***Financial Markets and Institutions, 7e* (Saunders)**

**Chapter 24 Managing Risk off the Balance Sheet with Loan Sales and Securitization**

1) A mortgage pass-through security is a bond issue backed by a group of mortgages that pays fixed semiannual coupon payments and the principal is repaid only at maturity.

Answer: FALSE

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

2) In 2008, loan sales primarily consisted of sales of distressed loans.

Answer: FALSE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

3) The buyer of a loan in a participation has a double-risk exposure: one to the borrower and one to the selling bank.

Answer: TRUE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

4) A loan sold without recourse generates a contingent liability for the selling bank.

Answer: FALSE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

5) More than 90 percent of loan sales are via assignments.

Answer: TRUE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

6) Loans sold to correspondent banks are predominantly sales of distressed HLT loans.

Answer: FALSE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

7) Vulture funds specialize in buying distressed loans.

Answer: TRUE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

8) Most loan sales are now accomplished in about 10 days.

Answer: TRUE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

9) Advantages of Brady bonds over LDC loans include improved liquidity and higher coupon rates.

Answer: FALSE

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

10) Under current reserve requirements, bank loan sales with recourse are considered a liability and are subject to reserve requirements.

Answer: TRUE

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.; 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

11) The sale or transfer of assets at less than fair value that occurs at a time when the seller is insolvent is termed fraudulent conveyance.

Answer: TRUE

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

12) When a vulture fund acquires a distressed loan, the fund usually assists the distressed firm's managers in formulating a long-term plan for restoring profitability.

Answer: FALSE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

13) An investor in a GNMA mortgage-backed security may be able to earn a return higher than the rate on a comparable maturity Treasury without taking on much, if any, default risk.

Answer: TRUE

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

14) An advantage of securitization and loan sales over interest rate swaps as a risk-management tool is that securitization, by removing loans from the balance sheet, reduces the regulatory tax imposed by existing regulations.

Answer: TRUE

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

15) Because of the government backing, investors in GNMA pass-throughs are guaranteed to earn at least the T-bill rate on their investments.

Answer: FALSE

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

16) A CMO is a multiclass pass-through that helps investors choose the amount of prepayment risk they will face.

Answer: TRUE

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

17) Loan sale by assignment provide more control over the contract to the loan buyer than participations loans.

Answer: TRUE

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

18) HLT loans are long maturity loans backed by the borrower's assets with floating interest rates tied to the Federal Funds rate.

Answer: FALSE

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

19) In collateralized mortgage obligations, Class A holders have higher prepayment risk protection than class C holders.

Answer: FALSE

Difficulty: 1 Easy

Topic: Collateralized mortgage obligations

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

20) Increased liquidity of bank loans, enhanced ability to manage the maturity gap and overcollateralization are some of the benefits of securitization.

Answer: FALSE

Difficulty: 2 Medium

Topic: Can All Assets Be Securitized

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-05 Determine whether all assets can be securitized.

Accessibility: Keyboard Navigation

21) Advantages of loan sales and securitization typically include all but which one of the following?

A) Reduction in credit risk

B) Reduction in interest rate risk

C) Increase in liquidity of the balance sheet

D) Reduction in regulatory tax burden

E) Increase in net interest income

Answer: E

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

22) In selling loans, FIs act as an asset \_\_\_\_\_\_\_\_ and in creating CMOs, FIs act as an asset \_\_\_\_\_\_\_\_.

A) transformer; broker

B) transformer; transformer

C) broker; broker

D) broker; transformer

Answer: D

Difficulty: 3 Hard

Topic: Loan Securitization; Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.; 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

23) A pass-through security is best characterized as

A) a multiclass mortgage-backed bond.

B) a security with a pro rata claim to the underlying pool of assets.

C) a bond backed by real estate.

D) a part of a loan assignment.

E) a part of a loan participation.

Answer: B

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

24) Which one of the following types of transactions leaves the assets on the balance sheet?

A) Loan sale without recourse

B) GNMA pass-throughs backed by mortgages placed in trust

C) CMOs issued using mortgage pool as collateral

D) Mortgage-backed bonds issued

E) None of the options are correct.

Answer: D

Difficulty: 1 Easy

Topic: Loan Securitization; Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.; 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

25) For a loan sold with recourse,

A) the loan seller has no further obligation at all to the loan buyer.

B) the loan seller removes the assets from the balance sheet and does not report a contingent liability in the footnotes.

