LM17 · FIXED INCOME · CFA LEVEL I

Fixed-Income Securitization

How loans become ABS: originator, SPE / trust, servicer; benefits and risks of securitization; the waterfall.

Learning Outcomes

LOS a Describe the securitization process and the parties involved

LOS b Describe the benefits and risks of securitization for issuers, investors, and the financial system

Exam Tip: Remember the 3-party structure (Originator / SPE / Servicer), the SPE's bankruptcy-remote status, and the waterfall from senior to junior tranches. Know covered bonds vs ABS (covered bonds = dual recourse, no SPE).

LOS A · SECURITIZATION STEPS

Three-Step Securitization Process

1. The **originator** (bank or corporate lender) creates a pool of debt-based assets (mortgages, auto loans, receivables).
2. The pool is sold to a **special purpose entity (SPE)**, a legal entity separate from the originator.
3. The SPE issues **ABS** supported by cash flows from the pool. Cash from investors flows to the originator.

LOS A · PARTIES & ROLES

Parties to a Securitization

PARTY	ROLE
Originator / seller / depositor	Creates the loan pool and sells it to the SPE
SPE / trust / issuer	Buys the loans and issues ABS. Is **bankruptcy-remote** from the originator.
Servicer	Collects payments, notifies delinquents, may seize collateral. May or may not be the originator.
Trustee	Disinterested party that safeguards collateral and CFs and provides information to ABS holders.
Credit enhancer	Provides internal (overcollateralization, excess spread, subordination) or external enhancement (letter of credit, wrap).

Bankruptcy remote: because the SPE is a separate legal entity, the originator's financial troubles do not directly impair the SPE's obligations to ABS investors.

CHECKPOINT 1

Quiz 1: Process

Answer all questions to test your understanding. Your score updates on the final step.

Q1. The **SPE** in a securitization is best described as:

Q2. The **servicer** in a securitization:

Q3. Which of the following is a benefit of securitization to the *originator*?

Q4. Waterfall structure in an ABS directs cash flow:

Q5. A covered bond differs from an ABS because:

LOS B · BENEFITS AND RISKS

Benefits & Risks of Securitization

Benefits

- **Originator:** new loans funded; fees; improved liquidity; reduced regulatory capital (for banks).
- **Investors:** customized risk/return exposures; access to otherwise illiquid pools; liquidity in a secondary market.
- **Economy:** less liquidity risk in the system; improved market efficiency.

Risks

- Cash flows from collateral are **uncertain** (timing and size).
- Credit risk of the collateral is passed through to ABS investors.
- Systemic buildup of credit risk in ABS can destabilize the financial system (2007–2009 GFC).

LOS A · CREDIT ENHANCEMENT STRUCTURES

Credit Enhancement

Overcollateralization

Collateral value > face value of ABS.

Excess spread

Income on collateral > coupon promised to ABS investors; excess retained to absorb losses.

Credit tranching / subordination

Multiple ABS classes with different priority of claims. Subordinated tranches absorb credit losses first.

Credit enhancements are **internal** to the structure. External enhancements (letters of credit, insurance wraps) can also be used.

CHECKPOINT 2

Quiz 2: Benefits & Structures

Answer all questions to test your understanding. Your score updates on the final step.

Q6. Overcollateralization means:

Q7. In a waterfall, the **junior** tranche:

Q8. A main risk of securitization to the *financial system* is:

Q9. A letter of credit is an example of:

Q10. One benefit of securitization to the *investor* is:

LOS A · CDOS AND CLOS

Collateralized Debt Obligations (CDOs)

A **CDO** is a structured security backed by a pool of debt obligations. Types include CBOs (corporate & EM bond collateral), CLOs (leveraged bank loans), and structured-finance CDOs. Most post-GFC CDOs are **CLOs**.

Unlike regular ABS, CDOs have a **collateral manager** who dynamically buys and sells securities in the collateral pool to generate cash for investor payments.

Three major types of CLOs

1. **Cash-flow CLOs** — payments from collateral cash flows.
2. **Market-value CLOs** — payments from trading collateral market value.
3. **Synthetic CLOs** — exposure via credit derivatives; trust does not own the collateral.

CHECKPOINT 3 · SYNTHESIS

Quiz 3: Synthesis

Answer all questions to test your understanding. Your score updates on the final step.

Q11. A collateralized loan obligation (CLO) backed by leveraged loans differs from a typical ABS because it has:

Q12. A synthetic CLO:

Q13. The originator of a securitization benefits by:

Q14. A **credit-tranched** ABS is designed to:

Q15. A covered bond's principal advantage over an ABS is:

MODULE COMPLETE

Your Scorecard

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LM17 Key Takeaways — Exam-Ready Cheat Sheet

3-party structure

Originator sells loans → **SPE (bankruptcy-remote)** issues ABS → **Servicer** collects payments. Trustee oversees.

Credit enhancement

Internal: overcollateralization, excess spread, subordination (tranching). **External:** letters of credit, insurance wraps.

CDOs / CLOs

Active collateral manager (vs. static ABS). Cash-flow / market-value / synthetic structures.

Covered bonds vs ABS

Covered bonds: no SPE, dual recourse to issuer + collateral, issuer must replenish pool.

Step 1 of 10