Reading 66

ASSET-BACKED SECURITY (ABS) INSTRUMENT A & MARKET FEATURES

1. (B) Higher levels of collateral are beneficial for generating excess spread.

Explanation

Higher levels of collateral help generate higher income on the collateral, increasing excess spread relative to the ABS coupons. However, overcollateralization is not necessary to earn excess spread, since excess spread is primarily determined by the level of interest rates. The level of excess spread is dependent on both the income earned on collateral and the coupon interest paid on the ABS.

(Module 66.1, LOS 66.b)

2. (A) tranches do not receive a pro rata share of principal and interest payments.

Explanation

Under a waterfall structure, all tranches receive interest payments, but senior tranches receive all principal repayments first (therefore the payments are not made on a pro rata basis among all tranches). As a result, senior tranches carry less prepayment risk than junior tranches.

(Module 66.1, LOS 66.b)

3. (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.

(Module 66.1, LOS 66.b)

4. (A) a soft-bullet covered bond.

Explanation

A soft-bullet covered bond may postpone the originally scheduled maturity date by as much as a year to delay default. A hard-bullet covered bond is in default if the issuer fails to make a scheduled payment. A conditional pass-through covered bond converts to a pass-through bond on the maturity date if any payments remain due.

(Module 66.1, LOS 66.a)

5. (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.

(Module 66.1, LOS 66.c)

6. (B) Yes, because the excess spread is positive.

Explanation

The excess spread is positive, and therefore there is a built-in safety margin that protects the ABS from credit losses.

Tranche Name	Face Value ($ mil)	Interest Rate	Interest (paid)/earned
Tranche A senior notes	$120	MRR + 0.25%	($3.90)
Tranche B subordinated notes	$20	MRR + 1.25%	($0.85)
Tranche C equity tranche	$10	–	
Collateral	$150	MRR + 0.75%	$5.63
MRR = 3%			$0.88
			Excess spread

(Module 66.1, LOS 66.b)

7. (A) excess spread.

Explanation

Excess spread is one of three main credit enhancement structures for ABS securities. It involves building up reserves to generate sufficient income to absorb credit losses in the collateral.

The other two types of credit enhancement structures are overcollateralization (the collateral value exceeds the value of the ABS) and credit tranching (credit losses are absorbed by different priority classes of securities).

(Module 66.1, LOS 66.b)

8. (B) a hard-bullet covered bond.

Explanation

A hard-bullet covered bond is in default if the issuer fails to make a scheduled payment. A soft-bullet covered bond may postpone the originally scheduled maturity date by as much as a year to delay default. A conditional pass-through covered bond converts to a passthrough bond on the maturity date if any payments remain due.

(Module 66.1, LOS 66.a)

9. (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.

(Module 66.1, LOS 66.d)

10. (C) **10.**

Explanation

The most subordinated / least senior tranche in the ABS structure is typically called the equity tranche. All losses up to $10 million will be absorbed by this tranche.

(Module 66.1, LOS 66.b)

11. (B) **recourse to the issuing firm.**

Explanation

Covered bonds provide bondholders with recourse to the issuing firm, while ordinary ABS do not. This results in higher credit quality and lower yields for covered bonds than comparable ABS.

(Module 66.1, LOS 66.a)

12. (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.

(Module 66.1, LOS 66.d)

13. (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.

(Module 66.1, LOS 66.d)

14. (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.

(Module 66.1, LOS 66.c)