Question #1 of 30

Question ID: 1458650

A collateralized debt obligation (CDO) in which the collateral is a pool of residential mortgage-backed securities is *most accurately* described as a:

A) collateralized loan obligation (CLO). ✗

B) structured finance CDO. ✓

C) synthetic CDO. ✗

Explanation

In a structured finance CDO the collateral is a pool of mortgage-backed securities, asset-backed securities, or other CDOs. In a synthetic CDO the collateral is a pool of credit default swaps. In a CLO the collateral is a pool of leveraged bank loans.

(Module 45.2, LOS 45.i)

Question #2 of 30

Question ID: 1462933

Asset-backed securities (ABS) may have a higher credit rating than the seller's corporate bonds because:

A) the seller's ABS are senior to its corporate bonds. ✗

B) ABS are investment grade while corporate bonds may be speculative grade. ✗

C) they are issued by a special purpose entity. ✓

Explanation

The SPE in a securitization is bankruptcy-remote from the seller, which means the seller's creditors do not have a claim against the pool of assets underlying an ABS. As a result, the ABS may have a higher credit rating than the seller's corporate bonds.

(Module 45.1, LOS 45.b)

Question #3 of 30

Question ID: 1458648

Which of the following classes of asset-backed securities typically includes a lockout period?

A) Auto loan ABS.

B) Credit card ABS.

C) Non-agency residential MBS.

Explanation

Credit card ABS typically have a lockout period during which principal payments by credit card borrowers are used to purchase additional credit card debt, rather than paid out to the ABS holders.

(Module 45.2, LOS 45.h)

Question #4 of 30

Question ID: 1458629

Total cash flows to investors in an ABS issue are:

A) equal to the total interest and principal payments from the underlying asset pool if only one class of ABS has been issued from the trust.

B) equal to the total interest and principal payments from the underlying asset pool.

C) less than the total interest and principal payments from the underlying asset pool.

Explanation

Cash flows from the underlying asset pool are used to pay fees to the servicer as well as payments to the ABS investors. Thus payments to investors are less than the total cash flows from the pool of assets.

(Module 45.1, LOS 45.b)

Question #5 of 30

Question ID: 1458654

A covered bond that is in default if the issuer fails to make a scheduled payment is:

A) a soft-bullet covered bond.

B) a conditional pass-through covered bond.

C) a hard-bullet covered bond.

Explanation

A hard-bullet covered bond is in default if the issuer fails to make a scheduled payment. A soft-bullet covered bond may postpone the originally scheduled maturity date by as much as a year to delay default. A conditional pass-through covered bond converts to a pass-through bond on the maturity date if any payments remain due.

(Module 45.2, LOS 45.j)

Question #6 of 30

Question ID: 1458652

In contrast with most asset-backed securities (ABS), a collateralized debt obligation (CDO):

A) employs a collateral manager. ✓

B) has senior and subordinate tranches. ✗

C) is issued through a special purpose vehicle. ✗

Explanation

The feature that distinguishes a CDO is that it has a collateral manager who buys and sells securities in the collateral pool to generate cash to meet the CDO's obligations.

(Module 45.2, LOS 45.i)

Question #7 of 30

Question ID: 1458632

An asset-backed security with a senior/subordinated structure is said to have:

A) credit tranching. ✓

B) prepayment tranching. ✗

C) time tranching. ✗

Explanation

A senior/subordinated structure in an ABS establishes credit tranching, in which risk of losses due to defaults on the underlying loans is redistributed among different classes of ABS holders. Time tranching redistributes prepayment risk among different classes of ABS holders.

(Module 45.1, LOS 45.c)

Question #8 of 30

Question ID: 1458627

One of the primary benefits of securitization is that it:

A) improves the collectability of the loans that are securitized.

B) improves the legal claims of the security holders to the loans that are securitized.

C) removes problem assets from the issuing firm's balance sheet.

