Introduction to Asset-Backed Securities & Credit Analysis

Test ID: 7441716

Question #1 of 131

Question ID: 463937

Principal-only strips are:

✓ **A) sold at a considerable discount to par.**

✗ **B)** sold at par.

✗ **C)** could be sold at a discount or a premium, depending on economic conditions.

Explanation

Principal-only strips are sold at a considerable discount to par.

Question #2 of 131

Question ID: 463881

Prepayments or curtailments:

✓ **A) will reduce the amount of interest the lender receives over the life of the loan.**

✗ **B)** will increase the amount of interest the lender receives over the life of the loan.

✗ **C)** cause the duration of the original mortgage to lengthen or increase.

Explanation

Prepayments or curtailments will reduce the amount of interest the lender receives over the life of the loan.

Question #3 of 131

Question ID: 463911

What is the relation between the PSA prepayment benchmark and the conditional prepayment rate (CPR)? The PSA prepayment benchmark is:

✗ **A) not related to the CPR.**

✓ **B)** expressed as a monthly series of CPR's.

✗ **C)** expressed as an annual series of CPR's.

Explanation

The PSA prepayment benchmark is expressed as a monthly series of CPR's that increase over the life of the liabilities.

Question #4 of 131

Question ID: 463941

When assessing credit risk for a Commercial Mortgage-Backed Security (CMBS), the underwriter will complete which of the following financial analysis?

✗ **A)** **Compute a weighted debt service coverage ratio (DSC ratio) for the overall portfolio.**

✗ **B)** Compute the DSC ratio for each property in the CMBS.

✓ **C)** Both of the answer choices are correct.

Explanation

Financial analysis of the DSC ratio for each property in the CMBS and analysis of the DSC ratio for the overall portfolio are both completed by the underwriter when assessing credit risk for a CMBS.

Question #5 of 131

Question ID: 463973

Which of the following statements concerning the early amortization trigger for a credit card receivable-backed security is CORRECT? An early amortization trigger leads to:

✓ **A)** **credit card tranches being retired sequentially.**

✗ **B)** partial default.

✗ **C)** the principal payments made by credit card holders being reinvested in receivables.

Explanation

The most frequent trigger is when the 3-month average excess spread earned on the receivables falls to zero or less. When this happens, prepayments are used to retire credit card tranches sequentially, instead of using them to purchase more receivables.

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Question ID: 463879

Which of the following mortgage loan characteristics *least likely* affects prepayments?

✓ **A)** **reputation of the lender with the agencies (e.g., Fannie Mae, Ginnie Mae).**

✗ **B)** type of loan (e.g., 30-year fixed rate, 15-year variable).

✗ **C)** original mortgage rate.

Explanation

The reputation of the lender does not affect prepayments.

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Question ID: 463860

Alan Barding is a bank analyst currently reviewing data on the credit scores of 3 individuals who have applied for a bank loan. The credit scores for the 3 individuals are shown below:

Individual	Credit score
A	700

B	440
C	350

Which of the following conclusions is Barding *least likely* to draw?

✓ **A)** **Individual C is twice as likely to default as individual A.**

✗ **B)** Individual B is less likely to default than individual C.

✗ **C)** Individual A has a lower credit risk than individual B.

Explanation

Credit scores are ordinal rankings. Individual C is more likely to default than individual A, but it cannot be concluded that A is twice as likely.

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Question ID: 463883

Which of the following *best* describes how a growing economy can affect prepayments? A growing economy:

✓ **A)** **leads to increasing prepayments.**

✗ **B)** does not affect prepayments.

✗ **C)** leads to decreasing prepayments.

Explanation

The reason for this link is as follows: A growing economy leads to a rise in personal income and opportunities for worker migration and mobility. This results in higher housing turnover and therefore increasing prepayment rates.

Question #9 of 131

Question ID: 415450

Which of the following is *least likely* an example of external credit enhancements?

✓ **A)** **Excess spread.**

✗ **B)** Letters of credit.

✗ **C)** Bank guarantees.

Explanation

Excess spread is an example of internal, not external credit enhancement.

Question #10 of 131

Question ID: 463915

Regarding prepayment rates, which of the following statements is *least* accurate?

✗ **A)** **The conditional prepayment rate (CPR) is the assumed rate at which the mortgage pool balance is prepaid.**

✓ **B)** The conditional prepayment rate (CPR) is the actual rate at which the mortgage pool balance is prepaid.

✗ **C)** If the conditional prepayment rate (CPR) is converted into a monthly rate, it is called the single monthly mortality rate (SMM).

Explanation

CPR is the assumed rate at which the mortgage pool balance is prepaid, not the actual rate at which it is prepaid.

Questions #11-16 of 131

Financial consultant George Price advises high-net-worth individuals on income investments. His firm, Price Enterprises, specializes in asset-backed securities (ABS). Price's son-in-law, Roger Camby, also works for the firm. Price and Camby do not get along well, and they often engage in heated arguments in the office.

On a certain morning, Price and Camby are arguing about which asset-backed securities (ABS) to purchase. Over the last two weeks, Price Enterprises signed up a half-dozen new clients and received several million in new funds from existing clients, and the company needs some new ideas for the portfolios.

Camby is excited about a new ABS issued by a large retailer, Glendo's. The ABS reflects a bundle of nonamortizing consumer credit accounts. As usual, Price prefers a different option, in this case a new collateralized mortgage obligation (CMO) issued by Trident Mortgage. Both securities offer similar total return potential and seem reasonably valued. Both Camby and Price believe the other analyst's preferred securities are too risky.

Unable to come to an agreement about which ABS to purchase, Camby and Price return to an old topic of discussion, the merits of collateralized debt obligations, (CDOs). Both analysts agree on the benefits of CDOs, which allow investors to profit off the spread between return on collateral and the cost of funding. But they disagree on the best strategy for constructing a CDO. Price prefers a simple cash CDO and criticizes Camby for his preference for more complicated synthetic securities. Camby argues that synthetic CDOs offer several advantages over cash CDOs:

- It is cheaper to purchase exposure to an asset through a swap than to purchase the asset directly.
- Only the senior section must be funded.
- It takes less time to assemble the portfolio.
- A bank can use a synthetic CDO to take debt off the balance sheet without the consent of borrowers.

Bindle Bonds, a consultancy that sets up payment structures for entities that wish to issue asset-backed securities, has a referral relationship with Price Enterprises. Just before lunch, Bindle sales director Marty Malkin calls Price to offer him a piece of a new ABS comprised of thousands of home-improvement loans. Price likes the interest rates and the senior/subordinated structure that contains several junior tranches and senior tranches. But during his analysis of the default and prepayment projections, Price becomes concerned that Bindle is underestimating the risks. In response to Price's concerns, Malkin explains that the ABS has a shifting-interest mechanism designed to limit risk for the senior tranches.

After Price agrees to invest in the new Bindle ABS, he and Camby go to lunch. As they wait for their food, they discuss an investment a colleague pitched to Camby that morning. The ABS issuer used a conditional prepayment rate to estimate prepayment risks. According to the issuer's model, prepayment risks are modest, in part because refinancing is not a major concern with the underlying securities. The underlying securities are fixed-rate loans, and their default risk is fairly high. One benefit of the securities is the fact that principal payments are immediately passed on to investors.

Immediately after Price and Camby return from lunch, Kay Peterson, a longtime client of Price Enterprises, comes into the office with questions about investing in the mortgage securities market. Price and Camby agree that this is an excellent time for Peterson to enter the MBS market, but disagree which mortgage securities would be best. Price believes Peterson's best alternative would be a commercial MBS. Price makes the following arguments for CMBS:

- There are currently plenty of attractive CMBS, evident by their low debt-to-service coverage ratios and low loan-to-value ratios.
- Contraction risk on a CMBS can be substantially lower than on a residential MBS due to prepayment lock out periods and yield maintenance charges.

Camby, however, disagrees with his father-in-law. He suggests that Peterson should invest in residential MBS, citing the following reasons:

- Residential MBS have more certain cash flows than a CMBS because you can rely on their government-backed guarantee.
- Residential MBS have more reliable collateral than CMBS, due to the fact that CMBS are structured with defeasance clauses which act to lower the credit quality of the underlying loan pool.

Question #11 of 131

Question ID: 464001

What affect will the shifting-interest mechanism connected to the ABS backed by home-improvement loans have on the senior tranches?

	Credit Risk?	Prepayment Risk?
✗ **A)**	**Increase**	**Reduce**
✓ **B)**	Reduce	Increase
✗ **C)**	Reduce	Reduce

Explanation

Shifting-interest mechanisms reduce the proportional share of the outstanding loan balance in junior tranches as prepayments occur. This has the effect of reducing credit risk for the senior tranches but increasing their prepayment risk. (Study Session 13, LOS 42.d)

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Question ID: 464002

The ABS Price and Camby discussed at lunch is most likely backed by:

✗ **A)** **Small Business Administration (SBA) loans.**

✓ **B)** auto loans.

✗ **C)** home-equity loans.

Explanation

The low prepayment risk eliminates home-equity loans, which have a high prepayment risk. The fact that the loans have a fixed interest rate suggests they are not SBA loans, most of which have a variable rate. That leaves auto loans, and the characteristics of the ABS presented in the vignette can all apply to auto-loan-backed securities. (Study Session 13, LOS 42.e)

Question #13 of 131

Question ID: 464003

Which of Camby's statements about the advantage of synthetic CDOs is *least* accurate?