C) the loan buyer cannot collect from the loan seller in the event of borrower default.

D) no reserve requirement is imposed.

E) None of the options are correct.

Answer: E

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

26) In a loan participation, which of the following is/are true?

I. The loan buyer has no part in the original underlying credit agreement, even after purchase of the loan.

II. If the selling bank fails, the loan buyer's claim against the selling bank may be treated as unsecured.

III. In the event the selling bank fails, the original borrower's deposits may be used to reduce the loan amount without any proceeds going to the loan buyer.

A) I only

B) II only

C) II and III only

D) I and II only

E) I, II, and III

Answer: E

Difficulty: 3 Hard

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

27) Characteristics of loan participations include the following:

I. The loan participant is not a primary creditor on the loan.

II. The original lender can change some loan terms without the participant's permission.

III. Participations are without recourse.

A) I only

B) II only

C) II and III only

D) I and II only

E) I, II, and III

Answer: D

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

28) If a mortgage pass-through experiences smaller prepayments than expected early on in the life of the security, the result will be that pass-through holders will receive \_\_\_\_\_\_\_\_ than expected cash flows early on and \_\_\_\_\_\_\_\_ than expected cash flows later on.

A) greater; less

B) greater; greater

C) less; greater

D) less; less

E) less; no different

Answer: C

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

29) You own a mortgage-backed security and you will receive fixed semiannual interest payments and no principal payments as long as prepayments remain within a given range. If prepayments move outside the range, cash flows will vary. You must be holding a \_\_\_\_\_\_\_\_.

A) class C or lower sequential pay CMO

B) PAC CMO

C) PO security

D) pass-through security

E) CDO

Answer: B

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

30) Important buyers of loans include all but which one of the following?

A) Foreign banks

B) Insurance companies

C) Closed-end bank loan mutual funds

D) Vulture funds

E) Credit unions

Answer: E

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

31) A loan that finances a merger or acquisition that results in a high-leverage ratio for the borrower is called a

A) correspondent loan.

B) CMO.

C) HLT loan.

D) low-recourse loan.

E) distressed loan.

Answer: C

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

32) Banks were willing to swap LDC loans for Brady bonds because

A) Brady bonds carried higher interest rates than the loans.

B) the bonds had variable interest rates.

C) the bonds were marketable and the loans were not.

D) the bonds were uncollateralized.

E) None of the options are correct.

Answer: C

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

33) Loan sales are likely to continue because

I. they can increase near-term reported earnings.

II. they reduce the amount of capital required.

III. more corporate borrowers have access to the commercial paper market.

A) I and II only

B) II and III only

C) I and III only

D) II only

E) I, II, and III

Answer: A

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

34) Fraudulent conveyance proceedings are

A) charges that a loan was improperly sold according to the conditions of the original loan agreement.

B) charges of improprieties in HLTs.

C) evidence of moral hazard on the part of the loan buyer.

D) illegal methods to boost borrower's earnings to increase probability of loan acceptance.

E) the primary cause of the subprime mortgage crisis.

Answer: A

Difficulty: 1 Easy

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

35) The act of buying a share in a loan syndication with limited contractual control and rights over the borrower is called a

A) correspondent loan.

B) loan assignment.

C) HLT loan.

D) loan participation.

E) distressed loan.

Answer: D

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

36) A three-class CMO has Class A, Class B, and Class C securities outstanding. Which class has the longest duration?

A) Class A

B) Class B

C) Class C

D) Class B and Class C have the same duration.

E) All of these choices are correct.

Answer: C

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

37) A bank originates $150,000,000 worth of 30-year single-family mortgages funded by demand deposits and the required amount of capital. Reserve requirements are 10 percent and the bank pays 32 basis points in deposit insurance premiums. The bank is earning a 6.25 percent coupon on the mortgages. The mortgages are priced at par and total monthly payments on the mortgages are $923,576.

How much capital is required to back the mortgages if the minimum risk-based capital requirement is 8 percent?

A) $75.0 million

B) $37.5 million

C) $12.0 million

D) $3.0 million

E) $6.0 million

Answer: E

Explanation: $150,000,000 × 0.50 × 0.08 = $6,000,000; mortgages carry a 50 percent risk weight.

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

38) A bank originates $150,000,000 worth of 30-year single-family mortgages funded by demand deposits and the required amount of capital. Reserve requirements are 10 percent and the bank pays 32 basis points in deposit insurance premiums. The bank is earning a 6.25 percent coupon on the mortgages. The mortgages are priced at par and total monthly payments on the mortgages are $923,576.

