Reading 67

MORTGAGE-BACKED SECURITY (MBS) INSTRUMENT & MARKET FEATURES

1. (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.

(Module 67.1, LOS 67.c)

2. (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.

(Module 67.1, LOS 67.d)

3. (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.

(Module 67.1, LOS 67.d)

4. (A) **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.

(Module 67.1, LOS 67.c)

5. (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.

(Module 67.1, LOS 67.b)

6. (C) **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.

(Module 67.1, LOS 67.c)

7. (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.

(Module 67.1, LOS 67.b)

8. (C) **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.

(Module 67.1, LOS 67.a)

9. (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.

(Module 67.1, LOS 67.a)

10. (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.

(Module 67.1, LOS 67.d)

11. (B) **nonrecourse loans only.**

Explanation

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

(Module 67.1, LOS 67.d)

12. (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.

(Module 67.1, LOS 67.b)

13. (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.

(Module 67.1, LOS 67.c)

14. (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.

(Module 67.1, LOS 67.c)

15. (B) **sequential-pay collateralized mortgage obligations.**

Explanation

In a sequential-pay CMO, the early tranches are more exposed to contraction risk, and the later tranches are more exposed to extension risk. PAC securities limit both contraction and extension risk for a range of prepayment rates. Mortgage pass-through securities, such as agency residential MBS, do not reallocate contraction and extension risk among bondholders.

(Module 67.1, LOS 67.a)