

CDO Newsletter

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MARK-TO-MARKET EXPOSURE OF THE AFFECTED TRUSTS

On August 13, 2007, amid a period of heightened volatility in global credit markets, a number of Canadian ABCP issuers (the Affected Trusts) were unable to roll over maturing ABCP, resulting in requests being made by the sponsors of the Affected Trusts to liquidity providers for provision of liquidity funding, or the extension of extendable notes. Requests for liquidity were not granted by a number of liquidity providers, who disputed the satisfaction of all conditions precedent for the provision of liquidity.

In an [August 16, 2007, press release](#), DBRS placed the Affected Trusts Under Review with Developing Implications, following an announcement that a consortium representing banks, asset providers and major investors in the Affected Trusts (the Pan-Canadian Investor's Committee or the Committee) had agreed in principle to take steps to establish "normal operations in the Canadian third-party ABCP market." The agreement in principle (the Montréal Accord) calls for all investors in the Affected Trusts to exchange their holdings for term notes matching the amortization and maturity of the transactions held within each series or trust, as applicable.

The Montréal Accord initially included a 60-day stand-still period during which there would be no collateral calls or calls on liquidity facilities. The stand-still has been extended a number of times and is currently set to expire on February 22, 2008. In a press release dated December 23, 2007, the Committee announced that an agreement in principle had been reached regarding a comprehensive restructuring of the ABCP issued by 20 of the Affected Trusts covered by the Montréal Accord (see the [December 24, 2007, DBRS press release](#)).

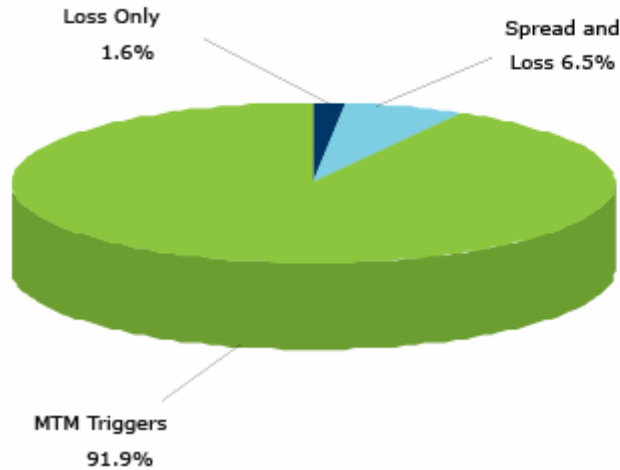
In previous CDO Newsletters, DBRS provided indicative ratings based on the probability of default for each underlying transaction held by the Affected Trusts covered by the Montréal Accord. These indicative ratings were provided with the caveat that they were based on the assumption that the protections of the stand-still agreement would remain in place, and that in the absence of the stand-still, such ratings could be revised.

In a [press release dated January 21, 2008](#), DBRS noted that it had commenced a review of its levered super-senior (LSS) collateralized debt obligation (CDO) methodology. The review was prompted by unprecedented volatility in credit markets which has seen spreads on widely-traded indexes of corporate debt increase considerably. In a [commentary dated January 28, 2008](#), DBRS noted that in the absence of the stand-still agreement, a number of Affected Trusts that funded LSS transactions would have already faced margin calls. Since the January 28, 2008, DBRS publication, market volatility has continued and spreads have widened further.

There are three main types of margin call regimes employed by LSS transactions: (1) loss only, (2) a combination of spread and loss and (3) mark-to-market (MTM). Under a loss based trigger regime, a margin call is determined by the accumulated default losses experienced by the referenced portfolio without regard to market value. Spread and loss based triggers use a combination of portfolio weighted average spread and accumulated default losses to determine whether a margin call is required. As opposed to a loss only trigger which incorporates only credit risk, spread and loss triggers introduce credit default swap (CDS) spreads as an element in determining when a margin call will occur. MTM triggers are based on the market price of protection on the referenced CDO tranche. In a stressed market, certain tranches may become illiquid, resulting in highly volatile prices. The spreads on these tranches may not match their actual credit risk. MTM triggers are generally considered more volatile and less transparent than loss only and spread and loss triggers.

The chart below provides a breakdown of the type of trigger regime employed by the LSS transactions funded by the Affected Trusts that are proposed for restructuring under the Montréal Accord. The majority of the transactions – 91.9%, representing \$16.0 billion by funded amount – utilize MTM triggers. Spread and loss triggers are less common, being used by 6.5% of the transactions, or \$1.1 billion by funded amount. Loss-only triggers are the least common, utilized by 1.6% of the transactions, or \$0.3 billion.

Trigger Regimes in LSS Transaction



In conditions where markets were open to issuance and ongoing rollover of obligations of the Affected Trusts, margin call funding would usually be met in one of the following manners: (1) by issuing additional notes, (2) by negotiating a revised margin call with the swap counterparty, or (3) by using other sources of liquidity such as advances from the Conduit Sponsor, or liquidation of other assets of the Conduit Sponsor. Any of the Affected Trusts that would presently experience a margin call would not have access to these options. The margin call would therefore likely go unsatisfied.

In light of the possibility that an Affected Trust would not have the ability to meet a margin call, DBRS stated in its [January 28, 2008, commentary](#) that any Affected Trust that faced a margin call would likely be subject to rating action.

A vital element of the plan to restructure the Affected Trusts under the Montréal Accord is that MTM triggers on LSS transactions funding notes issued by the Affected Trusts will be changed to more remote spread-loss triggers. As described above, if triggers are not restructured, without the protection of the stand-still agreement, several transactions in the Affected Trusts would likely face requests to fund margin calls, leading to DBRS rating action with regard to the Affected Trust.

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