Question 1 of 100

A traditional bank provides a company with mezzanine financing, where the amount of the loan is greater than the collateral value of the company's available assets. This form of financing is referred to as which of the following?

- **A.** blanket financing
- ✅ **B.** stretch financing
- **C.** excess financing
- **D.** subordinated financing

EXPLANATION • Learning Objective 5.1.5 **ID:** L1-5.1.5-028

With stretch financing, a bank lends more than is typically lent per traditional lending standards. The "stretch" part of the financing is the excess of debt beyond the collateral value of a company's assets. Senior lenders (e.g., banks) often provide stretch financing, and typically require an equity kicker in return.

Question 2 of 100

Which of the following is FALSE regarding the risk and rewards of venture debt funds and venture capital funds?

- **A.** Venture debt funds depend on a low rate of defaults because they do not have sufficient upside exposure in successful investments to compensate for failed ones.
- **B.** Venture debt funds are exposed to less downside from failing investments than venture capital funds.
- **C.** Profitable investments generate higher equity gains for venture capital funds than for venture debt funds.
- ✅ **D.** Break-even investments result in a total loss of venture debt funds, while venture capital funds recoup their initial investment.

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-011

Break-even investments do not result in a total loss for venture debt (VD) funds. In break-even investment scenarios (e.g., IRR = 0%), VD funds' performance is in fact higher than VC funds' performance, since VD funds get repaid with interest, while VC funds generate no return on their invested capital.

Other responses -

- Profitable investments (e.g., IRR > 0%) provide more upside equity participation to VC funds; the upside to VD funds is limited to their interest and warrant gain.
- Failed investments (e.g., IRR = -100%) result in a total loss for VC funds, while VD funds may recoup some of their capital and the security pledged against the loan.

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Question 3 of 100

Which of the following is true of project finance of an infrastructure project?

- A. The loans are funded with an equal mix of equity and debt.
- ✔ B. The loans are paid back with cash flows from the project.
- C. The loans provided are not secured.
- D. The loans provided are typically recourse loans.

EXPLANATION • Learning Objective 5.1.6 **ID:** L1-5.1.6-018

Project finance is the long-term financing of projects by investors who provide loans (typically non-recourse loans) to finance a specific project, and are repaid with the cash flows generated by the project. The loans are secured by the assets of the project.

Question 4 of 100

Which of the following statements apply to the practices of bank and non-bank venture lenders?

I. Bank lenders provide larger loans than non-bank lenders.
II. Banks engage in venture lending to secure future business from the start-up.
III. Non-bank lenders charge higher interest rates than bank lenders.
IV. Non-bank lenders' primary motivation is generating high yield.

- A. II and IV only
- B. I and III only
- C. I, II, and IV only
- ✔ D. II, III, and IV only

EXPLANATION • Learning Objective 5.1.7 **ID:** L1-5.1.7-012

Bank and non-bank lenders engage in different practices and with different motivations.

- Bank lenders offer smaller loans and lower interest rates than non-bank lenders.
- Bank lenders aim to develop a relationship with the borrower and secure their deposit accounts, while non-bank lenders aim to generate high interest income.

Question 5 of 100

Compared to corporate bonds, loans have:

- A. more default risk, more interest rate risk, and more liquidity.
- B. more default risk, less interest rate risk, and less liquidity.
- ✔ C. less default risk, less interest rate risk, and less liquidity.
- D. less default risk, more interest rate risk, and less liquidity.

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EXPLANATION • Learning Objective 5.1.3 **ID:** L1-5.1.3-010

Compared to corporate bonds, loans have less default risk (since they are the most senior debt instruments), less interest rate risk (since they tend to have floating rates), and less liquidity (since they are not publicly traded).

Question 6 of 100

In which of the following aspects does a commercial mortgage-backed security differ from an insured residential mortgage-backed security?

- **A.** whether it is backed by mortgage loans
- **B.** the use of tranches
- **C.** whether it is securitized
- ✓ **D.** the embedded risk

EXPLANATION • Learning Objective 5.2.4 **ID:** L1-5.2.4-009

Commericoal MBSs are mainly subject to default risk, whereas residential MBSs are subject to substantial prepayment risk.
In general, ways in which CMBSs differ from insured RMBSs -

1. Less prepayment risk
2. More default/credit risk
3. Fewer mortgages

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Question 7 of 100

Which of the following are internal credit enhancements typically used for pools of credit card receivables?