Explanation

Securitization reduces the cost of funding the assets. One way that is accomplished is through the transfer of the underlying financial assets to a special purpose entity so that securities holders have clear legal claim to them, something they may not have if they were to invest only in the securities of the securitizer, such as a bank. Securitization does not have improved collectability as a primary benefit. Problem loans are not good candidates for securitization because institutional investors require a minimum credit quality and even well performing loans can require internal or external credit enhancement for the securitized assets.

(Module 45.1, LOS 45.a)

Question #9 of 30

Question ID: 1458644

In a commercial mortgage-backed security (CMBS), which of the following is an example of CMBS-level call protection?

A) Prepayment lockout.

B) Residual tranche.

C) Yield maintenance charges.

Explanation

Call protection in the context of a CMBS refers to protection against prepayment risk. Structuring a CMBS with a residual (equity or first-loss) tranche provides investors in the senior tranches with CMBS-level call protection. Prepayment lockout periods and yield maintenance charges are examples of loan-level call protection because they apply to the individual loans.

(Module 45.2, LOS 45.g)

Question #10 of 30

Question ID: 1462935

The type mortgage-backed security that is *most likely* to offer significant call protection is:

A) a commercial mortgage-backed security.

B) an agency residential mortgage-backed security.

C) a non-agency residential mortgage-backed security.

Explanation

Commercial MBS typically have some type of call protection (restriction on prepayments), either in the structure of the MBS or at the loan level. Both agency RMBS and non-agency RMBS typically have no restrictions on prepayments and are subject to prepayment risk.

(Module 45.2, LOS 45.g)

Question #11 of 30

Question ID: 1462934

Extension in an agency residential mortgage-backed security is *most likely* to result from:

A) exhaustion of a support tranche.

B) a decrease in interest rates.

C) slower-than-expected prepayments.

Explanation

An agency RMBS is said to extend when prepayments of the underlying mortgages are slower than expected. A decrease in interest rates would tend to accelerate prepayments, resulting in contraction. Agency RMBS are not typically structured with tranches. Exhaustion of a support tranche is a source of extension risk for a planned amortization class of a CMO.

(Module 45.1, LOS 45.e)

Question #12 of 30

Question ID: 1458653

Compared to otherwise equivalent asset-backed securities, covered bonds offer:

A) recourse to the issuing firm.

B) higher yields.

C) lower credit quality.

Explanation

Covered bonds provide bondholders with recourse to the issuing firm, while ordinary ABS do not. This results in higher credit quality and lower yields for covered bonds than comparable ABS.

(Module 45.2, LOS 45.j)

Question #13 of 30

Question ID: 1458649

With respect to auto-loan backed ABS:

A) all of them have some sort of credit enhancement.

B) some of them have some sort of credit enhancement.

C) the underlying loans are collateralized so no credit enhancement is necessary.

Explanation

All automobile loan ABS have some sort of credit enhancement to make them attractive to institutional investors.

(Module 45.2, LOS 45.h)

Question #14 of 30

Question ID: 1458626

Securitization *least likely* benefits the financial system by:

A) increasing liquidity for mortgages and other loans.

B) increasing the amount banks are able to lend.

C) removing liabilities from bank balance sheets.

Explanation

By enabling banks to raise cash by selling their existing loans and mortgages (which are balance sheet assets for banks), securitization increases the amount banks are able to lend.

(Module 45.1, LOS 45.a)

Question #15 of 30

Question ID: 1458655

A covered bond that may postpone the originally scheduled maturity date by as much as a year to delay default is:

A) a hard-bullet covered bond.

B) a conditional pass-through covered bond.

C) a soft-bullet covered bond.

Explanation

A soft-bullet covered bond may postpone the originally scheduled maturity date by as much as a year to delay default. A hard-bullet covered bond is in default if the issuer fails to make a scheduled payment. A conditional pass-through covered bond converts to a pass-through bond on the maturity date if any payments remain due.

(Module 45.2, LOS 45.j)

Question #16 of 30

Question ID: 1458645

The pool of loans backing a commercial mortgage-backed security consists of:

A) both recourse and nonrecourse loans.

