

# MAKE YOUR OWN CDO'S – COLLATERALLISED DEBT OBLIGATIONS

## Step 1

Assume two \$1.00 bonds


Pay \$0 on default, + \$1.00 otherwise

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## Step 2

Combine the two in a structure

Junior
Senior

- Bears first \$1.00 loss
- Pays zero if **either** bond defaults
- Pays \$1.00 if both avoid default
  
- Only defaults if **both** bonds default

## Insight

If defaults on the two bonds are imperfectly correlated, the senior tranche will pay either \$0 or \$1.00 *except that it is less likely to default than either of the underlying bonds*

## Example

If the two bonds have a 10% default probability and the defaults are uncorrelated:

Senior tranche has 1% chance of default

Junior tranche has 19% chance of default

## Next Step

Include a third bond.

Again with 10% default probability and defaults uncorrelated.

	<i>Chance of Default</i>
Senior	0.1%
Middle	2.8%
Junior	27.1%

## Next Insight

By including a third bond in the pool, TWO THIRDS of the capital can be repackaged into claims that are less risky than the underlying bonds.

## Don't Stop There

Combine a junior tranche from one pool with a junior tranche from another pool and make

a "CDO squared"

sell it quickly

*Note:*

*Derived from "The Economics of Structural Finance". Coral, Jurek and Stafford. Harvard Business School Working Paper 09-060*