CDO Newsletter

Volume 3, Issue 10, September 17, 2008

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DBRS COMMENTS ON THE IMPACT OF THE LEHMAN BROTHERS CREDIT EVENT ON CANADIAN CDO TRANSACTIONS

On September 15, 2008, Lehman Brothers Holdings Inc. (Lehman) filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. The filing triggered a Credit Event under the Standardized International Swaps and Derivatives Association (ISDA) contracts and documentation, which is utilized by market participants to enter into credit default swap (CDS) transactions. Lehman is referenced in 28 of the 80 Canadian CDO transactions monitored by DBRS (the Transactions).[1]

When rating CDO transactions, DBRS typically applies a fixed recovery rate in the range of 30% to 40% to all underlying corporate obligors, depending on the rating of the CDO tranche. (Note that this is an assumption applied for modeling purposes only).

To demonstrate the level of ratings stability of the 28 transactions that reference Lehman, DBRS applied two stress scenarios: (1) Assume immediate default by Lehman with 30% recovery; (2) Assume immediate default by Lehman with 0% recovery. (Note this is a conservative worst-case scenario applied for modeling purposes. DBRS is not expressing a view on potential recovery.) Both stress tests also incorporate the recent credit events of Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), assuming a recovery rate of 95% for both companies based on current market indications.[2]

For the scenario assuming 30% recovery for Lehman, the model results indicated that 24 of the 28 Transactions were able to withstand this scenario while maintaining their current ratings. Of the four remaining CDO Transactions, three were for issuers of multiple CDO tranches referencing the same portfolio, with different levels of enhancement and initial ratings. The chart below shows the results of the scenario, including the number of rating notches that each Transaction would be downgraded.[3]

Scenario 1: 30% Recovery for Lehman

Required Downgrade from Scenario (Number of Notches)	Number of Transactions
0	24
1	1
2	1
3	0
4	2

For the scenario assuming lower recovery for Lehman, the model results indicated that 23 of the 28 Transactions are able to withstand this scenario while maintaining their current ratings. The table below shows the results.

Scenario 2: 0% Recovery for Lehman

Required Downgrade from Scenario (Number of Notches)	Number of Transactions
0	23
1	1
2	0
3	2
4	1
5	1

Due to the zero recovery assumption, an additional Transaction would be downgraded under the second scenario.

While the required subordination levels have increased for all of the CDOs with exposure to Lehman, most of the Transactions still have sufficient subordination to withstand the stress scenarios applied. However, further ratings migration or losses from future credit events affecting the Transactions may result in negative rating actions. For the Transactions requiring downgrades under the scenarios above, future rating actions will depend on the final recoveries of Lehman, Fannie Mae and Freddie Mac.

DBRS-rated CDO Transactions may be funded by asset-backed commercial paper (ABCP) or other sources. Revisions to the ratings of the Transactions may affect 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 not currently rated but are contemplated to form part of the Montréal 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. A small number of the Transactions have fixed recovery rates for each of their reference entities (normally between 30% and 40%). As a result, the Fannie Mae and Freddie Mac credit events will have a greater impact on these CDOs because the fixed recovery rate is significantly less than the expected recovery for these two companies. In the scenario analysis, DBRS has applied the appropriate fixed recovery rates for these transactions.

3. For Transactions with multiple tranches, the average number of notches required for a downgrade was used.