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Turmoil Continues in the ABCP Market

The collapse of the US financial markets in the wake of the subprime mortgage crisis inevitably took a heavy toll on the Canadian securitization market this past year. The chilling effect of the freeze in non-bank-sponsored asset-backed commercial paper (ABCP) in August of 2007 spread even to bank-sponsored ABCP and other asset backed securities, with volumes down dramatically over the year. The market is clearly in a period of retrenchment and reassessment with no clear end in sight.

While the roots of the current turmoil go back many years, matters came to a head in mid-August, 2007. Fears (which later proved largely unfounded) that non-bank-sponsored or third-party ABCP in Canada had significant exposure to subprime mortgages caused the market for such paper to dry up virtually overnight, making it almost impossible for third party ABCP issuers to roll over their ABCP to repay the maturing paper. Although back-up lines of credit were in place to address such liquidity crises, most Canadian ABCP liquidity facilities (unlike those elsewhere in the world) could be drawn only on the occurrence of a general market disruption (GMD) during which little, if any, ABCP could be rolled over even at much higher spreads. Most Canadian liquidity lenders opted to provide GMD liquidity lines because they received more favourable capital treatment under prudential guidelines provided by the Office of the Superintendent of Financial Institutions (OSFI) while, unlike US rating agencies such as S&P and Moody's, until January, 2007, DBRS Limited (DBRS) was prepared to give its highest investment grade rating to ABCP backed by GMD liquidity on the basis of the generally higher levels of credit enhancement in Canadian structures. Until the liquidity crisis of August, 2007, it is generally believed that no GMD liquidity lines had ever been drawn upon in Canada. All this changed dramatically when on August 13, 2007, one of the largest sponsors of third-party ABCP, Coventree Capital Inc., announced that it was unable to place new ABCP to fund the repayment of maturing ABCP. Many liquidity providers took the position that no GMD existed (in part because the bank sponsored ABCP market continued to roll over its ABCP) and they refused to fund. Similar scenarios played out with other third-party or non-bank sponsored conduits, and within days the C$32 billion third-party ABCP market abruptly grounded to a halt. Noteholders who had invested short-term funds in ABCP issued by 22 non-bank-sponsored conduits found their funds effectively frozen.

In an effort to bring some order to the growing chaos in the third-party ABCP markets, on August 16, 2007 a consortium organized by the Caisse de dépôt et placement du Québec on behalf of the largest holders of third-party ABCP signed an agreement in principle (which became known as the "Montréal Accord") with other large investors and key foreign financial institutions which were asset providers to the ABCP conduits to effect a 60-day standstill during which the parties would work together to restructure 20 of the 22 affected third-party conduits. Liquidity draw requests would be rescinded; collateral calls would be suspended during the standstill; no liquidity draws would be made for an additional 150-day period following the standstill, and investors and parties would work together to convert their outstanding ABCP to long-term floating rate notes. However, working out the details of the restructuring has proved much more complex than had been originally anticipated, and the original 60-day deadline has been repeatedly extended.

Because of the daunting complexity of the proposal, the Pan-Canadian Investors Committee, led by veteran Bay Street lawyer Purdy Crawford, decided that the most expeditious way of implementing it would be to proceed under the *Companies' Creditors Arrangement Act* (*CCAA*), the Depression era statute that since the early 1990s had become the legislation of choice for large corporate insolvency restructurings because of the flexibility it offered both debtors and creditors. One legal obstacle to using the *CCAA* for restructuring 20 securitization conduits was that while the *CCAA* applied only to insolvent companies, all the conduits were trusts. Although the trustees of the trusts were all "companies", notwithstanding the shortfall, most were perfectly solvent institutional trust companies. The applicants solved the company problem handily by having the institutional trustees agree to be replaced by special purpose corporations, all of which then technically satisfied the entry requirements of the *CCAA* because their securitized assets were insufficient to pay their outstanding ABCP liabilities. On March 17, 2008, the Committee filed a *CCAA* plan (the Plan) for all 20 conduits with the Ontario Superior Court of Justice. The information statement describing the plan ran to nearly 350 densely packed pages.

While a detailed review of the Plan is beyond the scope of this overview, in brief it created two new trusts known as Master Asset Vehicles or MAVs that would effectively pool the assets of the conduits and issue new long-term notes in exchange for the existing ABCP. Holders electing to participate in MAV1 (mainly banks and other large financial institutions) would self insure their exposure to collateral calls in exchange for a higher coupon. Participants in MAV2 would have the benefit of a C$14 billion senior third-party margin funding facility. The collateral supporting the ABCP would be pooled into the two MAVs pro rata and ranked in accordance with the relative value assigned to the collateral. Existing credit default swaps

(CDSs) would be replaced by new CDSs between the MAVs and asset providers with the market-to-market collateral triggers for the underlying leveraged super-senior assets replaced by more remote spread loss triggers. The maturities of the new notes would more closely match the term of the underlying assets, effectively extending the maturities to as long as nine years. The *CCAA* plan imposed a general stay of proceedings on most parties and when implemented would effect comprehensive releases from liability of most of the parties associated with the affected ABCP, including liquidity providers, trustees, dealers, agents, and the Committee itself.

