

## **Learning Module 17: Fixed Income Securitization**

Q.72 What is *most likely* the definition of a Special Purpose Vehicle (SPV)?

- A. A type of asset-backed security that is secured by a mortgage or collection of mortgages.
- B. A subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt.
- C. A structured financial product that pools together cash flow-generating assets and repackages this asset pool into discrete tranches that can be sold to investors.

The correct answer is **B**.

A Special Purpose Vehicle (SPV) is a subsidiary of a company that is bankruptcy remote from the main organization. The actions of an SPV are usually very tightly controlled, and they are only allowed to finance, buy, and sell assets.

**A is incorrect.** A type of asset-backed security that is secured by a mortgage or collection of mortgages is the definition of mortgage-backed securities.

**C is incorrect.** A structured financial product that pools together cash flow-generating assets and repackages this asset pool into discrete tranches that can be sold to investors is the definition of CDOs.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (b) Describe securitization, including the parties and the roles they play.**

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Q.2201 Compared to the traditional structure, with the bank serving the function of financial intermediary between borrowers and lenders, securitization can provide the following benefits, with the exception of:

- A. Securitization helps in reducing excessive lending by banks.
- B. The investors' legal claim to the mortgages or other loans is stronger.
- C. Securitization reduces intermediation costs, which results in lower funding costs for borrowers and higher risk-adjusted returns for lenders.

The correct answer is **A**.

Compared to the traditional structure, with the bank serving the function of financial intermediary between borrowers and lenders, securitization can provide the previously mentioned benefits, with the exception of helping in reducing excessive lending by banks. The benefits of securitization include:

- It allows investors to have more direct legal claims on loans and portfolios of receivables.
- The costs paid by borrowers can effectively be diminished due to disintermediation.
- Banks can improve their profitability by increasing loan origination and fees.
- Investors can easily access securities matching their risk, return, and maturity needs.
- Securitization also allows for the creation of tradable securities with much liquidity and results in more efficient financial markets.
- In emerging markets, companies and banks have used securitization to lower their funding costs.

**B is incorrect.** Securitization typically involves bundling loans into securities that are then sold to investors. This process can enhance the legal claim of investors to the underlying loans because they have direct ownership rights to the cash flows generated by those loans.

**C is incorrect.** Securitization can indeed reduce intermediation costs by eliminating the need for traditional banking intermediaries, such as banks, to hold the loans on their balance sheets. This can lead to lower funding costs for borrowers and potentially higher risk-adjusted returns for lenders.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a)**  
**Explain benefits of securitization for issuers, investors, economies, and financial markets.**

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Q.2203 Is the following statement correct? "A Special Purpose Entity (SPE) is a separate legal entity from the seller or the originator of the loan and the originator of the loan can never be the servicer of the loans."

- A. Correct.
- B. Incorrect, because the SPE and the originator are the same legal entity.
- C. Incorrect, because the originator of the loan can act as the servicer of the loan.

The correct answer is **C**.

A Special Purpose Entity (SPE) is a separate legal entity from the seller or the loan originator. Even if not always the case, the loan originator CAN be the servicer of the loans. In exchange for a fixed service fee, a loan servicer collects payments from obligors, liquidates collateral if need be, manages default, and prepares reports.

**A is incorrect.** This statement is incorrect because it suggests that the originator of the loan can never be the servicer of the loans.

**B is incorrect.** This choice is incorrect because the definition of a Special Purpose Entity (SPE) explicitly states that it is a separate legal entity from the seller or originator of the loan. Therefore, the SPE and the originator cannot be the same legal entity.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (b) Describe securitization, including the parties and the roles they play.**

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Q.2205 A corporation may issue asset-backed securities (ABS) because:

- A. It wants to reduce the cost of borrowing.
- B. It wants to change the structure of its balance sheet.
- C. Both to change the structure of its balance sheet and reduce the cost of borrowing.

The correct answer is **C**.

Both reasons are valid for the issue of asset-backed securities by a corporation. Both reasons are valid for the issue of asset-backed securities by a corporation. An asset-backed security is a separate legal entity from the loan originator. It is not included in the loan originator's balance sheet.