✗ **A)** **It is cheaper to purchase exposure to an asset through a swap than to purchase the asset directly.**

✓ **B)** Only the senior section must be funded.

✗ **C)** A bank can use a synthetic CDO to take debt off the balance sheet without the consent of borrowers.

Explanation

For a synthetic CDO, only the junior section must be funded. The other statements are accurate. (Study Session 13, LOS 42.f)

Question #14 of 131

Question ID: 464004

Camby's preference for Glendo's bonds suggests he is *most likely* concerned about:

✓ **A)** **prepayment risk.**

✗ **B)** credit risk.

✗ **C)** interest-rate risk.

Explanation

We have little information about Glendo and Trident bonds. All we know is that Glendo's ABS is backed by consumer credit accounts, while the Trident securities are backed by mortgage loans. Most ABS backed by consumer-credit accounts have a revolving structure; during the lockout period, any prepayments will be invested in new loans. As such, the Glendo's ABS probably has less prepayment risk than the Trident ABS. We don't know enough about the loans to conclude anything about their credit or interest-rate risk. But the difference in prepayment risk is apparent. Camby's preference for Glendo's suggest he wants to avoid prepayment risk. (Study Session 13, LOS 42.b)

Question #15 of 131

Question ID: 464005

With regard to statements made by Price concerning the reasons why Peterson should invest in commercial MBS:

✓ **A)** **only one statement is correct.**

✗ **B)** both statements are correct.

✗ **C)** both statements are incorrect.

Explanation

Only one of Price's statements is correct regarding commercial MBS. He is correct that contraction risk on a CMBS can be lowered by adding prepayment lock out periods and yield maintenance charges, as well as other loan-level call protections such as defeasance and prepayment penalty points. Price is incorrect to state that a low debt-to-service coverage ratio makes a CMBS attractive. A high debt-to-service coverage ratio and low loan-to-value ratio are better for lenders. (Study Session 15, LOS 48.l)

Question #16 of 131

Question ID: 464006

With regard to statements made by Camby concerning the reasons why Peterson should invest in residential MBS:

✗ **A)** **only one statement is correct.**

✓ **B)** both statements are incorrect.

✗ **C)** both statements are correct.

Explanation

Camby is incorrect in stating residential MBS have more certain cash flows than a CMBS because you can rely on their government-backed guarantee. Although it is true that government agency issued MBS do come with a pseudo-governmental guarantee, many residential MBS are non-agency issued, meaning they are issued by private entities and do not come with a government guarantee.

Camby's statement regarding a CMBS defeasance clause is incorrect. If the borrower makes early payments on the mortgage loan, the mortgage loan can be defeased, which means the loan proceeds are received by the loan servicer and invested in U.S. Treasury securities, essentially creating cash collateral against the loan. Treasuries provide higher-quality collateral than the underlying real estate, so loans structured with defeasance increase the credit quality of a CMBS loan pool. (Study Session 15, LOS 48.l)

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Question ID: 463954

Identify three risks associated with investing in mortgage-backed securities (MBS). Risks associated with investing in MBS are:

✓ **A) interest rate risk, default risk, and prepayment risk.**

✗ **B)** interest rate risk, contraction risk, and servicing fee risk.

✗ **C)** extension risk, credit risk, and downgrade risk.

Explanation

A mortgage is a loan that is collateralized with a specific piece of real property, either residential or commercial. The borrower must make a series of mortgage payments over the life of the loan, and the lender has the right to "foreclose" or lay claim against the real estate in the event of a loan default. An MBS represents a claim against a pool of mortgages. The cash flows from the pool are distributed amongst the holders of all the MBS as per the terms of the issue.

Risks associated with investment in MBS:

- Interest rate risk−changes in the value of the MBS as interest rates change (usually inverse).
- Default risk−risk that some or all of the borrowers default and the collateral is not enough to cover the entire mortgage.
- Prepayment risk−risk that the borrowers prepay as interest rates decline.

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Question ID: 463870

Which of the following *best* describes a stripped mortgage-backed security (MBS)? A stripped MBS is a security:

✓ **A) whose distribution of principal and interest has been altered from a pro rata distribution to an unequal distribution.**

✗ **B)** whose distribution of principal and interest has been altered from an unequal distribution to a pro rata distribution.

✗ **C)** that provides no interest payments.

Explanation

With a passthrough security, interest and principal payments generated by the underlying mortgage pool are allocated to the bondholders on a pro rata basis. This means that each passthrough certificate holder receives the same amount of interest and the same amount of principal. Stripped mortgage-backed securities differ in that principal and interest are not allocated on a pro rata basis.

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Question ID: 460699

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

✗ **A)** **PSA prepayment benchmark.**

✓ **B)** conditional prepayment rate.

✗ **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.

Question #20 of 131

Question ID: 463943

Which of the following is the primary difference between residential Mortgage-Backed Securities (MBS) and Commercial Mortgage-Backed Securities (CMBS) credit risk?

✗ **A)** **Residential credit risk does not use financial ratio analysis for the determination of borrower credit worthiness.**

✗ **B)** Residential credit risk is difficult to quantify because of the nature of the residential borrower.

✓ **C)** In residential MBS securities, the lender has the ability to seek repayment from the borrower beyond the value of the collateral.

Explanation

All CMBS mortgages are non-recourse loans; however, the residential mortgage lender can go back to the borrower personally in an attempt to repay a delinquent mortgage loan.

Question #21 of 131

Question ID: 460701

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)** **more protection against extension risk.**

✓ **B)** a higher interest rate.

✗ **C)** more protection against contraction 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.

Question #22 of 131

Question ID: 463902

Which of the following *most accurately* describes a mortgage passthrough security?

✗ **A)** **An option on a pool of mortgages.**

✗ **B)** A security that pays off the full amount of the mortgage if the borrower defaults.

✓ **C)** A participation certificate in a pool of mortgages.

Explanation

A mortgage passthrough security represents a claim against a pool of mortgages. Any number of mortgages may be used to form the pool, and any mortgage included in the pool is referred to as a securitized mortgage.

Question #23 of 131

Question ID: 463971

How is the principal retired when an early amortization provision is triggered? It is retired by:

✗ **A)** **reinvesting credit card borrowers' principal payments in receivables.**

✗ **B)** maturing credit card receivable-backed securities immediately.

✓ **C)** paying credit card borrowers' principal payments directly to investors without using them to purchase more receivables.

Explanation

When early amortization occurs, the credit card tranches are retired sequentially. This is accomplished by paying prepayments to investors instead of using them to purchase more receivables.

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Question ID: 463882

Which of the following factors does NOT affect prepayments?

✗ **A)** **Characteristics of the underlying mortgage pool.**

✓ **B)** Defeasance.

✗ **C)** Housing turnover.

Explanation

Defeasance is a type of call protection used in commercial loans.

Question #25 of 131

Question ID: 463919

The average life of a mortgage-backed security (MBS) is a more relevant measure than a security's maturity. It represents the average time to receipt of:

✗ **A)** **expected prepayments.**

✗ **B)** scheduled principal payments.

✓ **C)** both scheduled principal payments and expected prepayments.

Explanation

The average life of an MBS represents the average time to receipt of both scheduled principal payments and expected prepayments.

Question #26 of 131

Question ID: 463952

Which of the following is the *best* description of excess servicing spread accounts as an internal credit enhancement? Excess servicing spread accounts involve the allocation of:

✓ **A)** **excess cash into a separate reserve account after paying out coupon, servicing fee and other expenses.**

✗ **B)** all expenses into a separate reserve account.

✗ **C)** the servicing fee into a separate reserve account.

Explanation

All excess cash is paid into the excess servicing spread account in order to be used to pay for possible future losses.

Question #27 of 131

Question ID: 463925

Prepayment tranching refers to:

✗ **A)** **subdividing a corporate bond so some components pay earlier coupon payments than others.**

✓ **B)** subdividing an asset or mortgage backed security so some components are exposed to more prepayment risk than others.

✗ **C)** subdividing a corporate bond so some components pay coupon and others pay principal.

Explanation

Prepayment tranching refers to when an asset or mortgage backed security is subdivided so some components are exposed to more prepayment risk than others.

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Question ID: 463974

The cash flows from mortgage-backed and some asset-backed securities are:

✗ **A)** **virtually free of prepayment risk.**

✓ **B)** interest rate path dependent.

✗ **C)** interest rate path independent.

Explanation

The cash flows from mortgage-backed and some asset-backed securities are interest-rate path dependent.

Question #29 of 131

Question ID: 463995

A collateralized debt obligation (CDO) is an asset that is *least likely* to be backed by which of the following types of debt obligations:

✗ **A) bank loans to corporations.**

✗ **B)** non-investment grade corporate bonds.

✓ **C)** investment grade corporate bonds.

Explanation

A CDO is an asset-backed security (ABS) that is collateralized by a pool of debt obligations comprising below investment grade corporate bonds, corporate loans advanced by commercial banks, and bond issues in emerging markets. Investment grade bonds are not typically an underlying asset in CDOs.

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Question ID: 463989

Two structures of collateralized mortgage obligations (CMO) are being considered. In the first structure, $300 million of pass-throughs will be used as collateral for two sequential-pay tranches: $225 million of bonds of tranche U and $75 million of bonds of tranche V. The principal for tranche U must be completely paid off before any payments are made to tranche V. In the second structure, the $300 million of pass-throughs will be used as collateral for $225 million of X bonds in a planned amortization tranche and $75 million of Y bonds in a support tranche. Which of the following is *least* accurate? The:

✓ **A) U bonds have less contraction risk than the V bonds.**

✗ **B)** U bonds have less extension risk than the V bonds.