B) nonrecourse loans only.

C) recourse loans only.

Explanation

The commercial real estate loans in a CMBS pool are nonrecourse loans.

(Module 45.2, LOS 45.g)

Question #17 of 30

Question ID: 1458639

A sequential-pay CMO has two tranches. Principal is paid to Tranche S until it is paid off, after which principal is paid to Tranche R. Compared to Tranche R, Tranche S has:

A) less contraction risk and more extension risk.

B) more contraction risk and less extension risk.

C) more contraction risk and more extension risk.

Explanation

In a sequential-pay CMO the short tranche, which receives principal payments and prepayments first, has more contraction risk, while the tranche that receives principal payments and prepayments last has more extension risk.

(Module 45.1, LOS 45.f)

Question #18 of 30

Question ID: 1458642

An annualized measure of the prepayments experienced by a pool of mortgages is its:

A) conditional prepayment rate.

B) PSA prepayment benchmark.

C) single monthly mortality rate.

Explanation

The conditional prepayment rate (CPR) is an annualized measure of a mortgage pool's prepayments. The single monthly mortality rate is the percentage by which prepayments have reduced the month-end principal balance. The PSA prepayment benchmark is a monthly series of CPRs to which a mortgage pool's CPR may be compared.

(Module 45.2, LOS 45.e, 45.f)

Question #19 of 30

Question ID: 1458635

A mortgage is most attractive to a lender if the loan:

A) has a prepayment penalty.

B) is convertible from fixed-rate to adjustable-rate.

C) is non-recourse.

Explanation

Prepayment penalties are attractive to a lender because borrowers are most likely to prepay when interest rates have decreased (i.e., when the lender will earn a lower return by reinvesting prepaid principal). Recourse loans are more favorable to the lender than non-recourse loans because with a non-recourse loan the lender can only reclaim the collateral in the event of default, while recourse gives the lender a claim against the borrower's other assets. The conversion option in a convertible mortgage is held by the borrower and is therefore attractive to a borrower rather than a lender.

(Module 45.1, LOS 45.d)

Question #20 of 30

Question ID: 1458640

Which of the following statements concerning the support tranche in a planned amortization class (PAC) CMO backed by agency RMBS is *least accurate*?

A) The purpose of a support tranche is to provide prepayment protection for one or more PAC tranches.

B) If prepayments are too low to maintain the scheduled PAC payments, the shortfall is provided by the support tranche.

C) The support tranches are exposed to high levels of credit risk.

Explanation

The support tranches are exposed to high levels of prepayment risk, not credit risk.

(Module 45.2, LOS 45.e, 45.f)

Question #21 of 30

Question ID: 1458651

A synthetic collateralized debt obligation (CDO) is backed by a pool of:

A) credit default swaps.

B) leveraged bank loans.

C) other CDOs.

Explanation

A synthetic CDO is backed by a pool of credit default swaps. Collateralized loan obligations (CLOs) are backed by a pool of leveraged bank loans. CDOs backed by a pool of other CDOs are an example of structured finance CDOs.

(Module 45.2, LOS 45.i)

Question #22 of 30

Question ID: 1458630

The special purpose entity (SPE) in a securitization is:

A) a joint venture partner of the seller.

B) a subsidiary of the seller.

C) an entity independent of the seller.

Explanation

The SPE in a securitization must be a legal entity independent of the seller so that the seller's creditors do not have a claim against the securitized assets.

(Module 45.1, LOS 45.b)

Question #23 of 30

Question ID: 1458646

When evaluating the loans backing a commercial mortgage-backed security based on credit ratios, which of the following *most likely* indicate better credit quality?

A) Lower debt-service coverage ratios and higher loan-to-value ratios.

B) Higher debt-service coverage ratios and lower loan-to-value ratios.

C) Higher debt-service coverage ratios and higher loan-to-value ratios.

