Glossary of Financial Terms

Structured Product
For our purposes, a bond backed by a pool of assets, such as mortgages.

Mortgage-Backed Securities
The mortgages are pooled into Mortgage-Backed Securities. Investors buy tranches of the securities.

Tranche
The word tranche is French for slice, section, series, or portion. A tranche is a portion of a structured product created such that each portion has the same cash flow characteristics. A structured product is divided into multiple tranches that have different risk characteristics.

CDO
A structured product which gives the bond holders the right to receive the cash flows from a pool of other securities – often including mortgage backed securities. A CDO is divided into multiple tranches that have different risk characteristics.

CDO² (or CDO squared)
A structured product which gives the bond holders the right to receive the cash flows from a pool of tranches of different CDOs.

AAA rating
The highest available rating from a credit rating agency, representing the lowest credit risk of any class of debt securities. For example, the AAA tranches of a mortgage-backed security, a CDO, or a CDO squared are the highest rated, lowest risk tranches.

By the numbers
Take a hypothetical $750 million mortgage-backed security backed by 5,000 subprime mortgages of $150,000 each. Typically, about 80% or $600 million of these subprime mortgage-backed securities are rated AAA.

5,000 mortgage loans of $150,000 each = $750 million

$600 million

AAA

$150 million

AA and lower tranches

80%

$750 million mortgage-backed security

84%

$635 million

AAA-rated bonds

Now, if you take the AA and A tranches of the CDO and repackage them into a CDO squared with other AA and A tranches, over 84% or nearly $635 million of the original $750 million in mortgage-rated assets has now been translated into AAA-rated bonds.