure and enhance liquidity while providing investors with opportunities to invest in diversified pools of debt obligations.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (d): Describe collateralized debt obligations, including their cash flows and risks.

Q.73 Asset-backed securities, mortgage-backed securities, and collateralized debt obligations all have collaterals attached to them. What is the main difference between these three fixed-income products?

A. The different types of issuers.

B. The different types of collaterals.

C. The different rating agencies rankings.

The correct answer is **B.**

The main difference between the three products is that they have different types of collaterals attached to them.

Structured Product	Collateral
Asset-backed securities (ABS)	Underlying pool of assets
Mortgage-backed securities (MBS)	Pool of mortgages
Collateralized debt obligations (CDO)	Pool of assets and loans

A is incorrect. While the issuers of ABS, MBS, and CDOs can vary, the key distinguishing factor among these securities is not the issuer but the type of collateral backing each product. The issuer's identity may influence the security's creditworthiness but does not fundamentally differentiate these products.

C is incorrect. Although rating agencies may assign different rankings to ABS, MBS, and CDOs based on their assessment of the securities' credit risk, the primary distinction among these products lies in their collateral types. Ratings help investors assess risk but do not define the fundamental differences between these securities.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (a): Describe characteristics and risks of covered bonds and how they differ from other asset-backed securities.

Q.953 Which of the following is *most likely* the main difference between an asset-backed security (ABS) and a collateralized debt obligation (CDO)?

A. Management of collateral.

B. Approach for dividing tranches.

C. Requirement for pooling of debt obligations.

The correct answer is **A.**

Both asset-backed securities (ABSs) and collateral debt obligations (CDOs) require the creation of a special purpose vehicle (SPV) and pooling of debt obligations. In a CDO, a manager actively buys and sells debt obligations to alter debt composition whereas such management is not required in the case of an ABS.

B is incorrect. This option suggests that the approach for dividing tranches is the main difference between ABS and CDO. While it's true that both ABS and CDO structures involve tranching, which is the process of dividing the pool of assets into different slices or tranches with varying degrees of risk and return, this is not the primary distinguishing feature between the two.

C is incorrect. The requirement for pooling of debt obligations is a characteristic common to both ABS and CDO. Pooling refers to the aggregation of individual loans, receivables, or other debt obligations into a single portfolio, which is then used to back the issued securities. This pooling is a fundamental aspect of the securitization process for both ABS and CDO, allowing for the diversification of risk and the creation of securities that can be sold to investors.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (d): Describe collateralized debt obligations, including their cash flows and risks.

Q.954 Which of the following is *most likely* distributed to holders of credit card receivable backed securities during the lockout period?

A. Interest.

B. The principal invested.

C. Finance charges and fees.

The correct answer is **C.**

Interest is paid to holders of credit card receivable ABS periodically (e.g., monthly, quarterly, or semiannually). The collateral of credit card receivable ABS is a pool of non-amortizing loans that have lockout periods during which the cash flows that are paid out to security holders are based only on finance charges collected and fees. Credit card receivable backed securities are non-amortizing loans as only finance charges and fees are paid during the lockout period. When the lockout period is over, the principal that is repaid by the cardholders is distributed to investors.

A is incorrect. While interest is a component of the finance charges paid to holders of credit card receivable ABS, during the lockout period, the specific distributions are more accurately described as finance charges and fees rather than interest alone. Interest payments are part of the broader category of finance charges, which also includes various fees.

B is incorrect. The principal invested is not distributed to holders of credit card receivable backed securities during the lockout period. The lockout period is characterized by the absence of principal repayments from the pool of credit card receivables. Instead, the focus during this period is on collecting and distributing finance charges and fees generated from the credit card balances.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.955 Which of the following may *least likely* result in the prepayment of securities backed by auto loans?

A. Capital gain resulting in prepayment.

B. Sale and trade-ins requiring full payoff of the loan.

C. Insurance proceeds received upon loss or destruction of autos.

The correct answer is **A.**

Capital gains does not result in prepayment of securities backed by auto loans. The cash flows for auto loan-backed securities consist of scheduled monthly payments and any prepayments. For securities backed by auto loans, prepayments result from sales and trade-ins requiring full payoff of the loan, repossession and subsequent resale of autos, insurance proceeds received upon loss or destruction of autos, and early payoffs of the loans.

