***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.

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

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

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

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

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

7) Vulture funds specialize in buying distressed loans.

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

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

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

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.

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.

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.

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.

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

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

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

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

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

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

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

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

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.

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.

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.

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

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

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

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

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

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.

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.

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

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.

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.

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.

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

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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

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

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.

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

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

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

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.

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.

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.

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

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?

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?

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

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

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?

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

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

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.

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

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

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

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?

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