If the mortgages are securitized and deposits are reduced, how much will the bank save in the first year's reserve requirements and deposit insurance premiums in total?

A) $14,912,000

B) $16,512,000

C) $16,000,000

D) $17,332,500

E) $18,249,300

Answer: B

Explanation: 150,000,000 − 6,000,000 = 144,000,000 in deposits need to fund the mortgages.

Since the reserve requirement is 10%, this requires [(150,000,000 − 6,000,000)/(1 − 0.1)] = 160,000,000 in deposits

Reserve requirements are 160,000,000 × 0.1 = 16,000,000.

Deposit insurance premiums = (160,000,000 × 0.0032) = 512,000;

Total saved in reserve requirements and deposit insurance premiums = $16,512,000 (16,000,000 + 512,000)

Difficulty: 3 Hard

Topic: Loan Sales

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

39) A bank originates $150,000,000 worth of 30-year single-family mortgages funded by demand deposits and the required amount of capital. Reserve requirements are 10 percent and the bank pays 32 basis points in deposit insurance premiums. The bank is earning a 6.25 percent coupon on the mortgages. The mortgages are priced at par and total monthly payments on the mortgages are $923,576.

If the bank can originate and securitize this amount of mortgages with the same terms four times over the next year (including the existing mortgages) and the bank earns a servicing fee each month equal to 3.5 percent of the monthly payments, what will be the bank's monthly fee income 12 months from now?

A) $110,456

B) $116,432

C) $122,673

D) $129,301

E) $133,444

Answer: D

Explanation: 4 × 923,576 × 0.035 = $129,301

Difficulty: 3 Hard

Topic: Loan Sales

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

40) A form of trust that can issue multiple class debt securities without having to pay taxes on the interest paid is called a

A) CMO.

B) REMIC.

C) MBB.

D) PIP.

E) GNMA.

Answer: B

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

41) In a three-class sequential pay CMO, if we consider Class B holders as having average prepayment risk, then Class A holders have \_\_\_\_\_\_\_\_ prepayment risk and Class C holders have \_\_\_\_\_\_\_\_ prepayment risk.

A) above average; below average

B) below average; below average

C) below average; above average

D) above average; above average

Answer: A

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

42) A three-class sequential pay CMO has an initial principal balance of $30 million per class. In the first month, interest payments of $5 million and principal payments of $2 million are received. In the second month, Class A holders receive interest on \_\_\_\_\_\_\_\_ principal and Class B holders receive interest on \_\_\_\_\_\_\_\_ principal.

A) $30 million; $30 million

B) $28 million; $28 million

C) $27 million; $27 million

D) $28 million; $30 million

E) $30 million; $28 million

Answer: D

Difficulty: 3 Hard

Topic: Loan Securitization

Bloom's: Understand; Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

43) Which one of the following forms of securitization is usually "double securitization"?

A) Mortgage-backed bonds

B) CMO

C) Pass-through

D) Loan sale

E) Loan purchase

Answer: B

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

44) The typical duration of a Class B CMO is

A) 1.5 to 3 years.

B) 3 to 5 years.

C) 5 to 7 years.

D) 7 to 10 years.

E) 18 to 20 years.

Answer: C

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

45) The sum of the market values of all the classes of a CMO is greater than the total value of the GNMA pass-throughs backing the CMO because

A) the CMO has less credit risk than the pass-through.

B) CMO investors can choose their degree of prepayment protection.

C) the government guarantees CMOs' performance.

D) CMOs have a more favorable tax status than pass-throughs.

E) CMO investors have no prepayment risk.

Answer: B

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

46) The FDIC is concerned about issuance of mortgage-backed bonds (MBBs) because

A) the FDIC is concerned about investors' prepayment risk.

B) MBBs increase deposit insurance premiums.

C) the process takes loans off the balance sheet and replaces them with liabilities.

D) the process reduces the amount of assets available to back insured deposits.

E) None of the options are correct.

Answer: D

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

47) With a GNMA pass-through, the investor bears \_\_\_\_\_\_\_\_ of the prepayment risk; with a non callable mortgage-backed bond, the investor bears \_\_\_\_\_\_\_\_ of the prepayment risk; and with a CMO, the investor bears \_\_\_\_\_\_\_\_ of the prepayment risk.