B is incorrect. The sale and trade-ins of vehicles directly lead to the prepayment of auto loans. When a vehicle is sold or traded in, the outstanding loan balance often needs to be paid off immediately, which results in a prepayment of the loan. This is a common scenario that directly impacts the cash flows of securities backed by auto loans.

C is incorrect. Insurance proceeds received upon the loss or destruction of autos can also lead to prepayment of auto loans. If a vehicle is totaled or significantly damaged, insurance payouts may be used to pay off the outstanding loan balance, resulting in a prepayment. This is another direct factor that can influence the prepayment of auto loan-backed securities.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.957 Calculate the excess spread from the following information.

- Interests paid by the borrowers: 6%
- Servicing and other charges incurred: 0.6%
- The interests paid to the bond class is 8 times the excess spread.

A. 0.6%.

B. 0.67%.

C. 0.73%.

The correct answer is **A.**

Excess spread is the difference between the interest received by an asset-based security issuer and the one paid to the security holder.

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\begin{aligned}
\text{Interest Received} &= \text{Interest Paid} + \text{Excess Spread} \\
(6.0\% - 0.6\%) &= 8(\text{Excess Spread}) + \text{Excess Spread} \\
(6.0\% - 0.6\%) &= 9(\text{Excess Spread}) \\
\frac{(6.0\% - 0.6\%)}{9} &= \text{Excess Spread} \ = 0.6\%
\end{aligned}
$$

B is incorrect. It suggests an excess spread of 0.67%, which does not align with the calculation based on the given information. The calculation clearly shows that after accounting for servicing and other charges, the remaining interest income divided by the factor (which is 9 in this case, representing 8 times the excess spread plus the excess spread itself) yields an excess spread of 0.6%, not 0.67%.

C is incorrect. It suggests an excess spread of 0.73%, which is also not supported by the given data and calculations. This option might result from a further misinterpretation of the formula or the relationship between the interest income and the payments made to bondholders and for servicing and other charges. The precise calculation based on the provided figures leads to an excess spread of 0.6%, demonstrating that the excess spread is not as high as 0.73%.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.958 The restriction on receiving payments for a period of time by subordinate bond classes if the credit enhancement of the senior tranche deteriorates is referred to as:

A. Block out.

B. Collateral shifting.

C. Shifting interest mechanism.

The correct answer is **C.**

The shifting interest mechanism refers to imposing a restriction on subordinate classes from receiving payments if the credit enhancement for the senior tranche deteriorates.

The point of a shifting interest mechanism is to maintain a certain level of protection to the senior tranche by reducing their loan amount overtime (paying them down) earlier than perhaps would have occurred.

Note: subordinate interest is simply an acknowledgment that one party's interests will be higher than another one's in the event of liquidation of the borrower's assets.

Collateral shifting allows you to instantly change your supplied, collateralized asset to a different one.

A is incorrect. The term "block out" does not accurately describe the process of restricting payments to subordinate bond classes due to the deterioration of the senior tranche's credit enhancement. Instead, "block out" is not a commonly used term in structured finance or securitization contexts, and it does not specifically relate to the mechanisms designed to protect senior tranche holders.

B is incorrect. Collateral shifting refers to the process of changing the collateral backing a particular debt obligation, which is different from the concept of shifting interest mechanism. While collateral shifting might involve the substitution or exchange of assets securing a loan or a debt instrument, it does not directly relate to the allocation of cash flows or the prioritization of payments among different classes of bondholders. The shifting interest mechanism specifically addresses the reallocation of cash flows to maintain or enhance the credit protection of senior tranches, without necessarily involving changes to the underlying collateral.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.2202 Which of the following statements about Asset-Backed Securities (ABS) is *most likely* accurate?

A. Credit enhancements are uncommon for ABS.

B. The credit rating of an ABS must be the same as that of the issuer.

C. Residential mortgages represent the largest type of asset that has been securitized.

The correct answer is **C.**

Residential mortgages represent the largest type of asset that has been securitized.

