Question #1 of 14

Question ID: 1577414

Which of the following statements about credit enhancement structures in asset-backed security (ABS) securitizations is *most accurate*?

A) The level of excess spread is independent of the coupon rate in the ABS.

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

C) Overcollateralization is necessary to earn excess spread in the ABS.

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)

Question #2 of 14

Question ID: 1577415

Under a waterfall structure:

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

B) principal repayments are first directed to the subordinated tranches.

C) senior tranches carry more prepayment risk than junior tranches.

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)

Question #3 of 14

Question ID: 1576511

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.

(Module 66.1, LOS 66.b)

Question #4 of 14

Question ID: 1574415

A covered bond that may postpone the originally scheduled maturity date by as much as a year to delay default is:

A) a soft-bullet covered bond.

B) a conditional pass-through covered bond.

C) a hard-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)

Question #5 of 14

Question ID: 1574408

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

A) Auto loan ABS.

B) Credit card ABS.

C) Non-agency residential MBS.

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)

Question #6 of 14

Question ID: 1577413

Consider the asset-backed security (ABS) structure in the table below, including the various tranches and collateral. If the market reference rate (MRR) is 3%, determine whether credit risk is fully mitigated by this structure.

Tranche Name	Face Value ($ mil)	Interest Rate
Tranche A senior notes	$120	MRR + 0.25%
Tranche B subordinated notes	$20	MRR + 1.25%
Tranche C equity tranche	$10	–
Collateral	$150	MRR + 0.75%

A) Yes, because the excess spread is zero.

B) Yes, because the excess spread is positive.

C) No, because the excess spread is negative.

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)

Question #7 of 14

Question ID: 1577412

A company originating an asset-backed security (ABS) has built up significant reserves within the ABS structure in order to absorb credit losses in collateral. This credit enhancement type is best described as:

A) excess spread.

B) credit tranching.

C) overcollateralization.

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)

Question #8 of 14

Question ID: 1574414

A covered bond that is in default if the issuer fails to make a scheduled payment is:

A) a soft-bullet covered bond.

B) a hard-bullet covered bond.

C) a conditional pass-through 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 pass-through bond on the maturity date if any payments remain due.

(Module 66.1, LOS 66.a)

Question #9 of 14

Question ID: 1574412

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

A) employs a collateral manager. ✓

B) has senior and subordinate tranches. ✗

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.

(Module 66.1, LOS 66.d)

Question #10 of 14

Question ID: 1577411

Based on the table below illustrating an asset-backed security (ABS) structure, what is the value of the equity tranche (in $ millions)?

Tranche Name	Face Value ($ mil)	Interest Rate
Tranche A senior notes	$120	SOFR + 0.25%
Tranche B subordinated notes	$20	SOFR + 1.25%
Tranche C equity tranche	$10	Variable
Total	$150	

A) 30. ✗

B) 0. ✗

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)

Question #11 of 14

Question ID: 1574413

Compared to otherwise equivalent asset-backed securities, covered bonds offer:

A) lower credit quality.

B) recourse to the issuing firm.

C) higher yields.

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)

Question #12 of 14

Question ID: 1574411

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

A) credit default swaps.

B) leveraged bank loans.

C) other CDOs.

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)

Question #13 of 14

Question ID: 1574410

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

A) collateralized loan obligation (CLO).

B) structured finance CDO.

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.

(Module 66.1, LOS 66.d)

Question #14 of 14

Question ID: 1574409

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.

(Module 66.1, LOS 66.c)