- **A.** cash collateral accounts and overcollateralization
- **B.** senior certificates and letters of credit
- **C.** collateral invested amounts and senior certificates
- ✓ **D.** overcollateralization and spread accounts

EXPLANATION • Learning Objective 5.2.3 **ID:** L1-5.2.3-008

Internal credit enhancements

1. Senior/subordinated certificates
2. Overcollateralization
3. Excess finance charges (excess spread)
4. Spread accounts (if performance indicators fall below thresholds, any excess spread is put into an account to benefit the noteholders)

Other responses include external credit enhancements -

1. Cash collateral accounts
2. Third-party letters of credit
3. Collateral invested amounts (CIAs)

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Question 8 of 100

If interest rates have been declining steeply for the past two years and are predicted to level off or decline only slightly at a slower rate over the next year, then, over the next year, prepayment rates are likely to do which of the following?

- **A.** decrease ✓
- **B.** increase
- **C.** be unaffected

EXPLANATION • Learning Objective 5.2.4 **ID:** L1-5.2.4-002

Prepayment rates are likely to decrease because of refinancing burnout. There was likely a great deal of refinancing in the previous two years, and the leveling off or slower declines will result in a fall in the rate of refinancing.

Question 9 of 100

A large U.S. pension fund has entered into an indemnity-based longevity swap contract to hedge its longevity risk. Which of the following most accurately represent the risks to which the pension fund is exposed?

- **A.** rollover risk, counterparty risk, and legal risk ✓
- **B.** basis risk, counterparty rate risk, and rollover risk
- **C.** legal risk, interest rate risk, and counterparty risk
- **D.** catastrophe risk, rollover risk, and legal risk

EXPLANATION • Learning Objective 5.3.4 **ID:** L1-5.3.4-001

Risks to which pension plans that use indemnity-based longevity swaps to hedge longevity risk are exposed –

1. Counterparty risk
2. Rollover risk (pension plan's hedging contracts have shorter maturities than its liabilities)
3. Legal risk

Unlike index-based swaps, indemnity-based swaps are not exposed to basis risk.

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Question 10 of 100

The exhaustion point of a cat bond trigger is best described as which of the following?

- **A.** level of claims loss at which investors are not responsible for any additional claims ✓
- **B.** point at which the issuer becomes exposed to basis risk
- **C.** time investors need to wait after the bond matures to reclaim the principal

EXPLANATION • Learning Objective 5.3.2 **ID:** L1-5.3.2-005

The exhaustion point is the level of claims loss at which the principal is "exhausted", so investors are not responsible for additional claims beyond this level.

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Question 11 of 100

Procedures for compliance with the Code and Standards related to dealing with all clients in a fair and impartial manner when giving investment advice include which of the following?

- **A.** putting together an investment policy statement for each client
- **B.** disclosing management compensation arrangements to all clients
- **C.** submitting itemized statements of funds and securities to each client
- ✓ **D.** developing and disclosing trade allocation procedures to clients

EXPLANATION • Standard SIII-B **ID:** L1-SIII-B-021

In accordance with Standard III(B), Fair Dealing, members and candidates must deal fairly and objectively with all clients when providing investment analysis or making investment recommendations. One of the procedures for compliance with this standard is developing and disclosing to clients trade allocation procedures, that is, the way in which accounts are selected for orders and the number of securities that an account buys or sells is determined.

Other procedures include limiting the number of people who know that a recommendation is to be announced, reducing the time between the decision to make a recommendation and its dissemination, and ensuring simultaneous dissemination of information.

Question 12 of 100

Trudy Banks, a portfolio manager, has designed a new algorithm for passive portfolio management and started using it instead of the old procedure. According to the Code and Standards, Trudy:

- ✓ **A.** should inform her clients of this change because it may have a significant effect on portfolio composition.
- **B.** should not inform her clients of this change because of the proprietary nature of the algorithm.
- **C.** does not have to inform her clients of this change as long as the data analyzed by the algorithm is still the same.
- **D.** does not have to inform her clients of this change as long as her superior approves the new procedure.

EXPLANATION • Standard SV-B **ID:** L1-SV-B-046

Trudy should inform her clients of this change. Standard V(B), Communication with Clients and Prospective Clients, requires that clients be kept informed of any changes to the investment process. This is because understanding the characteristics of an investment is important for assessing the investment's suitability on a standalone basis and for determining its impact on a portfolio.

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