A is incorrect. An ABS is a separate legal entity from the issuer (originator of the loan) . An ABS is not included in the balance sheet of the issuer. Therefore, An ABS can have a different rating from that of the issuer. An issuer may have a lower credit rating, but an ABS originated by the issuer may be having a higher credit rating and vice versa.

B is incorrect. The credit rating of an ABS pool is a function of its credit enhancements. Better credit enhancements lead to higher credit ratings. A higher credit rating will reduce an issuer's borrowing costs. For this reason, credit enhancements are common among ABS.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.2204 Which of the following is *least likely* a reason to enhance the credit quality of an ABS pool?

A. Increased liquidity.

B. Increased costs of borrowing.

C. Decreased probability of default.

The correct answer is **B.**

By reducing the risk of default, credit enhancements reduce borrowing costs as the loan issuer can now borrow at a low-interest rate.

A is incorrect. Credit enhancements improve the credit rating of a bond. A higher credit rating makes it easier to sell securities, thereby increasing the liquidity of the securities.

C is incorrect. It represents a true statement. Credit enhancements imply that an issuer has taken extra steps to ensure that he/she does not default on loan repayment.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.2206 When each class of asset-backed security (ABS) is paid sequentially, to the extent possible, from the cash flows from the underlying loan portfolio, this flow of funds is *most likely* called a:

A. Tranche structure.

B. Waterfall structure.

C. Mortgage pass-through structure.

The correct answer is **B.**

Each class of ABS (called tranche) is paid sequentially, to the extent possible, from the cash flows from the underlying loan portfolio. This flow of funds is commonly called a waterfall structure.

A is incorrect. A tranche structure is an investment structure that allows an issuer to split out the security into smaller pieces and subsequently sell it to investors.

C is incorrect. A mortgage pass-through security structure represents a bond with a claim on the cash flows of an underlying mortgage-backed pool passed through to bondholders.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.2207 Consider an asset-backed security (ABS) structured under credit tranching with the following bond classes:

Senior Tranche	$300,000,000
Subordinated Tranche A	$80,000,000
Subordinated Tranche B	$20,000,000
Total	$400,000,000

The tranche that should have the lowest yield is *most likely* the:

A. Senior tranche.

B. Subordinated tranche A.

C. Subordinated tranche B.

The correct answer is **A.**

The senior tranche is protected from any credit losses of $100 million or less and, therefore, will have the highest credit rating and offer the lowest yield of the three bond classes.

Investors in the subordinated tranches will require a higher yield to compensate them for the more risk. Losses less than $20,000,000 will only affect investors in subordinated Tranche B, whereas investors in subordinated Tranche A will be affected by losses greater than $20,000,000. Therefore, subordinated tranche B will have the highest yield, followed by subordinated Tranche A. The senior Tranche will offer the lowest yield.

B is incorrect. This option incorrectly suggests that the senior tranche should offer a higher yield due to its lower risk profile. In reality, the inverse relationship between risk and yield in fixed-income securities means that the senior tranche, with its lower risk, naturally offers a lower yield. The fundamental principle of finance that higher risk demands higher return applies here, making the senior tranche the one with the lowest yield due to its highest level of security and lowest risk of loss.

C is incorrect. Subordinated Tranche A is next in line to absorb losses after Subordinated Tranche B has been fully impacted. As a result, investors in Subordinated Tranche A require a higher yield to compensate for this increased risk compared to the Senior Tranche.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Features, LOS (b): Describe typical credit enhancement structures used in securitizations.

Q.2225 In a Commercial Mortgage-backed Security (CMBS) structure, the most junior tranche that is sometimes *not* rated is called a/an:

A. Equity tranche.

B. Support tranche.

C. Subordinate tranche.

The correct answer is **A.**

The most junior tranche that is not rated is referred to as the equity tranche, residual tranche, or first-loss tranche.

B is incorrect. As the name suggests, the support tranche offers support to a Planned Amortization Class (PAC) Tranche.

C is incorrect. Subordinated Tranche is a rated tranche that provides-protection to the more senior tranches.

CFA Level I, Fixed Income, Learning Module 18: Asset-Backed Security (ABS) Instrument and Market Featuress, LOS (d) Describe collateralized debt obligations, including their cash flows and risks.
