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Collateralized debt obligation

A mortgage-acquisition contraption disastrously popular in the early and mid-2000s. Collateralized debt obligations (CDO) financed these assets with layers of liabilities. Equity was the junior-most layer, or "tranche," with mezzanine debt, junior debt and senior debt completing the right side of the CDO balance sheet.

The CDO was a work of financial engineering. It was structured to apportion losses, should they arise, among the liability holders according to the seniority of their claims. Thus, the equity tranche bore the first loss. The mezzanine level was next in line, followed by the higher-ranking classes of debt. At the penthouse of the structure were the senior claimants whose holdings were typically rated triple-A.

The popularity of CDOs levitated along with house prices and mortgage debt. Issuance reached $520 billion in 2006, up from $68 billion in 2000, according to the Securities Industry and Financial Markets Association.

A 2012 study by Fitch Ratings entitled, "Global Structured Finance Losses, 2000-2011 Issuance," found that 51.7% of the value of the CDOs that came into the world over that dozen-year span have been, or will eventually be, lost. "Problematic" assets were one cause of this shocking record; CDOs held lots of subprime residential mortgage-backed securities. Extreme leverage was another source of trouble; some CDOs piled $100 worth of assets on just $1 of equity, with the result that losses reached even the supposedly insulated triple-A tranches. Needless to say, neither the engineers who designed the CDOs nor the investors who bought them nor the agencies that rated them were counting on a nationwide bear market in houses.

"Losses are especially severe for structured finance CDOs issued at the peak of the market," according to Fitch, "with approximately 80% of the 2006 and 2007 vintage issuance expected to be written off. This severe underperformance mirrors that of the more problematic assets securitized in structured finance CDOs—subprime residential mortgage-backed security bonds and, to a lesser extent, commercial mortgage-backed security bonds—with the higher losses resulting from the additional leverage created by the CDO structures."

In defense of the fundamental design of the CDO, let the record show that asset-backed securities (ABS) stocked with assets other than bubble-era home mortgages have performed creditably. Again to quote Fitch: "Consumer assets, which account for 28.3% of the overall U.S. structured finance balance, have especially proven their resilience throughout the crisis. No losses are expected on credit-card transactions, only two auto ABS tranches are expected to incur losses and student-loan transactions have low net losses of 0.3%."

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