

## Collateralized Debt Obligations

Collateralized Debt Obligations (CDOs) is a financial structure backed by a pool of loans hence they are basically a pool of loans; such as mortgages, credit card loans, car loans and student loans. How CDOs are formed is that Banks approve the above loans to individuals or businesses, these loans are then sold to investment banks or firms such as fidelity, maybe vanguard, Merrill Lynch and etc. The investment banks or firms then repackage these loans to form a single bond called the CDO, this is then sold to investors (in this case the investors are basically creditors.) Again, like the Mortgage Backed Securities, the banks act as the middleman between the borrower and the investors/lenders. Every time the principal and interest are made onto those loans, that money goes to the investors/lenders. If the loans go bad (most commonly rise in default rate), much of the risks are transferred to investors. CDOs are usually sliced into tranches (or pieces), each piece has their own characteristics, one might be of higher credit but lower rate of return but another might be lower credit rating but higher rate of return; typically senior and junior tranches, senior tranches has first claim on assets if some of the underlying loans default, junior tranches are riskier.

Prior to the housing market crash of 2008, CDOs became extremely popular in around 2003. Housing grew in 2003 and led Banks to use subprime mortgages as the main source of collateral for these CDOs. With the popularity of CDOs sky rocketing, home lenders received a steady flow of cash, therefore banks approved loans to riskier or high risk borrowers. Going close to 2008, the housing market started to stall, mortgage default rates increased and investors whom invested in these CDOs lost money on their investments.

<http://www.investopedia.com/terms/c/cdo.asp>