The Plan required the approval of both a majority in number of noteholders and 2/3 in principal amount. Because about 1800 small retail investors comprised a majority in number of holders, they initially held the balance of power and as a result about 1600 of them holding less than $1mm each secured promises of full repayment from their investment dealers. Despite criticism of some of its provisions, the Plan was overwhelmingly approved by over 96 per cent of the noteholders on April 25. Continuing criticism from some larger investors as to the breadth of the releases prompted an amendment to the Plan in late May that allowed for claims for express fraudulent misrepresentation. The court approved the Plan June 5, but a group of dissident corporate investors still dissatisfied with the broad releases imposed by the Plan appealed. On August 18, the Court of Appeal unanimously agreed with the lower court's decision that the Plan was fair and reasonable, and on September 18, the Supreme Court of Canada denied leave, effectively ending recourse to the courts.

Even after the Supreme Court's implied blessing, implementing the Plan has hardly been smooth sailing. Its mind-boggling complexity and the sheer number of players have continued to drag out the process. On October 20, 2008, Mr. Crawford announced yet another delay, conceding that the Plan would not be completed before the end of November. The saga continues.

Calls for Reform

In the wake of the ABCP crisis there have been calls for greater transparency in disclosure from ABCP issuers and greater due diligence on the part of investment dealers assessing the suitability of these products for their clients. In October, 2008, two industry studies revealed the depth of the problem and called for sweeping reforms.

On October 16, 2008, the Canadian Securities Administrators (CSA) released for comment a consultation paper entitled *Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada.* In light of the turmoil in the ABCP market, the CSA working group committee proposed, among other things, to (i) implement a regulatory framework applicable to credit rating agencies that would require compliance with the recently amended code of conduct established by the International Organization of Securities Commissions and requiring public disclosure of all information provided by an issuer that is used by a credit rating agency in rating an asset backed security; (ii) amend the short-term debt exemption to make it unavailable for sales of asset-backed short-term debt, including ABCP, so that exempt distributions of these products would have to be made under other exemptions; (iii) reduce reliance on the use of credit ratings in securities legislation; (iv) address the role of intermediaries that are registrants in distributing asset-backed securities such as ABCP; (v) review the definitions of "related issuer" and "connected issuer" in proposed NI 31-103 to ensure that these definitions capture issuers of ABCP and similar products and (vii) review specific issues regarding mutual fund investments in ABCP. The paper is available on the OSC website at <www.osc.gov.on.ca>.

On October 17, 2008, the Investment Industry Regulatory Organization of Canada (IIROC) (the national self-regulatory organization that oversees all investment dealers and trading activity on debt and equity markets) released a comprehensive 93 page regulatory study entitled *Review and Recommendations Concerning the Manufacture and Distribution by IIROC Member Firms of Third-Party Asset-Backed Commercial Paper in Canada*. The IIROC study has harsh words for the due diligence performed by investment dealers to assess suitability for investors. It concludes that (i) none of the 21 firms reviewed that sold third party ABCP, including 12 that sold the product to retail clients, put third-party ABCP through their usual product due diligence, making no distinction between bank-sponsored and non-bank sponsored ABCP and relying instead exclusively on the DBRS rating of R-1(high); (ii) none of the firms prepared marketing materials on ABCP; (iii) none provided special training regarding the product; and (iv) none considered suitability issues with respect to third-party ABCP because they regarded it as a fungible money market instrument with a high credit rating. The report also criticizes the relatively thin disclosure required for ABCP under current securities laws. In light of these concerns IIROC also released for comment the same day a draft guidance note, "Best Practices for Product Due Diligence". The IIROC Study and draft guidance note are available on the IIROC website <www.iiroc.ca>.

New Rules from OSFI

During and after the Canadian ABCP crisis some critics (including the House of Commons finance committee) alleged that some responsibility for the turmoil should be borne by the Office of the Superintendent of Financial Institutions (OSFI). By granting more favourable capital treatment to GMD style liquidity than to global style, it was argued, OSFI's Guideline B-5 encouraged Canadian banks to offer only GMD liquidity, leaving open what the media persisted in calling a loophole that allowed liquidity providers to decline funding requests in August, 2007, thereby effectively freezing the market. Superintendent Dickson has taken issue with these allegations. OSFI did not regulate the non-bank sponsors, she pointed out. OSFI did not dictate what forms of liquidity banks could offer. Moreover, ascribing a zero capital charge only to short term GMD facilities and not global-style liquidity was not unique to Canada; indeed the same distinction was adopted in the Basel II Accord. The difference was that until January 2007, in Canada, unlike the US, a single rating agency, DBRS, was prepared to give investment grade ratings to new issues of ABCP backed only by GMD style liquidity.

