CDO Newsletter

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DBRS COMMENTS ON THE IMPACT OF THE ICELANDIC BANK CREDIT EVENTS ON CANADIAN CDO TRANSACTIONS

On October 7, 2008, Iceland's government put two of the country's largest banks, Landsbanki Íslands hf (Landsbanki) and Glitnir Bank hf (Glitnir), into receivership under the control of the Icelandic Financial Supervisory Authority. On October 9, 2008, it seized control of another bank, Kaupthing Bank hf (Kaupthing), guaranteeing domestic deposits and maintaining business operations.

When market participants enter into credit default swap (CDS) transactions, they use standardized International Swaps and Derivatives Association (ISDA) contracts and documentation that include the concept of "credit events." According to Section 4.2 (f) 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 of the action taken by the government of Iceland, market participants have agreed that a credit event has occurred for CDS that reference Landsbanki, Glitnir and Kaupthing.

Of the 80 Canadian collateralized debt obligation (CDO) transactions monitored by DBRS, Landsbanki is referenced in eight, Glitnir in three and Kaupthing in five.[1] Nine of these transactions have exposure to least one of the Icelandic banks and three have exposure to all three banks.

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 modelling purposes only.)

To demonstrate the level of rating stability of the nine transactions that reference at least one of the Icelandic banks, DBRS applied two stress scenarios: (1) Assume immediate default by the banks with 30% recovery. (2) Assume immediate default by the banks with 0% recovery. (Note that this is a conservative worst-case scenario applied for modelling purposes. DBRS is not expressing a view on potential recovery.) Both stress tests also incorporate the recent credit events of Fannie Mae, Freddie Mac, Lehman Brothers Holdings Inc. (Lehman) and Washington Mutual, Inc. (WaMu). For Fannie Mae, Freddie Mac and Lehman, the final recovery rates from the CDS settlement auctions are applied.[2] For WaMu, a recovery rate of 0% is assumed.

For the scenario assuming 30% recovery for the banks, the model results indicate that all nine of the transactions would be able to withstand the scenario while maintaining their current or implied rating. For the scenario assuming 0% recovery, the model results indicate that eight of the nine transactions would be able to withstand the scenario while maintaining their current or implied rating. One of the transactions would require an actual or implied downgrade of two notches.

While the required subordination levels have increased for all of the CDOs with exposure to the Icelandic banks, eight of the nine transactions have sufficient subordination to withstand the credit event, regardless of the recovery values for the banks or for WaMu. However, further rating migration or losses from future credit events affecting the transactions may result in diminished credit quality.

DBRS-rated CDO transactions may be funded by asset-backed commercial paper (ABCP) or other sources. Revisions to the ratings of the transactions may have an impact on the ratings of the ABCP or of 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 80 Canadian collateralized debt obligation (CDO) transactions mentioned in this newsletter include all public transactions rated by the DBRS Canadian Structured Credit Group that reference corporate obligors, as well as 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%). In the scenario analysis, DBRS has applied the appropriate fixed recovery rates for these transactions.