A) some; all; none

B) all; some; none

C) all; none; some

D) none; some; all

E) none; some; none

Answer: C

Difficulty: 3 Hard

Topic: Loan Securitization

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

48) On January 1 a bank had originated 500 30-year fixed-rate mortgages with a 6.25 percent coupon at par. The average mortgage size is $255,000. The bank charges a 1 percent origination fee for each mortgage, but processing costs amount to 0.4 percent. After securitization the bank will retain 35 basis points in fee income for servicing the mortgage payments. The cost of this processing is 12 basis points.

What is the total amount of net fee revenue generated from the mortgages over the year?

Answer: Net origination fee income = (500 × $255,000) × (1% − 0.4%) = $765,000

Monthly mortgage payments: N = 360, I = 6.25/12, FV = 0, PV = −255,000, solve for PMT to get 1570.08 per average mortgage.

Total = 500 × 1570.08 = 785,039.43 for 500 mortgages

The bank nets 35 − 12 = 23 basis points on this total per month or 0.0023 × $785,039.43 × 12 months = $21,667.09 per year

Total annual net fee income = $765,000 + $21,667 = $786,667

Difficulty: 3 Hard

Topic: Loan Securitization

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

49) On January 1 a bank had originated 500 30-year fixed-rate mortgages with a 6.25 percent coupon at par. The average mortgage size is $255,000. The bank charges a 1 percent origination fee for each mortgage, but processing costs amount to 0.4 percent. After securitization the bank will retain 35 basis points in fee income for servicing the mortgage payments. The cost of this processing is 12 basis points.

The bank keeps a capital-to-asset ratio of 8 percent. If the bank does not securitize the mortgages, they will be fully funded with demand deposits that have a reserve requirement of 10 percent. The demand deposits also have a deposit insurance premium of 0.20 cents per $100 of deposits. If the bank securitizes the mortgages, how much less capital will the bank require? If the savings from not having the required reserves and the deposit insurance premiums could be invested at 5 percent, what is the dollar opportunity cost of not securitizing?

Answer: Capital requirement from the mortgages = (500 × $255,000) × 0.50 risk weight × 0.08 capital = $5,100,000

Opportunity cost from required reserves and deposit insurance:

Total deposits required to fund mortgages = ($127,500,000 − $5,100,000) / (1 − 0.10) = $136 million

Reserve requirement of 10 percent on this amount gives $136 million × 0.10 = reserves of $13,600,000 which earn 0 percent

Deposit insurance premiums = $136 million × 0.0020 = $272,000

Total costs = $13,600,000 + $272,000 = $13,872,000

This total could be invested and earn 5 percent so that in one year the bank could have had $13,872,000 × 1.05 = $14,565,600

The opportunity cost is thus the sum of the lost interest income and the deposit insurance premium cost = ($14,565,600 − $13,872,000) + $272,000 = $965,600

Difficulty: 3 Hard

Topic: Loan Securitization

Bloom's: Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

50) How does a mortgage pass-through differ from a CMO?

Answer: A pass-through simply "passes through" payments made by households to the investors on a pro rata basis. A CMO is a multiclass pass-through in which the issuer transforms or repackages the monthly mortgage payments made by households to provide investors with different risk and return characteristics. The CMO holder has less prepayment risk than a pass-through holder.

Difficulty: 1 Easy

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

51) Why are most loan sales on an assignment basis rather than a participation basis?

Answer: Assignment provides the loan buyer with clear legal rights in the event of default by the loan seller or borrower. In a participation, the loan buyer is not a direct claimant of the borrower, whereas a loan buyer has a direct claim on the original borrower in an assignment. In a participation, the loan seller also retains broad powers to modify the credit agreement without the consent of the loan buyers. This is not true in an assignment.

Difficulty: 3 Hard

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-01 Understand the purposes of loan sales and securitizations.

Accessibility: Keyboard Navigation

52) What are the major differences in the traditional and HLT segments of the loan sale market with respect to the types of loans sold?

Answer: In the traditional short-term segment, loan sales are generally sales of high-quality loans issued for 90 days or less with rates tied to the commercial paper market. Loans in the HLT segment are longer maturity (three to six years) and have floating rates tied to LIBOR. Some HLT loans are quite large and, because of the high leverage of the borrower, many HLT loans are distressed.

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-02 Identify characteristics that describe the bank loan sales market.

