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DBRS COMMENTS ON THE IMPACT OF THE WASHINGTON MUTUAL CREDIT EVENT ON CANADIAN CDO TRANSACTIONS

On September 25, 2008, U.S. government regulators seized the banking unit of Washington Mutual, Inc. (WaMu) after customers had withdrawn \$16.7 billion in the previous ten days. JPMorgan Chase & Co. subsequently acquired WaMu's deposits and branches for \$1.9 billion. On September 26, 2008, WaMu filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. The failure of WaMu has 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. WaMu is referenced in 47 of the 80 Canadian collateralized debt obligation (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 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 47 transactions that reference WaMu, DBRS applied two stress scenarios: (1) Assume immediate default by WaMu with 30% recovery; (2) Assume immediate default by WaMu with zero 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 Lehman Brothers Holdings Inc. (Lehman), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), assuming recovery rates of 30%, 95% and 95%, respectively.²

For the scenario assuming 30% recovery for WaMu, the model results indicated that 42 of the 47 Transactions were able to withstand the scenario while maintaining their current or implied rating. Of the five remaining CDO Transactions, two were for issuers of multiple CDO tranches referencing the same portfolio, with different levels of enhancement and initial ratings. Chart 1 shows the results of the scenario, including the number of actual or implied rating notches that each Transaction would be downgraded.³

Chart 1: 30% Recovery for WaMu

Actual/Implied Downgrade from Scenario (Number of Notches)	Number of Transactions
0	42
1	1
2	1
3	0
4	1
5	1
6	1

As shown in Chart 1, five Transactions would require actual or implied downgrades if a 30% recovery for WaMu is assumed. For each of these Transactions, the subordination required to maintain its current rating under this stress scenario would exceed the actual subordination available. As a result, these Transactions are now expected to exhibit less rating stability than other CDOs rated by DBRS. Each subsequent default affecting these Transactions would have a significant impact on their credit quality and would likely result in further rating action by DBRS.

For the scenario assuming 0% recovery for WaMu, the model results indicated that 41 of the 47 Transactions were able to withstand the scenario while maintaining their current or implied rating. Chart 2 shows the results.

Chart 2: 0% Recovery for WaMu

Actual/Implied Downgrade from Scenario (Number of Notches)	Number of Transactions
0	41
1	2
2	1
3	0
4	0
5	0
6	2
7	1

As shown in Chart 2, due to the lower recovery assumption, an additional Transaction cannot maintain its current or implied rating under the second scenario and the severity of actual or implied downgrades is greater.

While the required subordination levels have increased for all of the CDOs with exposure to WaMu, 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 diminished credit quality. For the Transactions requiring downgrades under the scenarios above, future rating actions will be taken once the final recoveries for WaMu, Lehman, Fannie Mae and Freddie Mac have been determined.

The scenarios in this newsletter make assumptions on the recovery rates for the aforementioned companies. If actual recoveries for these companies are materially lower than the assumptions used, actual or implied downgrades of certain Transactions will be more severe than indicated above.

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 not currently rated but are part of a restructuring process under the Montréal Accord. For the purposes of this newsletter, DBRS will use the terminology “Implied Rating” when referencing the credit strength of transactions covered by 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.