CHAPTER 42

INTRODUCTION TO ASSET-BACKED SECURITIES

1. (B) **more contraction risk and less 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 13, Module 42.1, LOS 42.f)

Related Material

SchweserNotes - Book 4

2. (A) **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 13, Module 42.1, LOS 42.e)

Related Material

SchweserNotes - Book 4

3. (A) **slower-than-expected prepayments.**

Explanation

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

For Further Reference:

(Study Session 13, Module 42.1, LOS 42.e)

CFA® Program Curriculum, Volume 4, page 604

Related Material

SchweserNotes - Book 4

4. (A) an entity independent of the seller.

Explanation

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

(Study Session 13, Module 42.1, LOS 42.b)

Related Material

SchweserNotes - Book 4

5. (A) a commercial mortgage-backed security.

Explanation

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

For Further Reference:

(Study Session 13, Module 42.2, LOS 42.g)

CFA® Program Curriculum, Volume 4, page 619

Related Material

SchweserNotes - Book 4

6. (A) credit 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 13, Module 42.1, LOS 42.c)

Related Material

SchweserNotes - Book 4

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

Explanation

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

(Study Session 13, Module 42.2, LOS 42.h)

Related Material

SchweserNotes - Book 4

8. (B) structured finance 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 13, Module 42.2, LOS 42.i)

Related Material

SchweserNotes - Book 4

9. (B) Credit card 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.

Related Material

SchweserNotes - Book 4

10. (A) 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 13, Module 42.2, LOS 42.i)

Related Material

SchweserNotes - Book 4

11. (B) they are issued by a special purpose entity.

Explanation

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

For Further Reference:

(Study Session 13, Module 42.1, LOS 42.b)

CFA® Program Curriculum, Volume 4, page 591

Related Material

SchweserNotes - Book 4

12. (B) less 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 13, Module 42.1, LOS 42.e)

Related Material

SchweserNotes - Book 4

13. (C) Higher debt-service coverage ratios and lower loan-to-value ratios.

Explanation

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

(Study Session 13, Module 42.2, LOS 42.g)

Related Material

SchweserNotes - Book 4

14. (A) employs a collateral manager.

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 13, Module 42.2, LOS 42.i)

Related Material

SchweserNotes - Book 4

15. (A) 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 13, Module 42.1, LOS 42.d)

Related Material

SchweserNotes - Book 4

16. (B) nonrecourse loans only.

Explanation

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

(Study Session 13, Module 42.2, LOS 42.g)

Related Material

SchweserNotes - Book 4

17. (B) **improves the legal claims of the security holders to 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 13, Module 42.1, LOS 42.a)

Related Material

SchweserNotes - Book 4

18. (A) **a higher interest rate.**

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 13, Module 42.1, LOS 42.e)

Related Material

SchweserNotes - Book 4

19. (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 13, Module 42.1, LOS 42.b)

Related Material

SchweserNotes - Book 4

20. (C) **Removing liabilities from the balance sheet.**

Explanation

Financial assets are securitized, not liabilities.

For Further Reference:

(Study Session 13, Module 42.1, LOS 42.a)

CFA® Program Curriculum, Volume 4, page 589

Related Material

SchweserNotes - Book 4

21. (A) 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 13, Module 42.1, LOS 42.d)

Related Material

SchweserNotes - Book 4

22. (C) non-recourse.

Explanation

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

(Study Session 13, Module 42.1, LOS 42.d)

Related Material

SchweserNotes - Book 4

23. (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 13, Module 42.1, LOS 42.e)

Related Material

SchweserNotes - Book 4

24. (C) removing liabilities from bank balance sheets.

Explanation

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

(Study Session 13, Module 42.1, LOS 42.a)

Related Material

SchweserNotes - Book 4

25. (B) Residual tranche.

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 13, Module 42.2, LOS 42.g)

Related Material

SchweserNotes - Book 4

26. (B) 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.

(Study Session 13, Module 42.1, LOS 42.e)

Related Material

SchweserNotes - Book 4