✗ **C)** X bonds have less contraction risk than the Y bonds.

Explanation

The U bonds have less extension risk, but they provide protection for the V bonds against contraction.

Question #31 of 131

Question ID: 460704

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

✓ **A) structured finance CDO.**

✗ **B)** collateralized loan obligation (CLO).

✗ **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.

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Question ID: 463962

Suppose that the collateral for an asset-backed securities (ABS) structure has a gross weighted average coupon of 10.5%. The servicing fee is 50 basis points. The tranches issued have a weighted average coupon rate of 8.5%. What is the excess servicing spread?

✗ **A) 2.50%.**

✓ **B)** 1.50%.

✗ **C)** 1.00%.

Explanation

The excess servicing spread is determined as follows:

Gross weighted average coupon	= 10.50%
−Servicing fee	= 0.50%
Spread available to pay tranches	= 10.00%
−Net weighted average coupon	= 8.50%
Excess servicing spread.	= 1.50% = 150 bps.

Question #33 of 131

Question ID: 463928

Which of the following is NOT a feature of an asset-backed security backed by non-amortizing assets?

✗ **A) A call provision can be triggered when collateral reaches a certain level.**

✗ **B)** During a lockout period, principal payments are not distributed to the bondholders.

✓ **C)** The composition of the underlying loans does not change.

Explanation

In an asset-backed security backed by non-amortizing assets (e.g. credit cards), the composition of loans in the pool will change. During the lockout period, principal payments are not distributed to bondholders. Instead, new loans are purchased and this structure is referred to as a revolving structure. However, the retirement of principal (i.e. a call provision) in a revolving structure can be triggered by several different events. These events include a specific date, when the collateral falls below a certain level, or when cumulative losses in the collateral reach a certain level.

Question #34 of 131

Question ID: 460702

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.

Question #35 of 131

Question ID: 415451

Which of the following is a general problem associated with external credit enhancements? External credit enhancements:

✓ **A)** **are subject to the credit risk of the third-party guarantor.**

✗ **B)** are only available on a short-term basis.

✗ **C)** are very long-term agreements and are therefore relatively expensive.

Explanation

If the guarantor is downgraded, the issue itself could be subject to downgrade even if the structure is performing as expected.

Question #36 of 131

Question ID: 463890

Prepayments cause the timing and amount of cash flows from mortgage loans and mortgage-backed securities (MBS) to be uncertain. Thus:

✗ **A)** **the rate of prepayments is important to valuing the passthrough securities but is impossible to estimate.**

✓ **B)** the analyst must make specific assumptions about the rate at which prepayments of the pooled mortgages occurs when valuing the passthrough securities.

✗ **C)** regulators mandate the convention firms must use when estimating prepayment rates.

Explanation

The analyst must make specific assumptions about the rate at which prepayments of the pooled mortgages occur when valuing the passthrough securities.

Question #37 of 131

Question ID: 463874

Which of the following types of assets are *least likely* to be securitized as asset-backed securities (ABS)?

✗ **A)** **Home equity lines of credit.**

✗ **B)** Auto loans.

✓ **C)** Insurance policies.

Explanation

Insurance policies are not assets securitized in ABS structures. Home equity lines of credit and auto loans are often securitized.

Question #38 of 131

Question ID: 463936

How is the price of an interest-only mortgage strip affected by declining mortgage rates in the market below the contract rate? The price of the interest-only strip:

✓ **A) decreases.**

✗ **B)** may increase or decrease.

✗ **C)** increases.

Explanation

When mortgage rates decline, prepayments are expected to increase. This results in a deterioration of the expected cash flows from an interest-only strip.

Question #39 of 131

Question ID: 463865

Which of the following is *most likely* a weakness of reduced form models?

✓ **A) Hazard rate estimation procedures predict future defaults using historic information.**

✗ **B)** The model assumes that a company's equity trades in frictionless markets.

✗ **C)** The model's credit risk changes with the business cycle.

Explanation

Unless the model is properly back tested and formulated, the use of historical data may not be appropriate for predicting the future. Only a single issue of zero coupon debt is assumed to trade under the reduced form models. Under reduced form models, the credit risk is allowed to change with business cycle. This is however, an advantage. There is no requirement that the company's equity is traded.

Question #40 of 131

Question ID: 463886

Payments in excess of the required monthly payment amount are called:

✗ **A) mega-payments.**

✗ **B)** passthroughs.

✓ **C)** prepayments.

Explanation

Payments in excess of the required monthly payment amount are called prepayments.

Question #41 of 131

Question ID: 463873

Carco Motor Company is an automobile manufacturer that is in the process of creating asset-backed securities (ABS) by utilizing a pool of loans from cars the company had financed for its customers and selling them to a separate legal entity. The issuer of the ABS is also referred to as:

✓ **A)** **a special purpose vehicle.**

✗ **B)** the servicer.

✗ **C)** the seller.

Explanation

A special purpose vehicle (SPV) is established for each securitization of loans. The loans are sold to the SPV, which in turn is the entity which issues the ABS.

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Question ID: 460700

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)** **more contraction risk and less extension risk.**

✗ **B)** more contraction risk and more extension risk.

✗ **C)** less 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.

Question #43 of 131

Question ID: 463935

Interest only (IO) strip cash flow:

✗ **A)** **starts out small and gets bigger over time.**

✓ **B)** starts out big and gets smaller over time.

✗ **C)** are the same throughout the life of the security.

Explanation

IO strip cash flow starts out big and gets smaller over time.

Question #44 of 131

Question ID: 463872

Which of the following statements regarding the basic structure of an asset-backed security (ABS) is *least* accurate?

✗ A) **The flow of funds from the underlying loan, through the servicer and issuer and finally to the investor, is called the waterfall.**

✓ B) The seller and the servicer of the ABS are always the same entity.

✗ C) Corporate bonds and emerging market bonds can be collateralized to create an ABS.

Explanation

The two separate functions of seller and servicer of an ABS can be performed by either two different entities or the same entity.

Questions #45-50 of 131

Jim Metabo, Senior Analyst with Pearl Partners, is evaluating an asset-backed security (ABS) for inclusion in client portfolios. The master prospectus establishes the shifting interest mechanism for this ABS in accordance with Table 1.

Table 1	
Senior Prepayment Percentage	
Years after Issuance	*Senior Prepayment Percent*
1-5	100
6	70
7	60
8	40
9	20
after year 9	0

The structure for the ABS is:

Senior tranche	$190 million
Subordinated tranche 1	$20 million
Subordinated tranche 2	$10 million

The value of the collateral for the structure is $220 million and subordinated tranche 2 is the first loss tranche. This ABS is wrapped and 10% of the securitization is guranteed by a third party monoline insurer.

Data about the weighted average coupon rates for the structure is as follows:

Gross WAC	7.00%
Servicing and other fees	0.25%
Net WAC	6.25%

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Question ID: 463964

In accordance with the senior repayment percentage presented in Table 1, if prepayments in month 110 are $5 million the senior tranche is paid:

✓ **A) $0 million.**

✗ **B)** $5 million.

✗ **C)** $1 million.

Explanation

If prepayments in month 110(which is beyond the 9th year) total $5 million, the amount paid to the senior tranche in accordance with Table 1 ("senior prepayment percentage") is 0.00% $0 million.

(LOS 49.b)

Question #46 of 131

Question ID: 463965

In accordance with the senior prepayment percentage presented in Table 1, if prepayments on a $50 million offering in month 30 are $2 million, the amount paid to the senior tranche is:

✗ **A) $1 million.**

✓ **B)** $2 million.

✗ **C)** $50 million.

Explanation

If prepayments in month 30 total $2 million, the amount paid to the senior tranche in accordance with the Table 1 senior prepayment percentage is 100% of the $2 million.

(LOS 49.b)

Question #47 of 131

Question ID: 463966

If losses due to default over the life of the structure total $7.5 million, the amount of the loss for each tranche is *closest* to:

	Total Loss Senior	Subordinated 1	Subordinated 2
✗ **A)**	**$0.0**	**$2.5**	**$5.0**
✓ **B)**	$0.0	$0.0	$7.5
✗ **C)**	$7.5	$0.0	$0.0

Explanation

The total loss is first applied to the subordinate tranche 2. Since $7.5 million is less than subordinated tranche 2's loss capacity of $10 million, there is no loss for subordinated tranche 1 or the senior tranche.

(LOS 49.b)

Question #48 of 131

Question ID: 463967

If losses due to default over the life of the structure total $25.0 million, the amount of the loss for each tranche is *closest* to:

	Total Loss	Senior	Subordinated 1	Subordinated 2
✗	**A)**	**$5.0**	**$5.0**	**$10.0**
✓	**B)**	$0.0	$15.0	$10.0
✗	**C)**	$2.5	$2.5	$15.0

Explanation

The loss is first applied to subordinate tranche 2. With a $25 million loss, subordinated tranche 2 is completely liquidated to pay losses of $10 million, and the next $15 million in losses are applied to subordinated tranche 1. The senior trache does not suffer any losses.

(LOS 49.b)

Question #49 of 131

Question ID: 463968

Internal credit enhancements for this ABS include

✓ **A)** **a reserve fund and a senior-subordinate structure.**

✗ **B)** overcollateralization and a senior-subordinate structure.

