Topic 7 - The Credit Crisis of 2007

Test ID: 8450895

Question #1 of 5

Question ID: 495079

Regarding the role of incentives in the outcomes of the recent credit crisis, which of the following actions could potentially lead to agency costs?

I. When the incentives of mortgage market participants do not align.
II. When traders are awarded with an employee compensation arrangement.

✗ **A)** **II only.**

✓ **B)** Both I and II.

✗ **C)** Neither I nor II.

✗ **D)** I only.

Explanation

Incentives describe the differing motivations of players in structured product creation. When incentives do not align, it is known as an agency cost. Employee compensation arrangements also contributed to another form of agency cost.

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Question ID: 495076

One of the main factors that contributed to the credit crisis of 2007 to 2009 was relaxed lending standards. Which of the following terms relates specifically to a lack of vetting of the accuracy of an applicant's information?

✓ **A)** **Liar loans.**

✗ **B)** Adjustable rate mortgages.

✗ **C)** NINJA borrowers.

✗ **D)** Teaser rates.

Explanation

In the period leading up to the credit crisis, liar loans (no vetting of the accuracy of an applicant's information) and NINJA borrowers (no income, no job, no assets) became common. It was also typical for lenders to offer adjustable rate mortgages (ARMs) with teaser rates that were very low for the first few years before the rates increased significantly in later years.

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Question ID: 495080

All of the following statements accurately describe a lesson learned from the 2007 to 2009 credit crisis except:

✗ **A)** **resecuritization results in investments that have risks that tend to exceed their expected returns.**

✗ **B)** traditional correlations can break down during periods of crisis, and default correlations can increase.

✓ **C)** investors should rely more on the analysis of rating agencies rather than conducting their own analysis.

✗ **D)** investments that initially appear to be good investments may be poor investments after further scrutiny.

Explanation

One lesson learned from the credit crisis suggests that investors should conduct their own analyses rather than solely rely on ratings provided by rating agencies.

Question #4 of 5

Question ID: 495078

Regarding the tranches of asset-backed securities (ABS) and ABS collateralized debt obligations (CDO), the more removed a new structured investment is from the original investment:

✓ **A)** **the riskier the tranches, especially the senior tranche.**

✗ **B)** the more investors would prefer lower yielding bonds.

✗ **C)** the more mortgages will default leading to increases in principal and interest cash flows.

✗ **D)** the less risky the tranches, especially the equity tranche.

Explanation

The more removed a new structured investment is from the original investment, the riskier the tranches, especially the senior tranche, despite all senior tranches having been assigned a very high rating (e.g., AAA).

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Question ID: 495077

From a risk perspective, which of the following asset-backed security (ABS) tranches will most likely absorb the first losses in the ABS asset pool?

✗ **A)** **Mezzanine tranche.**

✗ **B)** Senior tranche.

✓ **C)** Equity tranche.

✗ **D)** Super-senior tranche.

Explanation

From a risk perspective, the equity tranche has the highest risk and will absorb the first losses in the ABS asset pool.