Economics 252 – Financial Markets

Spring 2011

Lecture 9: Real Estate

February 16, 2011

Multiple Choice Questions

Question 10.1

Which of the following statements are true about Direct Participation Programs (DPPs) and Real Estate Investment Trusts (REITs) in the U.S.?
(More than one answer may apply.)

(a) Because DPPs were not accessible for small investors, the U.S. Congress created the legal framework for REITs in 1960.
(b) No investor in a DPP is protected by limited liability.
(c) DPPs and REITs do not pay corporate profits tax.
(d) REITs can be set up for all kinds of purposes, e.g. a financial advising company or a coal mine can have the legal form of a REIT.

Question 10.2

What is a balloon payment mortgage, as defined in class?

(a) It is a mortgage specifically suited for the financing of buildings that are used by the ballooning industry.
(b) It is a mortgage contract, where you only pay interest during the course of the contract and repay the entire mortgage principal as a balloon-payment at the maturity date of the contract.
(c) It is a mortgage contract, in which the monthly payments consist of an interest component and a principal repayment component, so that the mortgage balance, i.e. the remaining principal, at the maturity date is equal to zero.
(d) Mortgages that will subsequently be guaranteed by either Fannie Mae or Freddie Mac are referred to as balloon payment mortgages.

Question 10.3

Consider a level payment, fixed rate, fully amortizing mortgage. What happens to the total monthly payment and the interest payment component of the monthly payment, as the mortgage contract gets closer to the maturity date?

(a) The total monthly mortgage payment and the interest payment component increase.
(b) The total monthly mortgage payment and the interest payment component decrease.
(c) The total monthly mortgage payment remains constant and the interest payment component decreases.
(d) The total monthly mortgage payment remains constant and the interest payment component increases.

Question 10.4

Which of the following statements are true with respect to the two U.S. Government Sponsored Entities Fannie Mae and Freddie Mac?
(More than one answer may apply.)

(a) The federal government created Fannie Mae in 1938, and Freddie Mac in 1970.
(b) Since their creation, the federal government has always explicitly guaranteed the securities of both Fannie Mae and Freddie Mac.
(c) Fannie Mae and Freddie Mac have been put under federal conservatorship in 2008.
(d) Fannie Mae and Freddie Mac created securities with a corporate guarantee against default, which were backed by mortgages.

Question 10.5

The European Parliament has passed a directive in response to the financial crisis from 2007-2008 that has later been incorporated into the Dodd-Frank Act from 2010. What, according to the lecture, is the content of this directive and what is its purpose?

(a) The directive has declared the entire mortgage securitization process illegal, because of the role it has played in the onset of the financial crisis.
(b) Mortgage originators are required to keep 100% of the mortgage balances that they issue on their books, which eradicates the moral hazard problems inherent in the mortgage origination process.
(c) Mortgage originators are required to keep 5% of the mortgage balances that they issue on their books, which addresses the moral hazard problems inherent in the mortgage origination process.
(d) The directive required that only balloon payment mortgages could be securitized, which rules out all the kinds of mortgages whose securitization has led to the financial crisis.

Correct Answers

10.1: (a) and (c)
10.2: (b)
10.3: (c)
10.4: (a), (c), and (d)
10.5: (c)