✗ **C)** a reserve fund and a monoline insurer guarantee.

Explanation

Credit enhancements can be either external or internal. External credit enhancements can be guarantees from monoline insurers, letters of credit by banks or guarantee of assets by the seller. Internal credit enhancements include reserve funds, senior-subordinate structures, and overcollateralization.

This ABS includes a reserve fund by excess spread accounts - the difference between the gross weighted average coupon (gross WAC) and the net WAC plus the servicing and other fees. The difference is positive: 7.00% − 0.25% − 6.25% = 0.50%, so there is a 50 basis points spread for an reserve account to pay for potential losses.

The senior-subordinate structure (given in the vignette) enhances the creditworthiness of the senior class. Overcollaterialization does not exist as the amount securitized matches the value of the collateral.

Although this ABS is wrapped, a guarantee from a monoline insurer is considered an external credit enhancement.

(LOS 49.d)

Question #50 of 131

Question ID: 463969

Assuming that the ABS asset is credit card receivables with a lockout of 2 years. If 15 months after the securitization, an additional $20 million in excess of the scheduled principal and interest payments were paid. The senior tranche is *most likely* to receive:

✓ **A)** **$0 million.**

✗ **B)** $12 million.

✗ **C)** $20 million.

Explanation

Credit card receivables are non-amortizing assets and as such will not pay down principal during the lockout period of the first 24 months. The $20 million is likely used to pay for additional credit card receivables.

(LOS 49.e)

Question #51 of 131

Question ID: 463889

Which of the following *most accurately* describes prepayments?

✗ **A) A payment that pays the mortgage in full prior to maturity.**

✗ **B)** Prepayment occurs if both interest and principal are paid before the end of the mortgage term.

✓ **C)** A payment made in excess of the monthly mortgage payment.

Explanation

It is possible for a mortgage borrower to pay an amount in excess of the required payment or even to pay off the loan entirely. Payments in excess of the required monthly amount are called prepayments.

Question #52 of 131

Question ID: 463924

Which of the following is *least* accurate regarding planned amortization class (PAC) versus support tranches?

✓ **A) The PAC tranches have the greatest prepayment risk in the collateralized mortgage obligation (CMO) structure.**

✗ **B)** There is an inverse relationship between the prepayment risk of the PAC tranches and the prepayment risk associated with the support tranches.

✗ **C)** The prepayment risk protection provided by the support tranches causes the average life to extend and contract.

Explanation

The support tranches have the greatest prepayment risk in the CMO structure, not the PAC tranches.

Question #53 of 131

Question ID: 463970

Which of the following statements regarding credit card receivable-backed securities is *least* accurate?

✓ **A) Credit card receivable-backed securities pay principal and interest each payment just like a mortgage-backed security.**

✗ **B)** The cash flow to the pool of credit card receivables consists of finance charges, fees, and principal repayment.

✗ **C)** Credit card receivable-backed securities use a master trust structure.

Explanation

Credit card receivable-backed securities **do not** pay principal and interest each payment just like a mortgage-backed security. Interest is paid periodically and principal is placed under a lockout period.

Question #54 of 131

Question ID: 463990

Which of the following statements regarding CMOs is *least* accurate? The:

✓ **A)** **early maturing tranches offer relatively greater protection against contraction risk.**

✗ **B)** early maturing tranches offer relatively greater protection against extension risk.

✗ **C)** longer-term tranches offer relatively greater protection against contraction risk.

Explanation

The early maturing tranches offer relatively greater protection against extension risk, not contraction risk.

Question #55 of 131

Question ID: 463947

Which of the following regarding key credit enhancement features of defeasance as prepayment protection is *least* accurate?

✓ **A)** **The duration of the defeasance funds reduces the credit risk of the commercial mortgage-backed securities (CMBS).**

✗ **B)** No distributions are made when the defeasance takes place, so there is no issue concerning how prepayment penalties will be disbursed.

✗ **C)** The cash flow from the defeasance funds is substituted for payments made by the borrower.

Explanation

Duration is related to interest rate risk; it is not related to credit risk.

Question #56 of 131

Question ID: 460696

A mortgage that includes some repayment of principal in each payment, and has an outstanding principal balance at maturity, is *most accurately* described as a:

✓ **A)** **partially amortizing mortgage.**

✗ **B)** hybrid mortgage.

✗ **C)** rollover mortgage.

Explanation

A partially amortizing mortgage includes some amount of principal in each payment but still has an outstanding principal balance at maturity. A hybrid mortgage becomes an adjustable-rate mortgage after an initial fixed-rate period. A rollover mortgage changes from one fixed rate to another during its life.

Question #57 of 131

Question ID: 463994

Which of the following statements regarding collateralized debt obligations (CDOs) is *least* accurate?

✓ **A) Interest rate swaps are rarely used due to scrutiny from rating agencies.**

✗ **B)** The senior tranche is usually paid a floating rate.

✗ **C)** Mezzanine tranches receive a fixed rate.

Explanation

The collateral usually has a mix of floating and fixed rate debt so interest rate swaps are used to manage the risk from cash flow mismatches. Interest rate swaps are often used by asset managers to control the interest rate risk imposed by this mismatch, Rating agencies usually mandate the use of swaps. In CDOs there is usually a senior tranche that receives a floating rate, mezzanine tranches that receive a fixed rate, and a subordinate or equity tranche that provides prepayment and credit protection to the other tranches.

Question #58 of 131

Question ID: 463861

Which of the following statements regarding credit ratings is *least* accurate?

✓ **A) An advantage of traditional credit ratings is that they tend to vary with the business cycle which accurately reflects current risk.**

✗ **B)** A disadvantage of traditional credit ratings is that they are stable over time which reduces the correlation with a debt offering's default probability.

✗ **C)** An advantage of traditional credit ratings is that they provide a simple way of summarizing complex credit analysis.

Explanation

Traditional credit ratings tend to be stable over the business cycle. This is a disadvantage as a debt offering's default probability will vary with the cycle.

Question #59 of 131

Question ID: 463992

Which of the following is referred to as a sequential-pay CMO? A sequential-pay CMO is structured so that each class of bond:

✓ **A) is retired sequentially.**

✗ **B)** receives prepayments on a sequential pro-rata basis.

✗ **C)** has different credit risk.

Explanation

When there are prepayments, the principal in the first bond class (tranche) is reduced until it is fully retired, then the principal of the next bond class is retired, and so on.

Question #60 of 131

Question ID: 463934

Which of the following explains why the companion tranches have the *greatest* prepayment risk in a CMO structure? The companion tranches:

✓ **A)** **have to support any principal payments in excess of the scheduled principal payments.**

✗ **B)** consist of underlying mortgages for which prepayment is allowed, as opposed to the PAC tranches.

✗ **C)** are more interest rate sensitive and therefore prepayment risk is higher.

Explanation

There is an inverse relationship between the prepayment risk of PAC tranches and the prepayment risk associated with the support tranches. In other words, the certainty of PAC bond cash flow comes at the expense of increased risk to the support tranches.

Question #61 of 131

Question ID: 463876

In a passthrough structure, the principal cash flow from the credit card accounts are:

✓ **A)** **paid to security holders on a pro rata basis.**

✗ **B)** amoritized without penalty.

✗ **C)** never paid due to interest rate charges.

Explanation

In a passthrough structure, the principal cash flow from the credit card accounts are paid to security holders on a pro rata basis.

Question #62 of 131

Question ID: 463938

All of the following statements regarding nonagency securities are correct EXCEPT:

✗ **A)** **loans used to back nonagency CMOs are referred to as nonconforming loans.**

✓ **B)** the collateral behind nonagency collateralized mortgage obligations is passthrough securities.

✗ **C)** the collateral behind nonagency CMOs is a pool of loans.

Explanation

The collateral behind nonagency CMOs is a pool of loans, not passthrough securities.

Question #63 of 131

Question ID: 463930

Which of the following is NOT a form of internal credit enhancement?

✗ **A)** **Reserve funds.**

✗ **B)** A senior/subordinated structure.

✓ **C)** Sequential-pay structure.

Explanation

A sequential-pay structure is not a credit enhancement. External credit enhancements are financial guarantees from third parties that generally support the performance of the bond. Internal credit enhancements do not rely on a third-party guarantee. They commonly include setting aside reserve funds and structures that contain senior and subordinated debt.

Question #64 of 131

Question ID: 463951

Which of the following is *least likely* an example of internal credit enhancement?

✗ **A)** **Over-collateralization.**

✓ **B)** Bond insurance.

✗ **C)** Excess servicing spread accounts.

Explanation

Bond insurance is an example of external, not internal, credit enhancement.

Question #65 of 131

Question ID: 463998

Which of the following statements regarding collateralized mortgage obligations (CMOs) is *least* accurate:

✗ **A)** **The Z-tranche or accrual tranche does not receive current interest until the other tranches have been paid off.**

✗ **B)** CMOs are securities issued against passthrough securities for which the cash flows have been reallocated to different bond classes called tranches.

✓ **C)** CMOs perfectly protect investors against contraction risk but do not protect against extension risk.

Explanation

CMOs do not perfectly protect investors against contraction risk. They offer some protection against both contraction and extension risks, but not perfect protection against either.

Question #66 of 131

Question ID: 460694

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.

Question #67 of 131

Question ID: 460698

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) slower-than-expected prepayments.**
- ✗ **B)** faster-than-expected prepayments.
- ✓ **C)** issuance and servicing costs.

