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Turmoil in the ABCP Market

Despite a relatively uneventful winter and spring, 2007 proved to be a watershed year for the asset-backed commercial paper market in Canada, and after the liquidity crisis of mid-August things may never be the same again. Storm clouds had been gathering ever since DBRS Limited (DBRS) revised its ratings criteria for CDO-based ABCP programs in January 2007 to require, among other things, that liquidity support for subsequent CDO-based ABCP transactions not be limited to a general market disruption and must remain available without the confirmation of rating of such ABCP. The introduction of the revised criteria substantially reduced the level of new CDO-based ABCP transactions while market participants determined how to proceed in light of the changes. But it was not until mid-summer, when the sub-prime crisis in the US began to impact the market for non-bank sponsored or “third-party” asset-backed commercial paper in Canada, that the market for such paper dried up almost overnight. The root of the problem was a unique feature of Canadian liquidity facilities that derived from the bank regulators’ capital treatment.

ABCP (short-term commercial paper with terms one to 364 days, typically 30 or 60 days) is usually repaid at maturity through “rollovers”: new ABCP is sold and the proceeds are applied to repay maturing ABCP. However since there is always a possibility that insufficient ABCP will be rolled over on any given maturity date all ABCP backed by longer term assets requires a backup liquidity facility to provide substitute funding to mitigate the rollover risk. However, in contrast to the US, in Canada liquidity facilities typically could be drawn only on the occurrence of a “general market disruption” (GMD). The source of that requirement was Guideline B-5 of the

Office of the Superintendent of Financial Institutions (OSFI), which accorded favorable regulatory capital treatment to those liquidity facilities that could be drawn only on a GMD. Although non-GMD or “global style” liquidity was not prohibited, a lender providing such a facility would incur additional regulatory capital charges. In addition, prior to the changes to DBRS’ ratings criteria in 2007 for both CDO-based ABCP and traditional ABCP, global style liquidity had not been required in order to obtain a rating from DBRS. Further, in July 2006 DBRS announced standard market disruption language that it considered acceptable for CDO-based ABCP. Deviation from the permitted language could result in a lower rating of the ABCP. Even so, the draw conditions were still restrictive enough that the likelihood of a liquidity facility ever being drawn seemed remote. In fact before August 2007 it is generally believed that no liquidity facility backing ABCP had ever been involuntarily drawn in Canada, not even in the wake of September 11, 2001.

All this changed dramatically when on August 13, 2007, one of the largest sponsors of third-party ABCP, Coventree Capital Inc., announced that “as a result of the current unfavorable conditions in the Canadian asset-backed commercial paper market it has been unable to place new ABCP to fund the repayment of previously issued ABCP maturing today”. Coventree issued draw notices requesting funding under liquidity facilities that supported the ABCP in the aggregate amount of \$700 million. A number of liquidity providers, however, took the position that no GMD existed and they refused to fund. Similar scenarios were played out with other third-party conduits and within days the third-party ABCP market had essentially ground to a halt. Noteholders who had invested short-term funds in ABCP issued by about 20 third-party conduits found their funds effectively frozen.

In an effort to bring some order to the growing chaos in the ABCP markets, on

August 16 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”) to effect a 60-day standstill during which the parties would work together to restructure 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. Working out the details of the restructuring proved more complex than had been originally anticipated, and as a result on October 16 the parties agreed to extend the standstill until December 14, 2007. As of October 17, only one of the conduits, Skeena Capital Trust, had announced a concrete restructuring plan, which would see the principal of the smaller investors repaid in full with the larger investors accepting long term high-yield floating rate notes issued by a new trust.

At this point it is difficult to predict the long-term consequences of what some commentators have referred to as the “ABCP meltdown”. One immediate result is that in response to the new DBRS criteria for granting an investment grade rating to ABCP, general market disruption facilities will almost certainly be replaced by “global style” liquidity that does not require a market disruption to be drawn. On October 17, DBRS published a list of “Global Liquidity Standard-ABCP Compliant issuers” sponsored by six Canadian and two international banks that met the global-style liquidity standards published by DBRS on September 12. Competitive pressures may demand that all Canadian ABCP conduits adopt this standard.

