



Date of Commentary: April 11, 2007

## **Guidelines for Collateral in DBRS-Rated CDO Transactions Entered into by Canadian Asset-Backed Commercial Paper Issuers**

When reviewing eligible collateralized debt obligation (CDO) transactions for inclusion into Canadian asset-backed commercial paper (CP) issuer (CP Issuer) programs, one of the primary aspects of DBRS's rating process involves the review of the collateral that may be required by the counterparty to the CDO transaction (the Swap Counterparty).

In CDO transactions that involve collateral arrangements, the CP Issuer issues CP or other debt obligations and uses the proceeds to purchase collateral that will secure its obligations to the Swap Counterparty under the CDO transaction. The collateral is typically held by a custodian on behalf of the CP Issuer and is pledged to cover payments due to the Swap Counterparty. In the event that the Swap Counterparty is responsible for a default under the CDO transaction documents, the Swap Counterparty's rights in the collateral will either be extinguished or will be subordinate to that of the CP noteholders. On the other hand, if the CP Issuer is responsible for a default under the CDO transaction documents, the CP Issuer's rights in the collateral will either be extinguished or will be subordinate to that of the Swap Counterparty. Although the CDO transaction is structured such that the probability of default by the CP Issuer under the CDO transaction documents is rated AAA, it is still possible that the collateral may need to be partly or wholly liquidated during the term of the CDO transaction.

In reviewing a CDO transaction, DBRS will review the type of collateral to be purchased with the proceeds of CP issuance to ensure that the credit, liquidity and market-value risks of the collateral are minimal. Both the type of collateral proposed as well as its various attributes are carefully considered in this analysis.

To provide additional guidance to market participants, DBRS has revised its CDO collateral criteria. Acceptable CDO collateral includes debt obligations that:

- Are denominated in Canadian dollars.
- Possess a R-1 (high) short-term DBRS rating (or a long-term rating of at least AAA if the original term to maturity of the collateral was longer than one year).
- Have a term to maturity of less than 35 days.
- Are direct obligations of (or are guaranteed by) the Government of Canada, a Canadian province or a bank governed by the *Bank Act* (Canada).
- Yield a floating rate of interest.



Exceptions to the above will be permitted in the following circumstances:

- Where the term of the collateral is greater than 35 days but shorter than the scheduled term of the CDO transaction, DBRS will require a mechanism to be in place that mitigates the market risk on the collateral and addresses any interest-rate mismatch risk.
- Where the collateral has a term longer than the scheduled term of the CDO transaction, a mechanism to mitigate market risk will be required, and in addition, a par put provided by the Swap Counterparty on the termination of the transaction (for any reason) will be required to ensure CP holders are not exposed to any collateral unwind costs. Any interest-rate risk will also need to be adequately addressed.
- When U.S.-dollar denominated collateral is proposed, the Swap Counterparty and the CP Issuer would enter into a currency and interest-rate swap that converts U.S.-dollar denominated LIBOR-based interest payments into Canadian-dollar denominated banker's acceptance (BA) based interest payments to minimize the risk that the LIBOR and BA rates do not move in tandem.

In keeping with DBRS's eligibility requirements for hedge counterparties, the Swap Counterparty must maintain a rating of at least AA (low) or post collateral to support the creditworthiness of the swap obligation as follows:

- If the Swap Counterparty's long-term DBRS rating is below AA (low), DBRS will require that the Swap Counterparty post collateral on a periodic basis equal to the CP Issuer's exposure to the Swap Counterparty for the relevant periodic-payment period applicable to the transaction (usually monthly or quarterly periods).
- If the DBRS rating of the Swap Counterparty's long-term is below A (low), the Swap Counterparty will be required to (1) post additional collateral covering several periodic payment periods under the transaction or (2) provide a guarantee or a suitable replacement from a counterparty with a minimum AA (low) rating by DBRS, or (3) provide a suitable replacement.

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 CP Issuer 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 exchange-rate volatility.

Lastly, acceptable collateral should not include collateral that is itself classified as a CDO or where such collateral's performance is dependent on that of a CDO. DBRS's view is that collateral performance should not be correlated to the risks associated with a CDO transaction.



### ***Conclusions***

The above criteria reflect DBRS's view that collateral posted in CDO transactions should comprise, or be synthetically structured as, the equivalent of senior highly rated, short-term, Canadian-dollar denominated, floating-rate debt. Ensuring these criteria are met will mean the inherent risks of the overall transaction are those relating solely to the CDO transaction and not the collateral.

The collateral should (1) bear limited credit risk; (2) be highly liquid in case an early termination event occurs; and (3) 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 effectively risk free in order to facilitate the repayment of the CP issued to fund the CDO transaction at the end of the transaction (provided that there was no first-dollar loss on the transaction).

These guidelines are not exhaustive. While it is expected that these guidelines will be consistently applied in reviewing any transaction, DBRS retains the right to request changes to collateral arrangements that DBRS considers necessary or appropriate in particular circumstances. DBRS may also be willing to consider alternative collateral arrangements with different attributes than those outlined.

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

Jamie Feehely, LL.B.  
Senior Vice President – Canadian Structured Finance  
+1 416 597 7312  
[jfeehely@dbrs.com](mailto:jfeehely@dbrs.com)

Copyright © 2007, DBRS Limited, DBRS, Inc. and DBRS (Europe) Limited (collectively, DBRS). All rights reserved. The information upon which DBRS ratings and reports are based is obtained by DBRS from sources believed by DBRS to be accurate and reliable. DBRS does not perform any audit and does not independently verify the accuracy of the information provided to it. DBRS ratings, reports and any other information provided by DBRS are provided "as is" and without warranty of any kind. DBRS hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall DBRS or its directors, officers, employees, independent contractors, agents and representatives (collectively, DBRS Representatives) be liable (1) for any inaccuracy, delay, interruption in service, error or omission or for any resulting damages or (2) for any direct, indirect, incidental, special, compensatory or consequential damages with respect to any error (negligent or otherwise) or other circumstance or contingency within or outside the control of DBRS or any DBRS Representatives in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any information. Ratings and other opinions issued by DBRS are, and must be construed solely as, statements of opinion and not statements of fact as to credit worthiness or recommendations to purchase, sell or hold any securities. DBRS receives compensation, ranging from US\$1,000 to US\$750,000 (or the applicable currency equivalent) from issuers, insurers, guarantors and/or underwriters of debt securities for assigning ratings. This publication may not be reproduced, retransmitted or distributed in any form without the prior written consent of DBRS.