CDO Newsletter

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DBRS COMMENTS ON THE IMPACT OF FANNIE MAE AND FREDDIE MAC CREDIT EVENTS ON CANADIAN CDO TRANSACTIONS

On September 7, 2008, the U.S. Treasury announced that it was placing two government sponsored enterprises (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), in a conservatorship operated by the Federal Housing Finance Agency (FHFA). Together, Fannie Mae and Freddie Mac comprise 1.6% of each series of the CDX.NA.IG Index (Series 1 through 10). As such, these names are referenced in many DBRS-rated collateralized debt obligation (CDO) transactions (the Transactions). In total, Fannie Mae and Freddie Mac are referenced in 51 and 43 Transactions, respectively, out of 79 total Transactions.[1] All 43 Transactions referencing Freddie Mac also reference Fannie Mae.[2]

Standardized International Swaps and Derivatives Association (ISDA) contracts and documentation are utilized by market participants to enter into CDS transactions. These standard documents include the concept of Credit Events. According to Section 4.2 of the 2003 ISDA Credit Derivatives Definitions, a Bankruptcy Credit Event will occur if a Reference Entity "seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets." As a result, market participants have agreed that the conservatorship announcement constitutes the occurrence of a Credit Event for credit default swaps (CDS) referencing Fannie Mae or Freddie Mac.

In a physically-settled CDS contract, upon receiving notice of a Credit Event, the protection seller is required to pay the CDS notional amount in exchange for a deliverable obligation provided by the protection buyer. Under cash settlement, the auction process for determining recovery value will typically take approximately 30 days, at which time the final recovery prices for Fannie Mae and Freddie Mac will be established. The majority of DBRS-rated Transactions follow the cash settlement protocol.

In analyzing CDO transactions, DBRS typically applies a fixed recovery rate in the range of 30% to 40% to all underlying obligors, depending on the rating of the CDO tranche (note that this is an assumption applied for modeling purposes only and is not an expectation of actual recovery values). Based on current market pricing, DBRS expects that the recovery rates for Fannie Mae and Freddie Mac will be significantly higher than this assumption, mitigating the negative impact of these two Credit Events. Under such a scenario, the Credit Events are not expected to materially impact the Transactions. However, if actual recovery rates are much lower than current market indications, negative rating action may result for a number of the Transactions.

DBRS-rated CDO Transactions may be funded by asset-backed commercial paper (ABCP) or other sources. Revisions to the ratings of the Transactions may impact the ratings of such ABCP or other notes.

DBRS will continue to monitor the situation and release further information as appropriate on www.dbrs.com.

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1 The total Transactions covered in this newsletter include all public transactions rated by the Canadian Structured Credit Group that reference corporate obligors, including transactions that are contemplated to form part of the Montreal Accord. Please note that all transactions rated by the DBRS U.S. Structured Credit Group and all private transactions are not included in the transaction total.

2 For the purposes of this article, only senior debt obligations of Fannie Mae and Freddie Mac were considered.