Collateralized Debt Obligations
Innovation or Fad
The Impacts on Real Estate

Introduction

A fairly recent development, the Collateralized Debt Obligation ("CDO"), often operates below the radar screen, especially in the world of commercial real estate finance. CDOs can be looked at in many ways and cover many asset classes. They have had a profound impact on commercial real estate finance and that impact is expected to expand.

Let's first look at CDOs generally. They are a form of structured finance. In one sense they are a way to take the cash flow from a broad range of assets and to redistribute them to create another set of securities. In that view, they are cash flow structures and the CDO does not increase or decrease the cash flow or credit risks from the underlying assets. It merely re-allocates them among the new securities issued by the CDO. This re-allocation can tailor the risks in a way that makes them more liquid and understandable. This means that securities that themselves are hard to structure can be combined with other assets in a CDO and made more saleable. In this view the cash flows from the assets are restructured into a new sequence of cash flows and synthetic securities or bonds are created.

The range of possible CDOs is extremely broad. There is no single type of asset or structure used for CDOs. To develop a better understanding of CDOs it is helpful to look at four of the fundamentals regarding them - purpose, assets, cash flow allocation, and credit structure. Before we look at each of these, let's look at the capital stack structure or cash flow waterfall of a simple CDO shown in Figure 1 below.

