



 The Journal of Structured Finance

Assessing the Credit Risk of CDOs Backed by Structured Finance Securities

Rating Analysts' Challenges and Solutions

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The Journal of Structured Finance Fall 2007, 13 (3) 43-59; DOI: <https://doi.org/10.3905/jsf.2007.698655>

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Abstract

The collateralized debt obligation (CDO) market grew strongly in the last several years thanks to a strong U.S. housing market, a low interest rate environment, abundant global excess liquidity, and a healthy U.S. economy. The growth slowed significantly in 2007 amidst an unprecedented housing market turnaround and the sudden performance deterioration of recent-vintage subprime residential mortgage-backed securities (RMBS). CDOs' large exposure to these subprime RMBS brought them under intense scrutiny. The illiquidity, novelty, and complexity of CDOs made them easy targets of criticism. This paper describes the evolution of CDOs backed by structured finance securities (SF CDOs) and the analytical approaches used by Moody's to rate SF CDOs. We show that SF CDOs have experienced substantial changes in the last eight years in terms of asset distribution and transaction structure. We find that this sector has been dominated by Aaa-rated securities (about 85% by dollar volume of issuance), which had not experienced any defaults and losses as of the end of 2006. Although recently issued SF CDOs are expected to perform poorly, not all SF CDOs are backed by subprime RMBS and CDO performance is expected to vary significantly across transactions. This paper also describes Moody's methods for the modeling of four basic components—default probability, recovery rate, asset correlation, and prepayment rate—and the differences and similarities across different rating models for transactions with and without complex waterfalls. Additionally, we analyze the rationale of a number of structural features such as par haircuts on assets with low credit ratings and assets purchased at deep discounts in SF CDOs as well as additional stresses that are designed to protect SF CDO investors.



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