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.

Question #68 of 131

Question ID: 463912

Which of the following is the *best* explanation of a conditional prepayment rate? The conditional prepayment rate is the:

- ✗ **A) realized prepayment rate of a pool.**
- ✓ **B)** prepayment rate assumed for a pool based on the characteristics of the pool and the economic environment.
- ✗ **C)** percentage of the total liability that a borrower prepays conditional on the fact that he prepays.

Explanation

The conditional prepayment rate convention for describing the pattern of prepayments and the cash flow of a passthrough assumes that some fraction of the remaining principal in the pool is pre-paid each month for the remaining term of the mortgage. The rate is influenced by the economic environment and the characteristics of the mortgage pool.

Question #69 of 131

Question ID: 463923

The stated maturity of a mortgage passthrough security is:

- ✗ **A) will always be longer than its true life.**
- ✓ **B)** unlikely to equal its true life.
- ✗ **C)** will always be shorter than its true life.

Explanation

The stated maturity of a mortgage passthrough security is unlikely to equal its true life.

Question #70 of 131

Question ID: 463933

Which of the following is the *best* description of cash reserve funds as an internal credit enhancement? Cash reserve funds are investments in:

✗ **A) U.S. Treasury bonds created from issuance proceeds.**

✗ **B)** money market instruments created from securitizing mortgages.

✓ **C)** money market instruments created from issuance proceeds.

Explanation

Cash reserve funds are cash deposits that come from issuance proceeds. This excess cash provides for the establishment of a reserve account to pay for future losses. Cash reserve funds are usually used along with external credit enhancements.

Question #71 of 131

Question ID: 472713

Which of the following is referred to as principal-amortization period for a credit card receivable-backed security? The principal-amortization period is the period during which the:

✗ **A) interest is reinvested.**

✓ **B)** principal is no longer reinvested, but paid to investors.

✗ **C)** principal is reinvested.

Explanation

Since credit card balances are revolving, principal is not amortized. As such, interest on credit card ABSs is paid periodically and the principal is placed under a "lockout period," during which time no principal is paid to the ABS holders. Principal payments made during the lockout period are used to purchase additional underlying assets or receivables. Once the lockout period ends, principal payments are passed on to the security holders. This post-lockout period is known as the "principal amortization period."

Question #72 of 131

Question ID: 463885

Which of the following is the *best* definition of extension risk? The adverse consequences of:

✓ **A) increasing interest rates on passthrough securities.**

✗ **B)** lower prepayment rates.

✗ **C)** declining interest rates on passthrough securities.

Explanation

Extension risk for a passthrough security is defined as the adverse consequence of a rise in interest rates. Increasing interest rates will slow prepayments resulting in extending the maturity of the passthrough. This reduces the amount available to be invested at the currently high interest rates.

Question #73 of 131

Question ID: 463948

Commercial mortgage-backed securities (CMBS) provide call protection through loan-level and individual mortgage call protection. Which of the following are *least likely* forms of call protection?

- ✗ **A)** **Borrowers are charged the amount of interest lost by the lender had the loan not been prepaid.**
- ✓ **B)** If borrowers prepay their loan, proceeds are distributed to investors.
- ✗ **C)** Penalty fees assessed against the borrower for prepayment.

Explanation

Loan-level call protection includes: defeasance, prepayment penalty charges, prepayment lock out period, and yield maintenance charges. Prepayment proceeds *should not* be distributed to investors. When borrowers prepay, the mortgage loan can be "defeased" - the loan proceeds are received by the loan servicer and invested in U.S. Treasuries to create cash collateral against the loan.

Question #74 of 131

Question ID: 463917

Which of the following is a reason why the average life of a mortgage-backed security is a more relevant measure than the security's maturity? The average life:

- ✗ **A)** **takes interest rate risk into account.**
- ✓ **B)** takes into account the assumed prepayment rate.
- ✗ **C)** takes the economic environment into account.

Explanation

The stated maturity of a mortgage passthrough security is unlikely to equal its true life because of prepayments. Average life is used because it represents the average time to receipt of both scheduled principal payments and expected prepayments.

Question #75 of 131

Question ID: 463866

Which of the following two securities are *most likely* used to calculate the term structure of credit spreads?

- ✗ **A)** **A corporate issuer's coupon paying bond and the same issuer's zero coupon bond.**
- ✗ **B)** A corporate issuer's senior debt and the same issuer's subordinated debt.
- ✓ **C)** A corporate issuer's zero coupon bond and a default free zero coupon bond.

Explanation

If a zero coupon bond is not available an implied zero coupon bond price for the issuer can be derived from the coupon paying bond price.

Question #76 of 131

Question ID: 463991

$400 million of mortgage pass-throughs will be used as collateral for five tranches. The first two tranches are planned amortization tranches−$260 million of bonds of tranche U and $50 million of bonds of tranche V. Tranche U is a planned amortization class (PAC) I tranche and tranche V is a scheduled tranche. The third tranche is a scheduled support tranche-the holders of the $40 million of bonds in tranche W receive principal repayments according to a schedule as long as prepayment speed is between 190 and 240 PSA. The last two tranches are unscheduled floating-rate support tranches: $25 million of X bonds and $25 million of Y bonds. Which of the following statements regarding the prepayment risk of the bonds is *most* accurate? The:

✓ **A) U bonds have less prepayment risk than the V bonds, which have less prepayment risk than the Y bonds.**

✗ **B)** W bonds have less prepayment risk than the U bonds, which have less prepayment risk than the Y bonds.

✗ **C)** W bonds have less prepayment risk than the X bonds, which have less prepayment risk than the Y bonds.

Explanation

Even though U and V are PAC tranches. Once the PSA rate is exceeded by the tranche collars the support tranches absorb all the prepayment risk first and then the prepayment risk is absorbed by the tranches in reverse order with the lower unscheduled tranches absorbing more prepayment risk before the higher scheduled tranches. Therefore tranche V would have more prepayment risk than tranche U. Support tranches X and Y have the greatest prepayment risk because they are unscheduled and lowest in the order of tranches; there is not enough information given to know which has higher prepayment risk. Tranche W will have less prepayment risk than X and Y, but more prepayment risk than V and U. Prepayment risk for PACs is highest at the lower tranches and lowest at the upper tranches.

Question #77 of 131

Question ID: 463931

Which of the following statements regarding the structure of asset-backed securities (ABS) backed by amortizing assets is *least* accurate?

✗ **A) No new loans are added to the pool.**

✗ **B)** An example of this ABS is that backed by automobile loans.

✓ **C)** A lockout period results in a revolving structure.

Explanation

In an asset-backed security backed by amortizing assets (e.g. automobile loans), the composition of loans in the pool will not change. No new loans are purchased. A lockout period provision refers to an ABS backed by non-amortizing loans.

Question #78 of 131

Question ID: 463878

Which of the following *most accurately* describes the cash flows of a fixed rate, level payment, fully amortized mortgage loan?

✓ **A) The borrower pays equal installments over the term of the mortgage.**

✗ **B)** The borrower pays equal percentage installments over the term of the mortgage.

✗ **C)** The mortgage is amortized in the final payment as in corporate debt.

Explanation

A fixed rate, level payment, fully amortized mortgage loan requires equal payments (usually monthly) over the life of the mortgage. Each of these payments consists of an interest component and a principal component.

Question #79 of 131

Question ID: 463926

Which of the following *best* describes how planned amortization class (PAC) bonds are protected against prepayment risk to create products that provide better asset and liability matching for institutional investors? PAC bonds:

✗ **A) accrue the interest for one tranche and redistribute it to the support tranches.**

✗ **B)** have several different companion tranches to which repayments are directed sequentially.

✓ **C)** have a fixed principal repayment schedule that must be satisfied as long as the support tranches exist.

Explanation

The PAC tranche has significant protection against prepayment risk at the expense of the support or companion tranches.

Question #80 of 131

Question ID: 463996

How is a collateralized mortgage obligation (CMO) created? A CMO is created by:

✓ **A) redistributing the cash flows of mortgage-related products to different bond classes.**

✗ **B)** eliminating prepayment risk.

✗ **C)** eliminating extension risk.

Explanation

Creating CMO's distributes the various forms of prepayment risk among different classes of bondholders which allows the CMO to more closely satisfy the asset/liability needs of institutional investors.

Question #81 of 131

Question ID: 463863

Which of the following statements regarding using a reduced form model to assess credit risk is *least* accurate?

✗ **A) The company has debt that trades in frictionless markets.**

✗ **B)** Under the assumption of no arbitrage, the price of debt is equal to the expected discounted payoff at maturity.

✓ **C)** The model assumes that the company's assets trade in frictionless markets.

Explanation

Reduced form models do not require a company's assets to trade in frictionless markets

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Question #82 of 131

Question ID: 460695

The special purpose vehicle in a securitization is:

✗ **A)** **a subsidiary of the seller.**

✗ **B)** a joint venture partner of the seller.

✓ **C)** an entity independent of the seller.

Explanation

The SPV 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.

Question #83 of 131

Question ID: 463997

Which of the following is *most* accurate for a companion tranche with a schedule of principal repayments? Such a companion tranche:

✗ **A)** **has no prepayment risk.**

✓ **B)** has greater protection against prepayment risk than a support tranche without a schedule of principal payments.

✗ **C)** provides less protection against prepayment risk than a support tranche without a schedule of principal payments.

