



CDO NEWSLETTER

Issue 1, March 6, 2006

Manroop Jhooty
Senior Vice President
(416) 593-5577 x2280
mjhooty@dbrs.com

Jireh Wong
Senior Vice President
(416) 593-5577 x2227
jwong@dbrs.com

Sean O'Connor
Vice President
(212) 806-3252
soconnor@dbrs.com

Toronto Office
200 King Street West
Suite 1304
Toronto, ON M5H 3T4
Canada
(416) 593-5577

New York Office
One Exchange Plaza
55 Broadway
Suite 1502
New York, NY 10006
U.S.A.
(212) 806-3277

Chicago Office
101 North Wacker Drive
Suite 100
Chicago, IL 60606
U.S.A.
(312) 332-3429

London Office
75 Cannon Street
London, EC4N 5BN
United Kingdom
(0) 20 7556 7392

Tricia Macdonell
Publisher
(416) 593-5577 x2347
tmacdonell@dbrs.com

Concentration Risks in CDOs: Will idiosyncratic risks translate into systematic deterioration?

Given the relatively limited universe of names within the Credit Default Swap (CDS) market, many CDO transactions have overlapping reference obligors. Consequently, investors often express concern as to whether a limited number of adverse events could have a broad impact on senior tranche ratings within the synthetic CDO market.

To address this concern, Dominion Bond Rating Service (“DBRS”) analyzed the entire universe of its CDO ratings to determine the exposure it has to some of the most widely referenced names. Based on this review, two entities were identified as the most widely held names: Company A and Company B. For the purposes of this newsletter, they will remain nameless. Company A is represented in over 29% of DBRS-rated CDOs (excluding CDOs of ABS) and Company B is represented in approximately 21%. CDOs that reference both Company A and Company B equal 17% of DBRS’s rated universe.

An effective means of determining the ratings sensitivity a single name has on a CDO portfolio is to assume the name defaults. While credit migration of the entity is likely a more reasonable scenario for investment-grade names, defaulting provides the worst case impact on the portfolio. Table 1 below summarizes the frequency of each name across DBRS-rated CDO portfolios with senior tranches (Column A), the per cent of senior tranches potentially impacted by a default of either Company A and/or Company B (Column B), and the corresponding magnitude of downgrade risk (Column C).

Reference Entity	% of Portfolio with Name (Column A)	% of Deals Where Rating is Impacted (Column B)	# of Notches (Column C)
Company A	29%	5.0%	1
Company B	21%	2.0%	1
Both Entities	17%	6.5%	1

Despite being widely referenced, the impact of Company A or B defaulting does not have a broad impact on the universe of DBRS CDO ratings. Moreover, this limited impact is equally valid when both companies (A and B) are assumed to default simultaneously. In fact only 6.5% of DBRS senior ratings would be impacted, and such impact is limited to only a single notch downgrade on the long-term asset rating. In the context of CDOs purchased by ABCP conduits, this downgrade of the asset would likely not lead to a downgrade of the short-term conduit rating.

In summary, DBRS senior rated CDO tranches are effectively insulated from idiosyncratic risk as well as systematic risk due to the following reasons:

- Senior tranches are generally diluted to the credit risk on the underlying portfolio. As the level of seniority increases through the capital structure, the investment becomes increasingly deleveraged to the performance of each underlying asset.
- The conservative DBRS ratings methodology. DBRS employs a conservative methodology when evaluating CDO structures. The assumptions on default probability, recovery, and correlation are designed to provide protection against credit deterioration commensurate to tranche rating.
- Implicit limits on name concentration within CDO portfolios. On average, exposure to any one given name is limited to a range of 0.75% to 1.25%.

Generally, DBRS proactively monitors its CDO ratings to ensure that adverse credit event are continually monitored and evaluated. As such, ratings are continually updated to reflect changes in the credit risk in each underlying asset, and how it impacts the overall structure.