

1. Correct Answer: A.

The lower and upper PSA prepayment assumptions are called the “initial PAC collar”. If the prepayment speed is slower than lower limit of initial collar, the support tranche receives a lower level of prepayments, even no cash flow received and the PAC tranche also receives a lower level of prepayments. The average life of the support tranche and the PAC tranche will extend (lengthen).

2. Correct Answer: B

Many commercial loans backing commercial mortgage-backed securities (CMBS) are balloon loans that require significant repayment of principal at maturity. The risk that the borrower will not be able to make the balloon payment is called balloon risk. The lender may decide to extend the loan over a period of time called the workout period. Because the term of the loan can be extended, balloon risk is a type of extension risk.

A is incorrect because shorter-term tranches in a CMO structure have less extension risk than longer-term tranches.

C is incorrect because planned amortization class tranches in a CMO structure offer investors reduction in both extension and contraction risk.

3. Correct Answer: A.

Non-agency RMBS are credit enhanced, either internally or externally. The most common forms of internal credit enhancements are senior/subordinate structures, reserve funds, and overcollateralization. Conforming mortgages are used as collateral for agency (not non-agency) mortgage pass-through securities. An agency RMBS, rather than a non-agency RMBS, issued by a GSE (government sponsored enterprise), is guaranteed by the respective GSE.

B is incorrect because non-conforming (not conforming) mortgages are used as collateral for non-agency mortgage pass-through securities. To be included in a pool of loans backing an agency RMBS, it must meet specified underwriting standards. If a loan satisfies the underwriting standards for inclusion as collateral for an agency mortgage-backed security, it is called a conforming mortgage. If a loan fails to satisfy the underwriting standards, it is called a nonconforming loan.

C is incorrect because an agency RMBS, rather than a non-agency RMBS, issued by a GSE (government sponsored enterprise), is guaranteed by the respective GSE. The RMBS issued by GSEs are those issued by Fannie Mae (previously referred to as the Federal National Mortgage Association) and Freddie Mac (previously referred to as the Federal Home Loan Mortgage Corporation).

4. Correct Answer: A.

Because commercial mortgage loans are non-recourse loans, the lender can only look to the income-producing property backing the loan for interest and principal repayment. If there is a

default, the lender looks to the income-producing property backing the loan for interest and principal repayment. If there is a default, the lender looks to the proceeds from the sale of the property for repayment and has no recourse against the borrower for any unpaid mortgage loan balance.

5. Correct Answer: B.

Unlike a traditional asset-backed security, an arbitrage collateralized debt obligation involves active management because the CDO manager buys and sells debt obligations with the objective of paying off different classes of bondholders as well as generating a high return for the subordinated/equity tranche and the manager.

A is incorrect because both arbitrage collateralized debt obligations and traditional asset-backed securities involve the pooling of debt obligations.

C is incorrect because both arbitrage collateralized debt obligations and traditional asset-backed securities involve the creation of a special purpose entity.