Explanation

PAC II tranches are companion tranches having PAC prepayment schedules. Like regular PAC tranches, these scheduled support tranches receive a degree of prepayment risk protection at the expense of increased prepayment risk to other support tranches.

Question #84 of 131

Question ID: 463953

Which of the following is a disadvantage of bond insurance as an external credit enhancement?

✓ **A)** **Its cost.**

✗ **B)** It only provides protection against systematic risk, not against idiosyncratic risk.

✗ **C)** It covers only bond interest.

Explanation

Bond insurance provides for protection against losses when bonds default and includes both principal and interest payments. Issuers must weigh the costs of insurance against the decrease in required yield.

Question #85 of 131

Question ID: 463892

Regarding mortgage passthrough securities, which of the following statements is *least* accurate?

✗ **A)** **Passthrough security investors receive the monthly cash flows generated by the underlying pool of mortgages less any servicing and guarantee/insurance fees.**

✗ **B)** The passthrough coupon rates are less than the average coupon rate of the underlying mortgages in the pool.

✓ **C)** The passthrough coupon rates are greater than the average coupon rate of the underlying mortgages in the pool.

Explanation

The passthrough coupon rates are less than the average coupon rate of the underlying mortgages in the pool (due to servicing fees), not greater than the coupon rate.

Question #86 of 131

Question ID: 463921

Which of the following statements is *least* accurate concerning nonagency mortgage-backed securities (MBS)?

✗ **A)** **They usually require credit enhancement.**

✓ **B)** They are usually backed with "conforming" mortgage loans.

✗ **C)** They are issued by private entities.

Explanation

Nonagency MBS are usually backed by "nonconforming" mortgages, such as those that do not meet the underwriting standards of the agencies.

Question #87 of 131

Question ID: 463972

Which of the following is referred to as a lockout period for a credit card receivable-backed security? A lockout period is a specific period of time during which:

✓ **A)** **principal payments made by credit card borrowers are retained by the trustee.**

✗ **B)** credit card borrowers are not allowed to make repayments.

✗ **C)** interest payments made by credit card borrowers are retained by the trustee.

Explanation

Since credit card balances are revolving, principal is not amortized. As such, interest on credit card ABSs is paid periodically and the principal is placed under a "lockout period." During the lockout period, which may vary from 18 months to 10 years, no principal is paid to the ABS holders. Once the lockout period ends, principal payments are passed on to the security holders.

Question #88 of 131

Question ID: 463862

When assessing a company's credit risk using structural models, which of the following statements is *most* accurate?

✓ **A) Structural models do not account for the impact of interest rate risk of the value of a company's assets.**

✗ **B)** Owning equity is economically equivalent to owning a risk free bond and simultaneously selling a put option on the assets of the company.

✗ **C)** Owning debt is economically equivalent to owning a European call option on the company's assets.

Explanation

Owning equity is economically equivalent to owning a European call option on the assets of the company. Owning debt is economically equivalent to owning a risk free bond and simultaneously selling a put option on the assets of the company. The structural model assumes that risk-free rate is not stochastic (i.e., it assumes that risk-free rate is constant).

Question #89 of 131

Question ID: 463918

Which of the following is a reason why the stated maturity of a mortgage passthrough security is not as relevant as the average life measure? The security's maturity:

✓ **A) is not related to the remaining life of the underlying loans and the assumed prepayment rate.**

✗ **B)** does not take interest rate risk into account.

✗ **C)** is not know to the investor beforehand.

Explanation

The stated maturity of a mortgage passthrough security is unlikely to equal its true life because of prepayments. Average life is used because it represents the average time to receipt of both scheduled principal payments and expected prepayments.

Question #90 of 131

Question ID: 463884

Which of the following *best* describes prepayment risk?

✗ **A) The lender's interest rate risk resulting from prepayments.**

✓ **B)** The risk associated with the unknown amount and timing of cash flow's resulting from prepayments.

✗ **C)** The lender's spread risk resulting from prepayments.

Explanation

Mortgage prepayments reduce the amount of interest the lender receives over the life of the loan. The likelihood of this situation actually occurring is very real and is known as prepayment risk.

Question #91 of 131

Question ID: 463893

Which of the following is a characteristic of a fixed rate, level payment, fully amortized mortgage loan?

✗ **A) Each payment includes an equal portion of interest and amortized principal.**

✗ **B)** Each payment includes interest on the borrowed amount only.

✓ **C)** The payments are such that at the end of the mortgage, the loan has been fully amortized.

Explanation

As time passes, the proportion of the equal monthly mortgage payment that represents interest decreases and the proportion that goes toward the repayment of principal increases. This process continues until the outstanding principal reaches zero and the loan is paid in full (fully amortized).

Question #92 of 131

Question ID: 463910

Which of the following is the *best* explanation of a single-monthly mortality rate? The single-monthly mortality rate is the:

✓ **A) assumed monthly prepayment rate for a pool.**

✗ **B)** assumed monthly prepayment rate for each individual loan.

✗ **C)** realized monthly prepayment rate for a pool.

Explanation

The single-monthly mortality rate is equal to the conditional prepayment rate expressed on a monthly basis.

Question #93 of 131

Question ID: 463920

Regarding a fixed-rate, level payment, and fully amortized mortgage loan, which of the following statements is *least* accurate?

✗ **A) Interest payments fall as principal payments rise over the life of the loan.**

✓ **B)** Principal repayment falls as interest payments rise over the life of the loan.

✗ **C)** Payments are equal over the life of the loan.

Explanation

Interest payments fall as principal payments rise over the life of the loan, not the other way around.

Question #94 of 131

Question ID: 472424

Securitization *least likely* benefits the financial system by:

✓ **A) removing liabilities from bank balance sheets.**

✗ **B)** increasing the amount banks are able to lend.

✗ **C)** increasing liquidity for mortgages and other loans.

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.

Question #95 of 131

Question ID: 463932

Suppose an investor did not want to be concerned with the risk of having to reinvest the early repayment of principal. What type of security should he invest in? A security backed by:

✗ **A)** **automobile loans.**

✓ **B)** non-amortizing assets.

✗ **C)** amortizing assets.

Explanation

In security backed by non-amortizing assets (e.g. credit cards), early repayment of the principal will not be distributed to investors during the lockout period. Instead, new loans will be purchased. In a security backed by amortizing assets (e.g. automobile loans or mortgages), principal repayments can be distributed to investors.

Question #96 of 131

Question ID: 463922

Which of the following is a CORRECT description of the Public Securities Association (PSA) prepayment benchmark? The PSA prepayment benchmark assumes that prepayment rates are:

✗ **A)** **low during high-interest rate periods and high during low-interest rate periods.**

✓ **B)** low for newly originated mortgages and then will speed up as the mortgages season.

✗ **C)** high for newly originated mortgages and then will lower as the mortgages become seasoned.

Explanation

The PSA prepayment benchmark assumes that the monthly prepayment rate for a mortgage pool increases as it ages (becomes seasoned). PSA is expressed as a monthly series of CPRs. The PSA standard benchmark is referred to as 100% PSA (or just 100 PSA), which assumes the following graduated CPRs for 30-year mortgages:

- CPR = 0.2% for the first month, increasing by 0.2% per month up to 30 months
- CPR = 6% for months 30 - 360

Question #97 of 131

Question ID: 463993

$200 million of mortgage pass-throughs will be used as collateral for three tranches. The first two tranches are planned amortization class tranches: $110 million of bonds of tranche U and $50 million of bonds of tranche V. The third tranche consists of the holders of the $40 million of bonds in tranche W, which is a support tranche. Which of the following statements regarding the contraction risk and extension risk of the U bonds versus the V bonds is *most* accurate? The U bonds:

✓ **A)** **have less contraction risk and less extension risk than the V bonds.**

✗ **B)** have less extension risk but not less contraction risk than the V bonds.

✗ **C)** have less contraction risk but not less extension risk than the V bonds.

Explanation

The planned amortization portion of the tranches allows for the lower support tranches to absorb the prepayments first with the upper tranches having the least amount of prepayment risk with tranche V having more prepayment risk than tranche U because U is more senior than V. Because U has the least amount of prepayment risk it also has the least amount of contraction risk once again because all the lower subordinate tranches and support tranches absorb the prepayments first.

Question #98 of 131

Question ID: 463916

How is the price of a principal-only mortgage strip affected by declining mortgage rates in the market? The price of the principal-only strip:

✓ **A)** **increases.**

✗ **B)** is unaffected.

✗ **C)** decreases.

Explanation

When mortgage rates decline, prepayments are expected to increase. Therefore, the principal-only strip investor gets payments sooner increasing the value of the PO.

Question #99 of 131

Question ID: 463888

All of the following are factors that affect prepayments EXCEPT:

✗ **A)** **seasoning.**

✓ **B)** the amount of overall mortgage loan activity in the market.

✗ **C)** characteristics of underlying mortgage loans.

Explanation

The amount of overall mortgage activity does not impact prepayments.

Question #100 of 131

Question ID: 463877

Which of the following statements regarding mortgages is *least* accurate?

✗ **A)** **Mortgages are collateralized by a piece of real property, either residential or commercial.**

✓ **B)** Because mortgages are secured loans, mortgage insurance is unnecessary.

✗ **C)** In a conventional mortgage, the loan is based on the creditworthiness of the borrower.

Explanation

Mortgage insurance is often required, depending on the creditworthiness of the borrower or the amount of equity in the loan.