Partly in response to the crisis, on October 28, 2008, OSFI issued a new advisory entitled "Securitization - Expected Practices" which put an end to the zero percent credit conversion factor for GMD liquidity facilities, subjecting them to the same capital treatment as global style. Together with the adoption by DBRS of the requirement that all ABCP liquidity must be global style, this spelled the end to GMD liquidity. In addition, the advisory clarifies the sponsorship roles that federally regulated entities play with respect to securitization vehicles, including ongoing disclosure regarding vehicle sponsorship and an assessment of the impact of those roles on potential reputational risk. Moreover, effective October 31, 2008, two external credit ratings are required to apply ratings-related risk weights to most securitization exposures.

Bank of Canada Accepts ABCP As Collateral

Shortly before the ABCP Plan of Arrangement was presented to investors, the Bank of Canada announced in March 2008 that it would now accept ABCP as collateral for the Standing Liquidity Facility (SLF) that it makes available to member banks for their overnight liquidity needs, subject to certain restrictions: ABCP backed by previously securitized assets, for example, would not be eligible as collateral. After some industry participants complained that these restrictions would exclude ABCP issued by conduits that held other asset-backed securities, the Bank of Canada issued revised eligibility criteria in September 2008. Under the revised criteria, ABCP is now eligible as SLF collateral provided that, among other criteria, the conduit is sponsored by a highly-rated bank, the ABCP is backed by global style liquidity, and the program does not contain any exposure to highly structured products such as CDOs, either direct or synthetic. The Bank also requires a single concise document that contains all the relevant investment information and is accessible to all investors. The list of items required to be disclosed in this document goes beyond the fairly limited and generic disclosure contained in the information memoranda that until recently were the norm in the relatively unregulated Canadian ABCP market and may be perceived as an effort on the part of the central bank to encourage more transparency in the ABCP market.

Ironically, the Bank of Canada's acceptance of ABCP comes at a time when the market for this product is at an historic low. Assuming that the market eventually revives, the Bank's reluctance to accept structured products or anything resembling the leveraged-super seniors of years past may well accelerate the trend towards "plain vanilla" ABCP backed by safe, traditional asset classes and add one more nail to the CDO coffin.

Elimination of Withholding Tax

Effective January 1, 2008, amendments to the *Income Tax Act* (Canada) came into force that eliminated Canadian non-resident withholding tax on interest payments made by Canadian residents to arm's length foreign residents. Originally implementation of the change was to be deferred until ratification of the Fifth Protocol to the Canada-US Tax Treaty, but in November, 2007 the Government announced that date would be January 1, regardless of when the Protocol is ratified. The elimination of withholding tax on conventional interest payments made by Canadian taxpayers to US residents removes one of the main economic disincentives to cross-border securitizations of interest bearing assets of Canadian residents to US resident special-purpose vehicles (SPVs) and the issuance of debt securities by Canadian resident SPVs to US resident purchasers. Assuming the asset securitization market recovers from the current crisis, the elimination of withholding tax may herald an increase in the volume of cross-border transactions.

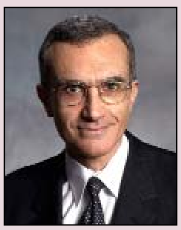
New Accounting Rules

Effective January 1, 2011, International Financial Reporting Standards (IFRS) will replace Canadian GAAP for all publicly accountable enterprises, including banks. Although not imminent, the change to the new accounting rules will likely have a major impact on securitization structures. For example, the IFRS criteria for derecognition of assets to achieve off-balance sheet treatment for accounting purposes are substantially different from those under Canadian GAAP; whereas CICA Accounting Guideline 12 focuses on the legal isolation of the assets being transferred, IFRS IAS 39 attaches great weight to the transfer of risks and rewards. Moreover, the concept of a qualifying special purpose entity (QSPE) as a mechanism for avoiding consolidation does not exist under IFRS. It is expected that the new rules will require many existing structures to be retooled to comply with IFRS.

Even before IFRS arrives, the QSPE will likely already have been consigned to the dustbin of accounting history. In the spring of 2008, the US Financial Accounting Standards Board (FASB) decided to remove the QSPE concept from FAS 140 and the related scope exceptions from Interpretation 46(R) dealing with consolidation. If these decisions become final, US originators and other parties that relied on the QSPE exception to avoid having a conduit's assets consolidated onto their balance sheet may now have to be consolidated. FASB has proposed that the amendments be effective for most variable interest entities and new transfers of financial assets for fiscal years beginning after November 15, 2008. If past practice is any guide, the CICA will quickly follow suit and adopt the FASB amendments verbatim. Again, the result may be that many existing Canadian structures will need to be revamped.

Back to the Future?

In light of recent developments in the capital markets it would be rash to speculate what securitization will look like a year, much less five or ten years, from now. For the immediate future it seems likely that activity levels will remain lower, and if the appetite for ABCP revives, it may only be for ABCP backed by safe, traditional assets using simpler structures that date back to the 1990s. Whatever the outcome, it seems safe to say that the landscape of securitization in Canada has changed forever. ■



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