Question #1 of 24

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

A) has senior and subordinate tranches.

B) employs a collateral manager.

C) is issued through a special purpose vehicle.

Explanation

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

(Study Session 16, Module 53.2, LOS 53.i)

Question #2 of 24

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.

(Study Session 16, 53.2, LOS 53.e)

Question #3 of 24

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

A) less than its weighted average maturity.

B) equal to its weighted average maturity.

C) greater than its weighted average maturity.

Explanation

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

(Study Session 16, Module 53.1, LOS 53.e)

Question #4 of 24

A renegotiable mortgage has a fixed interest rate that:

A) the borrower may change to a variable rate.

B) changes to a variable rate during its life.

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

Explanation

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

(Study Session 16, Module 53.1, LOS 53.d)

Question #5 of 24

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.

(Study Session 16, Module 53.2, LOS 53.i)

Question #6 of 24

When evaluating the loans backing a commercial mortgage-backed security based on debt service coverage (DSC) and loan-to-value (LTV) ratios, which of the following indicate better credit quality?

A) Higher DSC and lower LTV.

B) Higher DSC and higher LTV.

C) Lower DSC and higher LTV.

Explanation

Higher debt service coverage ratios and lower loan-to-value ratios indicate better credit quality.

(Study Session 16, Module 53.2, LOS 53.g)

Question #7 of 24

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

A) faster-than-expected prepayments.

B) issuance and servicing costs.

C) slower-than-expected prepayments.

Explanation

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

(Study Session 16, Module 53.1, LOS 53.e)

Question #8 of 24

One of the primary benefits of securitization is that it:

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

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

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

Explanation

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

(Study Session 16, Module 53.1, LOS 53.a)

Question #9 of 24

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

A) non-amortizing.

B) non-recourse.

C) non-conforming.

Explanation

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

(Study Session 16, Module 53.1, LOS 53.d)

Question #10 of 24

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

A) Credit card ABS.

B) Non-agency residential MBS.

C) Auto loan ABS.

Explanation

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

(Study Session 16, Module 53.2, LOS 53.h)

Question #11 of 24

With respect to auto-loan backed ABS:

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

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

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

Explanation

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

(Study Session 16, Module 53.2, LOS 53.h)

Question #12 of 24

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.

(Study Session 16, Module 53.1, LOS 53.d)

Question #13 of 24

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.

(Study Session 16, Module 53.1, LOS 53.a)

Question #14 of 24

Total cash flows to investors in an ABS issue are:

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

B) 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.

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.

(Study Session 16, Module 53.1, LOS 53.b)

Question #15 of 24

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

A) other CDOs.

B) leveraged bank loans.

C) credit default swaps

Explanation

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

(Study Session 16, Module 53.2, LOS 53.i)

Question #16 of 24

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 more extension risk.

B) more contraction risk and less 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.

(Study Session 16, Module 53.1, LOS 53.f)

Question #17 of 24

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.

(Study Session 16, Module 53.1, LOS 53.d)

Question #18 of 24

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

A) a subsidiary of the seller.

B) an entity independent of the seller.

C) a joint venture partner of the seller.

Explanation

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

(Study Session 16, Module 53.1, LOS 53.b)

Question #19 of 24

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

A) credit tranching.

B) prepayment tranching.

C) time tranching.

Explanation

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

(Study Session 16, Module 53.1, LOS 53.c)

Question #20 of 24

A waterfall structure is *least likely* describe:

A) auto loan ABS.

B) credit card ABS.

C) agency RMBS.

Explanation

A waterfall structure, where principal losses are allocated first to the lowest priority securities issued, would most likely describe auto loan ABS or credit card ABS, which often have a senior-subordinated structure. Agency RMBS are pass-through securities and do not have a senior-subordinated structure.

(Study Session 16, Module 53.2, LOS 53.h)

Question #21 of 24

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.

(Study Session 16, 53.2, LOS 53.e)

Question #22 of 24

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

A) PSA prepayment benchmark.

B) single monthly mortality rate.

C) conditional prepayment 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.

(Study Session 16, 53.2, LOS 53.e)

Question #23 of 24

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

A) recourse loans only.

B) both recourse and nonrecourse loans.

C) nonrecourse loans only.

Explanation

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

(Study Session 16, Module 53.2, LOS 53.g)

Question #24 of 24

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

A) Prepayment lockout.

B) Residual tranche.

C) Yield maintenance charges.

Explanation

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

(Study Session 16, Module 53.2, LOS 53.g)