Question #101 of 131

Question ID: 463913

The Public Securities Association (PSA) prepayment benchmark assumes that:

✗ **A) there is a linear relationship between conditional prepayment rate (CPR) and the single monthly mortality rate (SMM).**

✓ **B)** the monthly prepayment rate for a mortgage pool increases as it ages or becomes seasoned.

✗ **C)** the monthly prepayment rate for a mortgage pool decreases as it ages or becomes seasoned.

Explanation

The Public Securities Association (PSA) prepayment benchmark assumes that the monthly prepayment rate for a mortgage pool increases as it ages or becomes seasoned.

Question #102 of 131

Question ID: 463894

Which of the following is a characteristic of a mortgage loan?

✗ **A) A very risky loan since it is unsecured.**

✗ **B)** If the borrower defaults on the loan, the lender has the right to seize all assets of the borrower to ensure that the loan is paid off.

✓ **C)** If the borrower defaults on the loan, the lender has the right to seize the collateral.

Explanation

With a mortgage loan, the borrower must make a series of mortgage payments over the life of the loan, and the lender has the right to "foreclose" or lay claim against the real estate in the event of loan default.

Question #103 of 131

Question ID: 463875

Within an asset-backed security structure, the entity which collects the principal and interest payments from the borrower and, when necessary, sends out delinquency notices is the:

✗ **A) issuer.**

✗ **B)** seller.

✓ **C)** servicer.

Explanation

The servicer is responsible for processing the payments received on the underlying loan collateral, and remitting the resulting cash flows to the investors in the ABS.

Question #104 of 131

Question ID: 463927

Prepayment tranching is also referred to as:

✓ **A)** **time tranching.**

✗ **B)** serial tranching.

✗ **C)** credit tranching.

Explanation

Prepayment tranching is also referred to as time tranching. Prepayment tranching refers to when an asset or mortgage backed security is subdivided so some components are exposed to more prepayment risk than others.

Question #105 of 131

Question ID: 463939

Which of the following is a difference between agency and nonagency mortgage-backed securities (MBS)? Nonagency MBS:

✗ **A)** **can only be for commercial real estate property.**

✓ **B)** can be for any type of real estate property.

✗ **C)** have floating mortgage rates.

Explanation

For agency MBS the underlying mortgages are one to four-single family residential mortgages only. Nonagency securities exist that are backed by second mortgage loans, manufactured housing loans, and a variety of commercial real estate loans, in addition to single family residential mortgages.

Question #106 of 131

Question ID: 463942

A distinguishing characteristic of a commercial mortgage-backed security (CMBS) as compared to residential mortgages is:

✗ **A)** **Residential mortgages are non-recourse.**

✗ **B)** Both CMBS and residential mortgages are non-recourse.

✓ **C)** CMBS are non-recourse.

Explanation

CMBS are non-recourse. Residential mortgages are recourse, meaning that the lender can go back to the homeowner for payment if the collateral is insufficient.

Question #107 of 131

Question ID: 463868

Which of the following statements regarding evaluating credit risk of Asset Backed Securities (ABS) is *least* accurate?

✗ **A) The analysis should entail consideration of the composition of the collateral pool and the cash flow waterfall.**

✓ **B)** Unlike for corporate debt, structural and reduced form models are not appropriate.

✗ **C)** Credit rating agencies use the same credit ratings for ABS as for corporate debt.

Explanation

Reduced form and structural models can be used as long as they take into account the complex structure of the ABS.

Question #108 of 131

Question ID: 463945

Which of the following statements is *most* accurate concerning the effect of defeasance on the quality of a Commercial mortgage-backed securities (CMBS) loan pool? Defeasance:

✓ **A) increases the quality of a CMBS loan pool by reinvesting any prepayments in Treasury securities.**

✗ **B)** decreases the quality of a CMBS loan pool by selling some of the pool as payments come due.

✗ **C)** increases the quality of a CMBS loan pool by requiring fees for late payments.

Explanation

Defeasance increases the quality of a CMBS loan pool by reinvesting any prepayments in Treasury securities.

Question #109 of 131

Question ID: 463867

An investor currently holds a zero coupon bond that matures in two years and has a face value of $100,000. The continuously compounded risk free rate is 0.60% and the bond issuer's credit spread is 0.25%. The present value of the expected loss implied by the credit spread is *closest* to:

✓ **A) $493.**

✗ **B)** $1,679.

✗ **C)** $246.

Explanation

Risk free yield	0.60%
Credit spread	0.25%
Total yield	0.85%
Present value on a risk free basis:	$\$100{,}000 \times e^{-(0.0060 \times 2)} = \$98{,}807$
Present value on risky basis:	$\$100{,}000 \times e^{-(0.0085 \times 2)} = \$98{,}314$

Present value of expected loss due to credit risk = $98,807 − $98,314 = $493

Questions #110-115 of 131

The investment policy committee of Worthy, Drummond, Bakerslee & Corrier has decided to devote this month's overview meeting to a review of the firm's asset-backed securities (ABS) investments. Worthy Drummond runs several billion dollars of fixed income securities in a variety of portfolios, and the members of the investment policy committee are becoming concerned about the impact of economic weakness on credit quality.

Jamison Bakerslee has recently led a project to review the guarantees on some of the firm's ABS. He reports to the policy committee that one of the main guarantors of Worthy Drummond's ABS portfolio, First Credit Systems, Inc., is the subject of rumors about a credit downgrade. First Credit has provided financial guarantees that support the performance of the ABS, and many of the ABS have credit ratings that are the same as First Credit's current rating. Bakerslee points out, "If First Credit is downgraded, that means many of the issues we hold may be downgraded as well." Lucinda Corrier agrees that a First Credit downgrade would be a potential problem, since "First Credit's guarantee protects against losses in these ABS before the internal credit enhancements are triggered."

Internal credit enhancements are of primary interest to Worthy Drummond because many of the securities the firm holds are in subordinated tranches. The policy committee is particularly concerned about its investments in a pool of boat loans that are not subject to any third-party guarantees. The pool consists of three tranches:

> > Senior tranche $460 million
> >
> > Subordinated tranche A 90 million
> >
> > Subordinated tranche B 50 million

The collateral for the pool of boat loans is $657 million.

Corrier, however, is more concerned about prepayment risk across the portfolio if economic weakness causes interest rates to decline. She reminds the investment policy committee, "Our auto loan-backed securities face the same prepayment risk that our collateralized mortgage obligations (CMOs) do." Bakerslee points out that the firm's investments in credit card receivable backed securities will still be in the lockout period for another two years, "so we don't have to worry about prepayment of principal on those right now."

Question #110 of 131

Question ID: 463976

What is the amount of overcollateralization on the pool of boat loans?

✗ **A)** **$0.**

✗ **B)** $140 million.

✓ **C)** $57 million.

Explanation

The pool of boat loans totals ($460 + 90 + 50 =) $600 million dollars, and has collateral of $657 million.

Overcollateralization = $657 million − $600 million = $57 million.

(Study Session 15, LOS 49.d)

Question #111 of 131

Question ID: 463977

If the pool of boat loans suffers $154 million in losses, how much will holders of subordinated tranche A lose?

✓ **A)** **$47 million.**

✗ **B)** $23 million.

✗ **C)** $90 million.

Explanation

If the pool of boat loans suffers $154 million in losses, the losses will be first absorbed by the $57 million in overcollateralization. That leaves ($154 − 57 =) $97 million in losses to be distributed among the tranches.

Subordinated tranche B will lose $50 million, leaving ($97 − 50 =) $47 million in losses for holders of subordinated tranche A.

(Study Session 15, LOS 49.d)

Question #112 of 131

Question ID: 463978

Regarding the statements made by Bakerslee and Corrier about the risk of a downgrade of First Credit:

✗ **A) Bakerslee's statement is correct; Corrier's statement is incorrect.**

✗ **B)** Bakerslee's statement is incorrect; Corrier's statement is correct.

✓ **C)** Bakerslee's statement is correct; Corrier's statement is correct.

Explanation

The credit quality of an issue cannot be higher than the credit rating of the third-party guarantor. Thus, if Worthy Drummond's securities already have credit ratings as high as First Credit's own rating and First Credit's rating is downgraded; the credit ratings on the guaranteed securities will likely be downgraded. Bakerslee's comment is correct.

Third party guarantees (an external credit enhancement) protect against losses before internal credit enhancements come into effect. Corrier's statement is also correct. (Study Session 15, LOS 49.d)

Question #113 of 131

Question ID: 463979

Jodie Taylor, an intern with Worthy Drummond, was asked to sit in the meeting and take notes. After the meeting, Taylor comes into Corrier's office and tells Corrier that she wants to make sure she understands credit enhancements. She makes four statements:

Statement 1:	Corporate guarantees, bond insurance and cash reserve funds are all examples of external credit enhancements.
Statement 2:	The effectiveness of default protection offered by excess servicing spread funds can diminish if defaults are below initial projections.
Statement 3:	Third-party guarantees impose a limit on the guarantor's liability for losses at a specified level.
Statement 4:	Cash reserve funds come from issuance proceeds.

Which of the following regarding Taylor's statements is *most* accurate?

✗ **A) Statement 1 is correct and Statement 2 is incorrect.**

✓ **B)** Statement 3 is correct and Statement 2 is incorrect.

✗ **C)** Statement 4 is correct and Statement 3 is incorrect.

