



**Dominion  
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## **Guidelines for Collateral in DBRS-Rated CDO Transactions**

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In Canada, some collateralized debt obligation (CDO) transactions are entered into by trusts that are sponsored by either a Canadian bank or an independent investment company (a "Conduit"). Each sponsor may have one or more trusts established to either focus on purchasing various types of assets (usually referred to as a multi-seller conduit) or on investing primarily in CDO products. Most Conduits raise the funds necessary to enter into a CDO transaction by accessing the Canadian commercial paper (CP) market.

Dominion Bond Rating Service ("DBRS") has been very active in the Canadian CDO market and routinely provides Conduits that issue CP with a rating on their CP. The amount of CP outstanding that is used to finance CDO transactions has increased substantially on a year-over-year basis. Conduits that issue CP to enter into CDO transactions may use the proceeds to fund the purchase of a credit-linked note from an entity sponsored by the buyer of protection (or an affiliate) (the "Swap Counterparty") or, in the alternative, where the Swap Counterparty is a large bank or financial institution and the comparatively smaller Sponsor is required to post collateral in order to enter into the transaction, the Conduit may use the CP proceeds to fund the purchase of collateral that is posted to secure the Conduit's obligations under a credit default swap. The collateral provides comfort to the Swap Counterparty that if a first-dollar loss occurs, something is available to compensate the Swap Counterparty for the loss.

For every CDO transaction rated by DBRS, DBRS reviews the transaction before providing the CP-issuing Conduit with confirmation that the rating on its CP would not be downgraded as a result of the proposed additional issuance of CP to fund the new CDO transaction. One of the primary aspects of DBRS's process for approving a CDO transaction is to review the type of collateral that will be purchased with the proceeds of the CP issuance.

When DBRS reviews the proposed collateral for a CDO transaction, the type of collateral is not the only important consideration. The features of the proposed collateral are equally important. The following is a list, in order of preference, of the features of collateral that DBRS will typically find acceptable for a Conduit to acquire in a CDO transaction:

*(1) Short-Term, Canadian Dollar-Denominated, DBRS-rated, Floating-Rate Collateral*

DBRS's preference is for the collateral to be denominated in Canadian dollars, rated R-1 (high) by DBRS, less than one year in duration, and earning a floating rate of interest. DBRS will also accept collateral rated R-1 (middle) provided that it is denominated in Canadian dollars, has a term to maturity of less than 35 days, and is a debt obligation of (or guaranteed by) the Government of Canada, a Canadian province, or a bank governed by the Bank Act (Canada) that has a rating of at least R-1 (middle). If this type of collateral is proposed for a CDO transaction, DBRS will usually permit the Conduit to take all market and credit risk on the collateral.

*(2) Long-Term, Canadian-Denominated, DBRS-rated, Floating-Rate Collateral*

DBRS will permit a Conduit to acquire collateral that has a term longer than one year, provided that it is rated AAA by DBRS, earns a floating rate of interest, and the term of the collateral is not longer than the scheduled term of the CDO transaction. One of the concerns with using long-term collateral is that it may be more difficult to liquidate if the CDO transaction is terminated early. Where DBRS is satisfied with the liquidity of the proposed collateral, it will permit the Conduit to take credit and market risk on the collateral as long as the Swap Counterparty does not receive any breakage costs if either the Swap Counterparty causes the transaction to terminate or the transaction terminates as a result, absent default, of circumstances affecting the Swap Counterparty or the Conduit.

*(3) Short-Term or Long-Term, U.S.-denominated, DBRS-rated, Floating-Rate Collateral*

The same considerations apply as discussed in (1) and (2) above with DBRS preferring the use of short-term, U.S.-denominated collateral as opposed to longer-term collateral. DBRS will only permit collateral that has a term longer than the term of the CDO trade, if there is a par put provided by the Swap Counterparty on the termination of the transaction for any reason and the Swap Counterparty maintains a rating of at least AA (low) by DBRS. DBRS has an additional requirement when U.S.-denominated collateral is proposed for a CDO transaction. The counterparty and the Conduit must enter into a currency and interest rate swap that will convert U.S. dollar denomination LIBOR-based interest payments into Canadian dollar denomination banker's acceptance (BA)-based interest payments to minimize the risk that the LIBOR and BA rates do not move in tandem.

From the Conduit's perspective, the currency and interest rate swap is only as good as the credit profile of the Swap Counterparty. Therefore, DBRS requires that the Swap Counterparty have a minimum rating of AA (low) by DBRS. If the Swap Counterparty's rating is initially below AA (low) or ever migrates below that level during the term of the CDO trade, DBRS will require that the Swap Counterparty post collateral on a periodic basis equal to the Conduit's exposure to the Swap Counterparty for the relevant periodic payment period applicable to the transaction (usually monthly or quarterly periods). If the rating of the Swap Counterparty is initially at A (low) or ever migrates to that level during the term of the CDO trade, the Swap Counterparty will be required to post additional collateral, often covering several periodic payment periods under the transaction. Once the rating on the Swap Counterparty migrates below BBB the Swap Counterparty must be replaced or a guarantee must be provided such that the Swap Counterparty's rating will return to at least AA (low) by DBRS. A Swap Counterparty that initially has a rating of lower than A (low) will only be permitted by DBRS if a guarantee is provided by another entity that will effectively increase the Swap Counterparty's rating to AA (low) by DBRS.

As an alternative to the use of a currency and interest rate swap, a set of discounts can be agreed to before the transaction is finalized that will build in protection for the Conduit from movements in exchange and interest rates. If the discount regime is used, DBRS typically requires that the collateral be marked to market daily in order to minimize the exchange rate volatility.

*(4) Correlated Risks*

Acceptable collateral as described in (1) to (3) above will normally not include collateral that is itself classified as a CDO. DBRS's view is that a CDO must not be correlated to the risks associated with a CDO transaction.

The above list of features reflects DBRS's view that collateral used in CDO transactions should actually be, or be synthetically structured as, the equivalent of senior highly rated, short-term, Canadian dollar-denominated, floating-rate collateral. Moreover, the inherent risks of the CDO transaction should be contained in the CDO transaction itself and not the collateral. The collateral should: (a) bear limited credit risk; (b) be highly liquid in case an early termination event occurs; and (c) be term-matched such that the term of the collateral does not extend past the maturity date of the CDO transaction without a par put to the Swap Counterparty. The collateral should be as risk-free as possible in order to further facilitate the CP issued to fund the CDO transaction being repaid to the CP investors at the end of the transaction (provided that there was no first-dollar loss on the transaction).

The foregoing guidelines are published for the guidance of parties structuring transactions with Swap Counterparties but are not exhaustive. While the guidelines will normally be applied in reviewing any transaction, DBRS retains the right to request changes to collateral arrangements that DBRS considers necessary or appropriate in particular circumstances and may be willing to consider alternative collateral arrangements with different features than those enumerated.

For further information, please contact the author of this commentary.