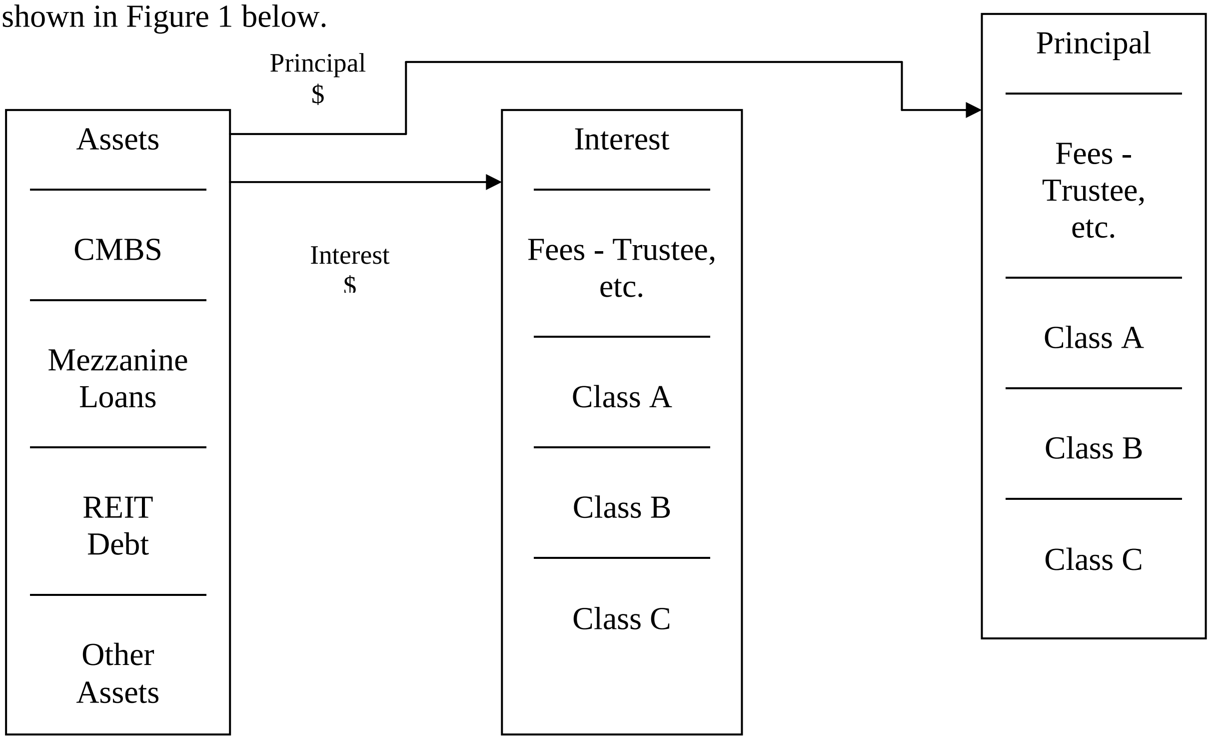

Figure 1

The list of assets for this simple CDO is assumed to be a series of mezzanine loans and secured junior lien loans. They have been acquired for fair market value and put into a Special Purpose Entity (SPE). Each month the cash is received by the servicer/paying agent in connection with these assets. The cash flow is distributed with respect to the new CDO securities as described in the CDO documentation. Let's assume that it is a sequential pay waterfall wherein the principal and interest each flow according to a separate waterfall. When payments of interest are received, they are distributed to the CDO securities holders in order of payment priority. The holders of Class A get paid in full for all interest due before any payment of interest can flow to Class B holders. Likewise, no Class C holder gets interest until all of the Class B holders have been paid their interest. Payments of principal also flow according to a separate sequential waterfall. There is no carry over from the interest waterfall to the principal waterfall - they are separate and distinct. Any payment of principal goes first to Class A (pro rata among the holders if there is not enough to pay all Class A claims), and only when Class A is fully paid all principal is any principal paid to the Class B members. This continues down the chain of Classes from A to B to the end. Losses are absorbed by those at the bottom of the distribution waterfall from the bottom up because there just isn't enough cash to make all required payments.

History

CDOs have evolved over time. When originally started around 1999, real estate CDOs were typically static pools that contained subordinate pieces of Commercial Mortgage Backed Securities ("CMBS"), in many cases the most risky, unrated pieces, often referred to as "B-pieces" and debt of public real estate investment trusts ("REITs"). The CDO was more flexible than other structures and essentially allowed holders of B-pieces to gain liquidity and leverage for otherwise difficult to sell assets. Starting about 2004 the CDO structure changed significantly. A number of CDOs almost became mutual funds for real estate debt. That is, they were actively managed pools of commercial real estate assets that bought and sold the debt instruments relating to real estate. As discussed later, debt instruments also expanded dramatically to include mezzanine loans, participations in mortgage instruments and even standard real estate loans, sometimes referred to as whole loans. The key is the active management of the debt instruments by the asset manager of the CDO. Since the CDO assets are so complex and diverse, asset managers have had to develop skills not only in a broad range of real estate and restructuring, but also in analyzing and trading complex fixed income products and derivatives.

Purposes

There are several main purposes for the CDOs.

1. Liquidity. An important advantage to CDOs is that they allow holders of hard-to-sell financial instruments to find a market for their assets. CDO managers are sophisticated purchasers of debt instruments and are willing to buy and sell complex instruments. Sponsors of financial instruments increasingly employ CDOs because they can create viable markets for their ever increasingly complex debt products.

2. Balance Sheet Management. Many institutions, particularly insurance companies and banks, often have regulatory requirements to hold reserves against their loan portfolios. For example, under the Basel Accords, capital adequacy requirements are set out to ensure stability

and to try to make an attempt at uniformity. Most CDO interests are rated by a national statistical rating agency and therefore have an advantage, and sometimes a material advantage against unrated debt or real estate loans with respect to reserve requirements.

3. Assets Under Management. Many CDO sponsors use CDOs as a vehicle to increase assets under management and thereby increase their fee income.

4. Diversification. A well diversified pool of assets can make an interest in a CDO less risky than owning the individual parts that go into the CDO pool of assets. It is a useful tool to hedge risk. Diversification is central to the idea of eliminating the riskiness of the individual assets owned by the CDOs.

5. Capture Arbitrage Spread. CDOs can only work if the underlying assets yield more income than the debt issued to acquire those assets. Some CDOs are simply an attempt to capture those excess spreads of high yielding assets over the CDO liabilities.

Obviously, not all CDOs provide the same benefits and sponsors structure different CDOs to accentuate one or more of the benefits for each CDO they create.

Assets

In most cases, the principal requirement for an asset in a CDO is its cash flow.[1] Originally, as mentioned above, for a real estate CDO, CMBS bonds and REIT debt were the principal components. Today, the list of assets in a real estate CDO has greatly expanded to include:

- CMBS bonds (including B-pieces)
- Whole loans[2]
- Credit tenant lease obligations[3]
- REIT debt
- Construction loans
- Mezzanine loans[4]
- Preferred equity[5]
- B-Notes[6]

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[1] Some CDOs have assets or derivatives and other exotic assets as the source of their cash flow, but these asset-backed and synthetic CDOs are not within the scope of this discussion of primarily real estate-backed CDOs. Some CDOs are based on the fair market value, but these are most often used with assets other than real estate related assets

[2] Standard commercial real estate loans, both secured and unsecured

[3] Rental streams from credit tenant leases are predictable and well suited to CDOs.

[4] Mezzanine loans are loans usually not secured by the real estate but rather by the limited liability membership interests, partnership interests, or corporate shares of the borrower.

[5] Preferred equity, although a pure equity interest, has an associated cash flow and can be used as an asset in a CDO.