Accessibility: Keyboard Navigation

53) Why has securitization progressed most rapidly for home mortgages?

Answer: Home mortgages have standard maturities and easily appraisable collateral; default insurance is provided by FHA, VA, FMHA, or some private source to alleviate the need for security investors to assess default risk. These features make it easier to create and sell large amounts of marketable securities for mortgages than for other loan types.

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

54) How does mortgage securitization reduce the regulatory tax burden of a depository institution?

Answer: By reducing the amount of capital an FI is required to back the mortgages

By reducing reserve requirements on demand deposits used to fund the mortgage loans

By reducing the amount of FDIC insurance premiums required on deposits used to fund the mortgages

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

55) A three-class (Class A, B, and C) sequential pay CMO starts with an $80 million principal amount in each class. The mortgages in the pool have a 7 percent interest rate. The CMO classes receive monthly payments. During the first month, $1 million in interest is received from mortgage holders and $1.5 million in principal. What principal amounts are outstanding for each class during the second month? How will this affect the total payment each class receives? Explain.

Answer: During the second month, Class A holders have total principal amount outstanding of $80 − $1.5 million = $78.5 million. They will receive interest on the reduced principal amount so the total payment they receive will fall. Class B and C holders are protected from prepayments as long as Class A has principal outstanding, so Class B and C holders will receive interest-only payments on the original $80 million principal amount.

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand; Analyze; Apply

AACSB: Analytical Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

56) Why are MBBs the least used form of mortgage securitization?

Answer: The process of creating pass-throughs and CMOs removes mortgages from FI balance sheets; the creation of MBBs does not. The purpose of issuing MBBs instead of debentures is to provide collateral to the bondholder to improve the credit rating and get a lower debt cost. However, the issuer of the MBB bears all the prepayment risk (just as in a pass-through the investor bears all the prepayment risk), so the bonds issued must be substantially overcollateralized. They also do not eliminate the regulatory tax burden, nor improve diversification. These drawbacks limit their attractiveness to issuers.

Difficulty: 3 Hard

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

57) How does a PAC CMO differ from a sequential pay CMO?

Answer: A PAC investor receives constant cash flows if prepayments remain within a given range. PACs have a principal repayment schedule absent from sequential pay CMOs that give the investor more certain cash flows. A PAC is another way to limit prepayment risk. In a sequential pay, CMO investors who desire greater prepayment risk choose a class with greater prepayment protection, but at some point their class will become unprotected. With a PAC, the PAC investor always remains in the better-protected class.

Difficulty: 3 Hard

Topic: Loan Securitization

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

58) What are the major factors that are likely to contribute to continued growth in the loan sale market?

Answer: \*Loan sales help to manage credit risk and achieve better diversification.

\* Loan sales can generate immediately recognized fees that boost current income levels.

\*Loan sales improve the liquidity of the loan portfolio.

\*Loan sales reduce capital and reserve requirements.

Difficulty: 2 Medium

Topic: Loan Sales

Bloom's: Create

AACSB: Analytical Thinking

Learning Goal: 24-03 Discuss factors that encourage and deter loan sales growth.

Accessibility: Keyboard Navigation

59) Explain the payment pattern on a GNMA pass-through and a new Class B CMO when interest rates fall. Which has more predictable payments, and why would an investor care?

Answer: Prepayments increase as interest rates fall. The GNMA investor will receive his or her pro rata share of all prepayments and the prepaid amounts will reduce the principal of his or her investment and thus reduce all subsequent dollars of interest earned on the security. The holder of the new Class B CMO will initially be protected from any prepayments until all of the principal of the Class A CMO holders is paid off, so the Class B CMO holder will have no principal reduction and will continue to collect the same dollars of interest.

Difficulty: 2 Medium

Topic: Loan Securitization

Bloom's: Understand; Evaluate

AACSB: Analytical Thinking

Learning Goal: 24-04 Describe the major forms of asset securitization.

Accessibility: Keyboard Navigation

60) What loans, other than mortgages, are currently being securitized?

Answer:

\* Automobile loans

\* Credit card loans

\* Small business loans backed by the SBA

\* C&I loans

\* Student loans

\* Mobile home loans

\* Junk bonds

\* Time-share loans

\* ARMs

Difficulty: 3 Hard

Topic: Can All Assets Be Securitized; Securitization of Other Assets

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 24-05 Determine whether all assets can be securitized.

Accessibility: Keyboard Navigation