

## The Securitization Alphabet: Of ABS, RMBS, CMBS, CDOs, CBOs, CLOs ...

**Securitization refers to pooling various types of debt and selling their principal- and interest-related cash flows as securities to investor clusters with different sets of risk appetite: This is achieved by dividing and prioritizing the pool's cash flows into sections, with some of these tranches more risky than others.**

The rationale of securitization has been twofold:

- Parts of a firm generating consistent cash flows may deserve a higher credit rating than the company as a whole (credit enhancement), and
- Rights to future expected cash flows can be liquefied in selling those as a lump sum already today.

First, a financial institution (originator) collects loans, usually backed by some sort of collateral (e.g. real estate), and subsequently sells them to a special purpose vehicle (pooling), which in turn transforms these receivables into marketable securities (securitization). The cash flows generated by the underlying debt-funded assets are then distributed like a waterfall among the newly created securities of different seniority, starting with the safest tranche, with possible losses first falling on the investors holding the most risky, junior tranche. Evidently, the least risky tranche (often rated AAA) would receive the lowest yields, whilst the most risky (usually unrated) tranche (also called equity tranche) would be first in line in absorbing losses and earn the highest yields. The mezzanine tranches (rated AA to BB) would absorb losses, once the equity tranche is wiped out.

Additional credit enhancement can be achieved by buying third-party insurance, reserve (or spread) accounts, but foremost by over-collateralisation (i.e. principal value of the underlying collateral exceeding the principal value of the CLO tranche). Coverage tests determine whether senior tranches are sufficiently protected. If a test fails, then cash flows are directed to senior tranches until a deal is back in compliance with the test.

Securities supported by underlying financial assets are generally referred to as Asset-Backed Securities (ABS). Whereby, following major securitization-

related categories of securities have crystallized, with terms by times somehow differing:

- ABS (in narrower sense) are backed by credit card debts, student loans, consumer loans, auto loans, else
- RMBS: Residential mortgage-backed securities (e.g. property, land, house)
- CMBS: Commercial mortgage-backed securities (e.g. office building, industrial land, plant, factory)
- CBOs: Collateralized bond obligations (backed by higher yielding bonds)
- CLOs: Collateralized loan obligations (backed by higher yielding loans)

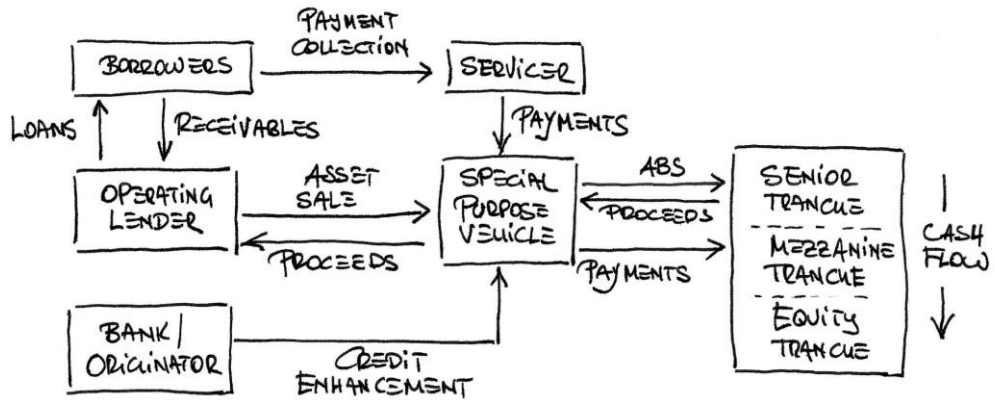
CDOs (collateralized debt obligations), for example, may refer to debt pools by larger corporates, whilst nearly always associated with the 2008 financial crisis and pools of sub-prime mortgages. Back then, CDOs were issued on (sub-prime mortgage backed) CDOs (referred to as CDOs squared). Additional complexity with which the (mostly housing-based) 2008 CDO crisis is associated with was caused by bets using credit default swaps (CDS) issued to protect against the decline of a certain CDO tranche.

Today, CLOs are foremost backed by non-investment grade, first lien, senior secured and broadly syndicated bank loans. By the early 2020s, historically low interest rates have not only stirred an unprecedented growth momentum of CLOs, but also resulted in credit standards of underlying loans deteriorating, referred to as covenant light. (Financial covenants are contractual agreements that, among others, may limit the amount of leverage a company is allowed to take on, or define the minimum amount of cash required at hand to pay interest on loans). A substantial amount of loans packaged in CLOs comes from corporates or vehicles used by private equity firms in the course of leveraged buyouts.

In structuring a CLO, a so-called warehouse bank initially provides the CLO manager financing to acquire assets, whereby subsequently proceeds from the issuance of CLOs are used to purchase additional assets. During the reinvestment period, the CLO manager is permitted to actively trade assets, whereby principal-related cash flows from underlying assets are used to purchase new assets. In the final (amortisation) period, cash flows are used to pay down the outstanding notes. Typical maturity of CLOs is around 10 years.

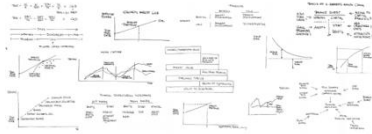
# ASSET BACKED SECURITIES

<u>MBS</u>	<u>CDOs</u>	<u>ABS (NARROW TERM)</u>	
RMBS	CLOs	CONSUMER	NON-CONSUMER
CMBS	CDOs	CREDIT CARDS	PROJECT FINANCE
	CBOs	STUDENT LOANS	SOVEREIGN FINANCE
	SPECIAL FORMATS	AUTO LOANS	⋮
	CDOs of ABS	⋮	⋮
	CDO <sup>2</sup>		
	CSOs		
	⋮		



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Christian Schopper