Explanation

Higher debt service coverage ratios typically indicate better credit quality because they suggest the borrowers have more income from which to pay interest and principal on their debts. Lower loan-to-value ratios typically indicate better credit quality because they indicate that the borrowers are less leveraged.

(Module 45.2, LOS 45.g)

Question #24 of 30

Question ID: 1458633

A renegotiable mortgage has a fixed interest rate that:

A) changes to a different fixed rate during its life.

B) changes to a variable rate during its life.

C) the borrower may change to a variable rate.

Explanation

A *renegotiable* or *rollover* mortgage has an initial fixed-rate period after which the interest rate changes to another fixed rate. A *hybrid* mortgage has an initial fixed-rate period after which the interest rate changes to a variable rate. A *convertible* mortgage may be changed from fixed-rate to variable-rate or from variable-rate to fixed-rate at the borrower's option.

(Module 45.1, LOS 45.d)

Question #25 of 30

Question ID: 1458636

An agency RMBS pool with a prepayment speed of 50 PSA will have a weighted average life that is:

A) greater than its weighted average maturity.

B) less than its weighted average maturity.

C) equal to its weighted average maturity.

Explanation

Weighted average life of a mortgage pool is less than its WAM if there are any prepayments. "50 PSA" means the prepayment speed is assumed to be 50% of the Public Securities Association prepayment benchmark.

(Module 45.1, LOS 45.e)

Question #26 of 30

Question ID: 1458641

The primary motivation for investing in the support tranche of a planned amortization class CMO, compared to investing in another tranche, is that the support tranche offers:

A) a higher interest rate.

B) more protection against contraction risk.

C) more protection against extension risk.

Explanation

In a planned amortization class (PAC) CMO, the support tranches have more extension risk and more contraction risk than the PAC tranches. Because of these higher risks, the support tranches offer a higher interest rate than the PAC tranches.

(Module 45.2, LOS 45.e, 45.f)

Question #27 of 30

Question ID: 1458637

A mortgage-backed security has a pass-through rate of 4.3%. The average interest rate on its underlying pool of mortgages is 4.5%. The difference between these rates is *most likely* due to:

A) faster-than-expected prepayments.

B) issuance and servicing costs.

C) slower-than-expected prepayments.

Explanation

Pass-through (i.e., coupon) rates on an MBS are less than the average interest rate on its underlying pool of mortgages because some of the cash flows from the mortgages are used to pay issuance costs and fees to the servicer of the mortgages.

(Module 45.1, LOS 45.e)

Question #28 of 30

Question ID: 1458643

An investor in mortgage-backed securities who is concerned about extension risk but willing to accept contraction risk should *most appropriately* invest in:

A) agency residential mortgage-backed securities.

B) planned amortization class collateralized mortgage obligations.

C) sequential-pay collateralized mortgage obligations.

Explanation

In a sequential-pay CMO, the early tranches are more exposed to contraction risk, and the later tranches are more exposed to extension risk. PAC securities limit both contraction and extension risk for a range of prepayment rates. Mortgage pass-through securities, such as agency residential MBS, do not reallocate contraction and extension risk among bondholders.

(Module 45.2, LOS 45.f)

Question #29 of 30

Question ID: 1462932

Which of the following is *least likely* a benefit of securitization?

A) Reducing funding costs.

B) Removing liabilities from the balance sheet.

C) Increasing the liquidity of balance sheet assets.

Explanation

Financial assets are securitized, not liabilities.

(Module 45.1, LOS 45.a)

Question #30 of 30

Question ID: 1458634

Strategic default by a mortgage borrower is *most likely* if the loan is:

A) non-amortizing.

B) non-conforming.

C) non-recourse.

Explanation

If a mortgage is a non-recourse loan, the lender has no claim against the borrower's assets other than the collateral for the loan. If the value of the collateral has decreased significantly below the remaining principal on a non-recourse loan, the borrower has an incentive to engage in "strategic default" and surrender the collateral to the lender.

(Module 45.1, LOS 45.d)