In addition there have been calls for greater transparency in disclosure from ABCP issuers. In the past some investors have complained that ABCP conduits are essentially “black boxes” that provide little or

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no disclosure regarding the underlying assets. The disclosure in information memoranda for ABCP has typically been very general in nature. With little specific information regarding the collateral, ABCP investors have had to rely heavily on the DBRS rating to decide whether to invest in a particular issue of ABCP. However investor confidence in the ratings assigned third party Canadian ABCP was severely eroded when investors began to fear that some of the third party ABCP was backed (directly or indirectly through credit default swaps) by the sub-prime mortgages that were imploding in the US and also began to appreciate that the assets supporting much of the third-party ABCP were complex credit derivatives whose current mark to market value had plummeted. It remains to be seen whether investors will demand prospectus level exposure for ABCP to restore confidence in the market.

Elimination of Withholding Tax

Canada and the United States signed a widely anticipated 5th protocol (the Protocol) to the Canada-US Tax Treaty (the Treaty) on September 21, 2007. Once it has been ratified by both countries, the Protocol will ultimately eliminate withholding tax on conventional interest payments made by Canadian taxpayers to US residents. These changes will remove some of the 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.

The Protocol will enter into force once it has been ratified by both the Canadian and United States governments. The Government of Canada intends to proceed with a bill at the earliest opportunity. The earliest date on which the Protocol could enter into force is January 1, 2008. This would require both countries to ratify the Protocol in 2007. The Canadian

government has announced that upon ratification of the Protocol, the Income Tax Act (Canada) will also be amended in order to eliminate the withholding tax on interest paid to all arm's length non-residents, regardless of their country of residence. However, the timing remains to be seen for the elimination of withholding tax for payments to persons of countries of residence other than the US.

Regulatory Developments

Currently the rules providing for the capital adequacy in respect of securitization are primarily addressed in OSFI's Guidelines B-5 and B-5A. The new international capital standard for internationally active banks of the Basel Committee on Banking Supervision (Basel II) will come into force for the Canadian Banks on November 1, 2007. Basel II addresses the various potential exposures of banks relating to securitization of its or other party's assets and sets out the corresponding required levels of capital for such exposures. In particular, to receive more beneficial capital treatment, liquidity facilities and servicer advances will need to meet Basel II's specific requirements for "eligible liquidity facilities" and "eligible servicer cash advance facilities", respectively. It is interesting to note that Basel II ultimately preserved special capital treatment for Canadian-style eligible liquidity facilities that are only available in a general market disruption. It seems unlikely that these provisions will be relied upon in any meaningful way in the future in the Canadian market given recent market developments.

In addition, amendments to Part XIII of the *Insurance Companies Act* (Canada), which came into force on April 20, together with certain policy clarifications by OSFI, have helped to open the door for the provision of "monoline" financial guarantee insurance by foreign-based insurers. Previously foreign based insurers were

effectively prohibited from providing such insurance as credit support for asset backed securities because the risk was located in Canada. However, in a letter dated May 14, 2007, OSFI indicated that its regulatory focus would shift from the location of the risk to the location of the insurance in determining whether Part XIII applied. Thus a monoline contract concluded outside Canada would not fall under OSFI regulation. In a Ruling 2007-03 released on October 25, 2007, OSFI confirmed this new regulatory policy with respect to residual value insurance provided in Canada by a foreign insurer. These changes should hopefully provide market participants with another structuring tool that has largely been absent from the Canadian market.

PPSA Updates

The most recent set of changes to the *Personal Property Security Act* (Ontario) (PPSA) came into force on August 1, 2007. Among the legislative amendments is a change in the treatment of anti-assignment clauses. The amended PPSA now provides that an assignment of a contract or account receivable to a third party in contravention of an anti-assignment clause will not invalidate the assignment. Originators of receivables will now be able to finance accounts through securitization which in the past would have been treated as ineligible under securitization programs. However, the assigning party may still be liable for breach of contract with respect to the assignment. It is worth noting that the change in treatment only applies to the assignment of "the whole of the account or chattel paper". As a result, an assignment of an undivided interest in a receivable (as opposed to the entire receivable) would still be subject to any contractual prohibition. Nevertheless, this change will bring Ontario into line with the state of the law in many of the other provinces and provide additional flexibility to companies looking for different financing alternatives for their receivables. [n](#)

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