Explanation

Cash reserve funds are internal, not external, credit enhancements, therefore Statement 1 is incorrect. The effectiveness of default protection offered by excess servicing spread funds can diminish if defaults exceed certain projections. Defaults that are below projections would be a positive occurrence and would not cause protection provided by the servicing spread to decline - Statement 2 is incorrect. Statements 3 and 4 are both correct statements. (Study Session 15, LOS 49.d)

Question #114 of 131

Question ID: 463980

Regarding the statements made by Bakerslee and Corrier about prepayment risk:

✓ **A)** **Bakerslee's statement is correct; Corrier's statement is incorrect.**

✗ **B)** Bakerslee's statement is incorrect; Corrier's statement is incorrect.

✗ **C)** Bakerslee's statement is incorrect; Corrier's statement is correct.

Explanation

No principal is paid to the ABS holders during the lockout period, so there can be no prepayment risk at that time. Bakerslee's statement is correct.

The prepayments from a pool of auto loans are much more predictable and much less dependent on interest rate changes than prepayments on mortgage loans. Corrier's statement is incorrect. (Study Session 15, LOS 49.b)

Question #115 of 131

Question ID: 463981

Following the investment policy meeting, Peter Drummond sends an e-mail to the other partners regarding key points discussed in the meeting. In the section of his e-mail about payment structures, Drummond makes two points:

> Point 1: Under a bullet payment structure, investors receive the total principal amount in a single payment.
>
> Point 2: Prepayment risk applies to individual non-amortizing loans.

Which of the following regarding Drummond's points is *most* accurate?

✓ **A)** **Point 1 is correct and Point 2 is incorrect.**

✗ **B)** Points 1 and 2 are correct.

✗ **C)** Point 2 is correct and Point 1 is incorrect.

Explanation

Point 1 is correct - under a bullet payment structure, investors receive the total principal amount in a single sum. Point 2 is incorrect - prepayment risk does not apply to individual non-amortizing loans because they have no scheduled principal payments. (Study Session 15, LOS 49.e)

Question #116 of 131

Question ID: 463950

Which of the following are *least likely* examples of internal credit enhancements?

✓ **A)** **Third party guarantees.**

✗ **B)** Structures containing senior and subordinated debt.

✗ **C)** Setting aside reserve funds.

Explanation

Third party guarantees are external credit enhancements, not internal enhancements.

Question #117 of 131

Question ID: 463949

The strongest form of prepayment protection is:

✗ **A)** **a one year prepayment lockout.**

✗ **B)** yield maintenance charges.

✓ **C)** defeasance.

Explanation

According to the CFAI, the two strongest forms of prepayment protection are prepayment lockout and defeasance. In this case, the prepayment lockout is specified as a "one-year" prepayment lockout, so that protection will expire after one year, while the defeasance will continue. This makes defeasance arguably the stronger form of protection in this specific instance. Defeasance occurs when prepayment loan proceeds received by the loan servicer are invested in U.S. Treasury securities. When the defeasance period ends, the U.S. Treasuries are liquidated and the proceeds are used to repay the mortgage.

Question #118 of 131

Question ID: 463891

Which of the following *most accurately* describes a mortgage loan?

✗ **A)** **An unsecured loan to enable the borrower to finance a real estate property.**

✓ **B)** A loan secured by the collateral of some specified real estate property.

✗ **C)** A commercial loan secured by the collateral of some specified real estate property.

Explanation

A mortgage is a loan that is collateralized with a specific piece of real property, either residential or commercial.

Question #119 of 131

Question ID: 463914

Which of the following statements regarding a conditional prepayment rate (CPR) is CORRECT? A CPR is the:

✗ **A)** **annual prepayment expressed as a percentage of the amount at the end of the period.**

✓ **B)** annual prepayment expressed as a percentage of the amount at the beginning of the period.

✗ **C)** monthly prepayment expressed as a percentage of the amount at the beginning of the period.

Explanation

The CPR is the annual rate at which a mortgage pool balance is assumed to be prepaid during the life of the pool. The CPR for any given mortgage pool depends on characteristics such as past prepayment rates, along with the current and expected economic state of affairs. To convert the CPR into a monthly rate called the single-monthly mortality rate (SMM), the following formula applies: $SMM = 1 - (1 - CPR)^{1/12}$.

Question #120 of 131

Question ID: 460703

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

✓ **A)** **Residual tranche.**

✗ **B)** Prepayment lockout.

✗ **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.

Question #121 of 131

Question ID: 463887

Which of the following statements is *least* accurate regarding prepayment risk?

✗ **A)** **Investor in mortgage-backed securities must reinvest at lower rates when rates fall and borrowers prepay and are "stuck" with lower rates when rates rise and borrowers hold onto their mortgages.**

✗ **B)** Contraction risk refers to the shortening of the expected life of the mortgage pool due to falling interest rates.

✓ **C)** Reinvestment rate risk is a result of rising interest rates.

Explanation

Reinvestment rate risk is a result of falling interest rates, not rising rates.

Question #122 of 131

Question ID: 460697

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

✗ **A)** **is convertible from fixed-rate to adjustable-rate.**

✗ **B)** is non-recourse.

✓ **C)** has a prepayment penalty.

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.

Question #123 of 131

Question ID: 463999

Which of the following statements is *least likely* to be considered an advantage generally associated with collateralized debt obligations?

✗ **A)** **The spread between an asset's return and the associated cost to finance the asset can be "locked-in" through the issuance of a CDO.**

✗ **B)** Through the issuance of a CDO, an issuer can maintain legal ownership of the underlying assets but can transfer the economic risks to an investor.

✓ **C)** The senior tranche of a CDO provides an attractive fixed-rate vehicle for fixed-rate investors.

Explanation

The senior tranche of a CDO will most likely be structured with a floating-rate coupon, and the mezzanine tranches will have a fixed-rate payment.

Question #124 of 131

Question ID: 463929

The most common form of credit enhancement for asset backed securities is:

✗ **A)** **corporate guarantees.**

✓ **B)** credit tranching.

✗ **C)** cash reserve funding.

Explanation

Credit tranching is the most common form of credit enhancement for asset-backed securities. In credit tranching, bonds are divided into senior and subordinated sections. In this senior-subordinated structure, subordinated bonds absorb losses up to their par value after which losses are absorbed by senior bonds.

Question #125 of 131

Question ID: 463859

A corporate bond has one year to maturity with a probability of default of 2.05% and a recovery rate of $32.00 per $100 par value. If an investor holds $100,000 of par value, what is the expected loss?

✓ **A) $1,394.**

✗ **B)** $656.

✗ **C)** $2,050.

Explanation

Expected loss = Probability of default × expected loss per $ × par value

= 0.0205 × (1 − 0.32) × $100,000

= $1,394

Question #126 of 131

Question ID: 463944

When assessing credit risk for a commercial mortgage-backed security (CMBS), the underwriter will calculate which of the following ratios?

✗ **A) Loan-to-value ratio only.**

✓ **B)** Both the debt-to-service coverage ratio and the loan-to-value ratio.

✗ **C)** Debt-to-service coverage ratio only.

Explanation

When assessing credit risk for a CMBS, the underwriter will complete both the debt-to-service coverage ratio and the loan-to-value ratio.

Question #127 of 131

Question ID: 463880

Which of the following is the *best* definition of contraction risk? The adverse consequences of:

✗ **A) expected prepayment rates.**

✗ **B)** lower prepayment rates.

✓ **C)** declining interest rates on passthrough securities.

Explanation

A decrease in interest rates will give borrowers an incentive to prepay the loan and refinance the debt at a lower rate. Therefore, the maturity of the passthrough will contract. The second adverse consequence is that the cash flows resulting from prepayments have to be reinvested at a lower interest rate.

Question #128 of 131

Question ID: 463946

Commercial Mortgage-Backed Securities (CMBS) provide structural call protection through which of the following key repayment terms?

✗ **A) Losses of principal are allocated to specific tranches, rather than to the CMBS overall.**

✓ **B)** Sequential repayment of the CMBS tranches and the allocation of losses of principal to specific tranches, rather than to the CMBS overall.

✗ **C)** Sequential repayment of the CMBS tranches.

Explanation

CMBS securities provide structural call protection through sequential repayment of the CMBS tranches, as well as the allocation of losses of principal to specific tranches rather than to the overall CMBS.

Question #129 of 131

Question ID: 415447

Which of the following is *least likely* an example of external credit enhancement?

✓ **A) Excess spread.**

✗ **B)** Bank guarantee.

✗ **C)** Surety bond.

Explanation

Excess spread is an internal credit enhancement. External credit enhancements include bank guarantees, letters of credit, and surety bonds.

Question #130 of 131

Question ID: 463869

Which of the following *most accurately* describes the term "securitizing a mortgage"?

✗ **A) Selling an entire mortgage to another investor.**

✗ **B)** Selling shares of one mortgage to other investors.

✓ **C)** Including a mortgage in a pool of mortgages that is used as collateral for a mortgage passthrough security.

Explanation

A mortgage passthrough security represents a claim against a pool of mortgages. Any number of mortgages may be used to form the pool, and any mortgage included in the pool is referred to as a securitized mortgage. Passthrough securities may be traded in the secondary market, and, as such they effectively convert illiquid mortgages into liquid securities. This process is called securitization.

Question #131 of 131

Question ID: 463871

An evaluation of the quality of the servicer is a key consideration for which type of credit?

✓ **A) Asset-backed securities.**

✗ **B)** Corporate bonds.

✗ **C)** Municipal bonds.

Explanation

The quality of the seller/servicer is critical for the assessment of asset-backed securities.