

U.S. Structured Finance Newsletter

Volume 4, Issue 39, September 22, 2008



Claire Mezzanotte

Managing Director, ABS/RMBS
U.S. Structured Finance,
+1 212 806 3272
cmezzanotte@dbrs.com

Jan Buckler

Senior Vice President,
Research and Modeling
U.S. Structured Finance
+1 212 806 3925
jbuckler@dbrs.com

David Hartung

Senior Vice President, ABS
U.S. Structured Finance
+1 212 806 3269
dhartung@dbrs.com

Quincy Tang

Senior Vice President, RMBS
U.S. Structured Finance
+1 212 806 3256
qtang@dbrs.com

Kathleen Tillwitz

Senior Vice President,
Operational Risk
U.S. Structured Finance
+1 212 806 3265
ktillwitz@dbrs.com

Toronto

DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
+1 416 593 5577

New York

140 Broadway, 35th Floor
New York, NY 10005
+1 212 806 3277

Chicago

101 North Wacker Drive
Suite 100
Chicago, IL 60606
+1 312 332 3429

THE INCREASING COST OF CONFIDENCE

As financial instruments trade in the capital markets, new information is conveyed in each price adjustment. Generally, prices adjust to reflect future expected increases or decreases in asset value. For example, prices of fixed-income assets tend to increase when decreases in spot interest rates render the asset as more valuable. Recent events in the capital markets signal a dislocation between pricing and future asset valuation. Alternatively, such pricing dislocation may express a draconian view of how financial instruments ought to be valued; however, the effect has frustrated efforts to restore liquidity in the debt capital markets. It is clear that a general lack of confidence in counterparty stability is manifest in current pricing. Such confidence is the foundation on which an orderly capital market depends.

Traditionally, financial instruments are traded in a cash market whereby risk is transferred from a seller to a long buyer. In the modern capital markets, alternative risk transfer is accomplished with credit default swaps (CDS). In a CDS, two parties enter into a contract: one to sell and the other to buy credit protection against a credit event (e.g., a default). The buyer of protection pays a premium to ensure that the seller will satisfy the par value of the debt instrument as a result of a credit event. For example, a 100 basis point spread means that it costs \$100,000 to protect \$10 million in bonds issued by the reference entity. The five-year CDS premium represents a market consensus of credit risk spread of a reference entity and, by extension, the confidence in an institution. In recent days, premiums have widened significantly commensurate with the increased risk of counterparty default.

CDS Premium Spreads and Issuer Share Prices Trends, September 12 to 19, 2008

Reference Entity ¹	Five-Year CDS Premium (Basis Points)			Closing Share Price		
	Sept. 12	Sept. 17	Sept. 19	Sept. 12	Sept. 17	Sept. 19
U.S. Government	17.89	25.00	24.79	-	-	-
Bank of America Corporation	162.19	234.30	194.39	\$33.74	\$27.20	\$37.48
Citigroup Inc.	194.10	369.20	313.29	\$17.96	\$14.03	\$20.65
JPMorgan Chase & Co.	150.50	235.19	194.30	\$41.17	\$35.77	\$47.05
Wachovia Bank Corporation	441.60	781.70	670.79	\$14.27	\$9.12	\$18.75
Wells Fargo & Company	156.10	230.50	194.00	\$34.29	\$33.43	\$39.80

1. Reference entities represent candidate issuers of future covered bond issuance as drawn from U.S. Treasury Secretary Henry M. Paulson's July 28, 2008, press conference releasing the "Best Practices for Residential Covered Bonds."

Given the dislocation in pricing of corporate credit risk as reflected in the widening of five-year CDS premiums, investors are now debating how covered bonds should be priced in the primary market. As discussed in our [May 5, 2008, U.S. Structured Finance Newsletter](#), a covered bond has developed recognition as a senior corporate debt obligation that finances an on-balance sheet mortgage portfolio. Covered bond holders not only have a secured interest in a dynamic pool of high-quality collateral assets, but they also benefit from a senior claim on other assets in the event of default, insolvency or liquidation of the issuing bank.

Given the status of a covered bond as a corporate hybrid debt security, investors have debated whether it is appropriate to look to the five-year CDS premium of the issuing bank or to the quality of the cover pool when pricing the covered bond. Market participants who favor holding to maturity generally look to the underlying asset quality to price. On the contrary, those with a short-term focus may reference the corporate credit risk of the issuing bank. That said, DBRS believes the actual yield of a covered bond should reflect the liquidity difference between corporate credit risk and asset credit risk.

For questions or comments, please contact the author, Bernard Maas at bmaas@dbrs.com.