**Note:** The costs of borrowing will be reduced only after credit enhancements. Credit enhancements will lead to a higher credit rating of the asset-backed security. In return, A higher credit rating will lower the borrowing costs.

**A is incorrect.** While reducing the cost of borrowing can be a motivation for a corporation to issue asset-backed securities (ABS), it's not the only reason. ABS issuance can serve other purposes beyond just lowering borrowing costs.

**B is incorrect.** Changing the structure of the balance sheet is indeed one potential reason why a corporation may choose to issue asset-backed securities (ABS). However, this answer choice alone does not encompass all the possible motivations behind ABS issuance.

***CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.***

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Q.4802 Matching asset maturities to anticipated liability payout dates and increasing diversity in an asset pool while maintaining the option to adjust holdings quickly and cost-effectively is *most likely* a benefit to:

- A. Issuers.
- B. Investors.
- C. Economies and financial markets.

The correct answer is **B**.

Matching asset maturities to anticipated liability payout dates and increasing diversity in an asset pool while maintaining the option to adjust holdings quickly and cost-effectively is a benefit to investors, as it allows them to manage risk and optimize portfolio performance.

**A is incorrect.** While issuers benefit from securitization in various ways, this particular benefit is more relevant to investors.

**C is incorrect.** While securitization can have broader benefits for economies and financial markets, this specific benefit is more directly applicable to investors.

***CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.***

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Q.4803 Which type of asset-backed securities (ABS) remains on the balance sheet of the issuing bank, with investors receiving payments directly from the bank rather than from the cash flow generated by a specific pool of assets?

- A. Covered Bonds.
- B. Pass-through Securities.
- C. Bonds with Structural Enhancements

The correct answer is **A**.

Covered Bonds remain on the balance sheet of the issuing bank, and investors receive payments directly from the bank, not from the cash flow generated by a specific pool of assets. Covered Bonds are distinct from other ABS types because they do not involve the transfer of assets to a separate legal entity. Instead, the assets remain on the balance sheet of the issuing bank, and investors have a direct claim to the issuing bank's assets, making payments directly from the bank.

**B is incorrect.** Pass-through Securities involve investors receiving payments from the cash flow generated by a specific pool of assets.

**C is incorrect.** Bonds with Structural Enhancements redistribute cash flows in the pool across specified tranches according to a preset schedule, but investors still receive payments from the cash flow generated by the pooled assets.

Covered Bonds are distinct from other ABS types because they do not involve the transfer of assets to a separate legal entity. Instead, the assets remain on the balance sheet of the issuing bank, and investors have a direct claim to the issuing bank's assets, making payments directly from the bank.

***CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.***

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Q.4804 Which of the following is *least likely* a benefit of securitization for issuers?

- A. Enhancing profitability by collecting origination fees.
- B. Offloading illiquid assets to improve risk oversight.
- C. Increasing capital requirements for loans traded to investors.

The correct answer is **C**.

Increasing capital requirements for loans traded to investors is not a benefit of securitization for issuers. In fact, securitization often allows issuers to reduce capital requirements by transferring assets off their balance sheets.

**A is incorrect.** Enhancing profitability by collecting origination fees is a benefit of securitization.

**B is incorrect.** Offloading illiquid assets to improve risk oversight is indeed a benefit of securitization for issuers.

***CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.***

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Q.4805 Which type of asset-backed securities (ABS) involves pooling assets into a separate legal entity and distributing principal and interest payments to investors based on the cash flow generated by the assets?

- A. Covered Bonds.
- B. Pass-through Securities.
- C. Bonds with Structural Enhancements

The correct answer is **B**.

Pass-through Securities involve pooling assets into a separate legal entity and distributing principal and interest payments to investors based on the cash flow generated by the assets.

**A is incorrect.** Covered Bonds do not involve pooling assets into a separate legal entity; instead, they remain on the balance sheet of the issuing bank.

**C is incorrect.** Bonds with Structural Enhancements redistribute cash flows across specified tranches according to a preset schedule, but they still involve pooling assets into a separate legal entity.

***CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.***

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Q.4806 Which of the following is a benefit of securitization for investors?

- A. Directly managing the assets that back the securities.
- B. Tailoring interest rate and credit risk exposures.
- C. Obtaining higher returns from traditional bonds.

The correct answer is **B**.

Investors benefit from securitization by being able to tailor interest rate and credit risk exposures to suit their specific risk, return, and maturity needs. Securitization allows investors to customize their risk and return perspectives by choosing from different tranches or categories of securities, each with its credit risk level. This flexibility promotes portfolio diversification and aligns with specific investor preferences.

**A is incorrect.** Investors do not directly manage the assets that back the securities in securitization.

**C is incorrect.** Securitization may offer higher returns compared to traditional bonds, not the other way around.

***CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.***

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Q.4807 Which statement *accurately* describes the function of a Special Purpose Entity (SPE) in securitization?

- A. To provide loans directly to borrowers.
- B. To act as an intermediary between banks and borrowers.
- C. To receive pooled assets and issue securities backed by these assets to investors.

The correct answer is **C**.

A Special Purpose Entity (SPE) receives pooled assets and issues securities backed by these assets to investors in securitization.

**A is incorrect.** SPEs do not provide loans directly to borrowers.

**B is incorrect.** SPEs do not act as intermediaries between banks and borrowers; they are separate legal entities that hold pooled assets.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (a) Explain benefits of securitization for issuers, investors, economies, and financial markets.**

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Q.4808 Which party in the securitization process is primarily responsible for the administration of the loans, including collection of payments and management of loan defaulters?

- A. Seller/Originator.
- B. Special Purpose Entity (SPE).
- C. Servicer.

The correct answer is **C**.

The servicer is primarily responsible for the administration of the loans, including collection of payments and management of loan defaulters.

**A is incorrect.** The Seller/Originator's role is primarily to grant loans and sell them to the SPE.

**B is incorrect.** While the SPE issues the securities, it does not typically handle the administrative duties associated with the loans.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (b) Describe securitization, including the parties and the roles they play.**

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Q.4810 Which entity in the securitization process serves as a separate legal entity that buys loans from the originator and issues securities backed by these loans to investors?

- A. Seller/Originator.
- B. Special Purpose Entity (SPE).
- C. Servicer.

The correct answer is **B**.

The Special Purpose Entity (SPE) serves as a separate legal entity that buys loans from the originator and issues securities backed by these loans to investors.

**A is incorrect.** The Seller/Originator grants loans to customers but does not issue securities.

**C is incorrect.** The Servicer is responsible for administering the loans, not issuing securities.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (b)**  
**Describe securitization, including the parties and the roles they play.**

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Q.4811 Which document in the securitization process typically outlines the structure of the securitization, illustrating the flow of payments to different parties and describing any credit enhancements used?

- A. Purchase Agreement
- B. Bond Indenture
- C. Prospectus

The correct answer is **C**.

The Prospectus typically outlines the structure of the securitization, illustrating the flow of payments to different parties and describing any credit enhancements used.

**A is incorrect.** The Purchase Agreement details the conditions and responsibilities of the seller and the SPE regarding the assets being sold.

**B is incorrect.** The Bond Indenture is associated with bonds and not directly with the assets being sold in securitization.

**CFA Level I, Fixed Income, Learning Module 17: Fixed-Income Securitization, LOS (b)**  
**Describe securitization, including the parties and the roles they play.**

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Q.4812 Which party in the securitization process is primarily responsible for safeguarding the assets and performing duties as per the terms of the prospectus, such as holding funds due to ABS holders?

- A. Seller/Originator.
- B. Special Purpose Entity (SPE).
- C. Trustee or Trustee Agent.

The correct answer is **C**.

The Trustee or Trustee Agent is primarily responsible for safeguarding the assets and performing duties as per the terms of the prospectus, such as holding funds due to ABS holders.

**A is incorrect.** The Seller/Originator's role is primarily to grant loans and sell them to the SPE.

**B is incorrect.** While the SPE issues the securities, it does not typically handle the administrative duties associated with safeguarding the assets.

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