



Canada's ABCP Crisis - The Aftermath



by Lou Brzezinski

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An award-winning background article describing and explaining the Canadian experience in the global credit crisis, the role played by asset-backed commercial paper (ABCP), and Canada's management of the crisis here through a court-approved plan to restructure the ABCP market, was published in the October, 2008 issue of [Commercial Litigation Update](#). That article, written by Lou Brzezinski, who leads Blaney McMurtry's commercial litigation group, began as follows:

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“The credit crisis that has affected Canada, the United States, and the rest of the world in recent months has its roots in an esoteric financial market known as asset-backed commercial paper (ABCP).

“The collapse of this market effectively removed hundreds of billions of dollars of assets from financial institutions in North America. The loss of these assets essentially prevented financial institutions from borrowing money at the same interest rate, or in the same quantity, as they did before. In addition, U.S. banks that had chosen to inject an inordinate portion of their investment capital into these assets found themselves unable to meet their own debt obligations to other financial institutions, and soon either sought protection from their creditors under the U.S. Bankruptcy Code Chapter 7 and Chapter 11, or were gobbled up by their creditors, or were rescued by large cash injections by the U.S. government.

“The Canadian approach to this crisis was far different. Through a negotiated consensus, the stakeholders in Canada reached a standstill agreement which ultimately was incorporated into a court order. As a result, the fallout in Canada from this market failure was relatively inconsequential.”

In this issue of [Commercial Litigation Update](#), Mr. Brzezinski writes about developments since.

Three important developments have occurred since the Supreme Court of Canada refused to hear an appeal from the Court of Appeal for Ontario dealing with the plan to restructure third-party ABCP.

First, the Pan Canadian Investors' Committee, which was established to restructure the ABCP market, was compelled by market forces to seek financial assistance from the federal and provincial Governments so as to implement the restructuring plan for the third party ABCPs.

Second, the Investment Industry Regulatory Organization of Canada (IIROC), the national, self-regulator that oversees all investment dealers and trading activities in Canada's debt and equity marketplaces, issued a report as to the manner, process and role that investment dealers played in the ABCP freeze-up. The IIROC report clearly pointed a finger at its own dealer members in contributing and assisting in the ABCP crisis.

Third, an expert panel on securities regulation in Canada was struck and a report was delivered to the Minister of Finance by Thomas Hockin, Chair of the expert panel. The Hockin Report recommended the establishment of a National Canadian Securities Commission which would have control over all capital markets, and further recommended the regulation of exchange-traded derivatives and over-the-counter derivatives.

The ABCP Restructuring Plan

Despite the fact that the Supreme Court of Canada paved the way for the implementation of the plan proposed by the Pan Canadian Committee, by mid-December 2008, the plan had yet to be implemented.

The main hurdle this time was the rising turmoil in the financial markets, which caused credit spreads to move apart to record levels. As a result, approximately \$18 billion had to be placed in a margin pool to support leverage credit default swaps. This was \$4.5 billion more than the original plan proposed.

Once again, Purdy Crawford, the committee's distinguished chair, was able to broker a deal among the governments of Canada, Quebec, Ontario and Alberta to make the additional \$4.5 billion available.

The plan would see small investors holding less than \$1 million of ABCP receive refunds immediately. The original ABCP notes of all classes and kinds have now been converted to approximately 157 different classes of notes. The bulk of them mature at the end of 2016. These notes have been rated by the Dominion Bond Rating Service between A to top-rated AAA.

Experts say that while there is no secondary market for the new notes yet, a seller, at present, would likely get between 25 cents and 50 cents on the dollar for most of them.

The final touches of this plan, with its amendments, was approved January 16, 2009 by Mr. Justice Colin Campbell of the Ontario Superior Court of Justice. (It was Mr. Justice Campbell who approved the original Pan-Canadian Investor's Committee plan last June 8.)

The IIROC Report

This report that was published by the independent investment dealers came up with a series of findings after its investigation in October of 2008. The general findings were that third party ABCPs were issued under the same securities law exemptions that were intended for traditional commercial paper. These prospectus and registration exemptions were recently made uniform across Canada and required an "approved credit rating" from their approved credit rating organization in lieu of minimum purchase amounts.

Because of confidentiality agreements with sponsors, there was no transparency as to the underlying assets or quality and performance of the portfolio.

In the survey, of 21 investment firms, it was found that none had put third party ABCP through their product due diligence process. The reasons given were:

1. They did not view third party ABCP as a new product and did not distinguish between bank-sponsored ABCP and third party ABCP.
2. Most dealer members relied exclusively on the DRBS rating of R1.
3. They viewed third party ABCPs as cashable money market instruments that had obtained the highest possible credit rating.
4. None of the firms interviewed reported referring any marketing materials for general distribution to its clients or sales personnel.

5. Dealer members interviewed were not worried that third-party ACBP might be unsuitable for clients because they viewed it as a cashable money market instrument with a high credit rating.

6. No dealer member reported providing any training or special written materials to registered representatives, supervisors or compliance staff regarding third party ABCPs.

Canadian-style liquidity triggered only by market interruption was different than global-style liquidity guarantees. It was the Canadian-style liquidity guarantee that prevented the rating agencies in the U.S.A. from providing any rating whatsoever to the Canadian ABCP.

The Dominion Bond Rating Service (DBRS) which provided a rating was the only credit rating agency for third party ABCP programs in Canada.

The fact that three U.S.A. bonding agencies refused to even rate the Canadian ABCP financial instrument because of its liquidity provision should have been a red flag to the dealers to undertake a thorough and complete investigation of this market.

These findings shine a light on what appears to be a murky, unregulated, and, in large part, misunderstood financial investment vehicle. The fact that investment dealers throughout Canada seem to have paid little or no attention to the underlying assets of the ABCP instruments emphasizes the importance of the releases from potential findings of liability of officers, directors and financial institutions involved in the ABCP market which form part of the plan of compromise under the *Companies Creditors' Arrangement Act* order regarding the ABCP market.

It is self-evident that if the investment dealers' own self-regulatory body found there to be significant deficiencies in the practice and process of marketing ABCP to retail clients, then it would be clear that in a court of law, there would most probably be a good chance that there would be findings of liability on the part of these investment dealers to any individuals who were advised to get into the ABCP market without the proper and requisite disclosure.

The Hockin Report

Yet a further response took place on January 8, 2009, when the expert panel on securities regulation published its findings. The committee was chaired by the Honourable Thomas Hockin, the former federal cabinet minister and CEO of the Investment Funds Institute of Canada. This report essentially pointed out that the lack of a national Canadian securities regulator has raised concerns about systemic risk, as there is no national entity accountable for the stability of Canada's national markets. As the ABCP financial crisis had indicated, systemic risk is no longer to be confined to just banking institutions. It now presents itself in capital markets.

The Office of the Superintendent of Financial Institutions, which is the primary regulator and supervisor of federally-registered deposit-taking institutions, insurance companies and federally-registered pension plans, published a press release in April of 2008 which indicated that the Office of the Superintendent of Financial Institutions did not oversee the firms that created a non-bank ABCP, so these firms were not subject to its published capital guidelines. These guidelines did not apply to the offshore banks that negotiated the bulk of the liquidity lines non-bank ABCP conduits; they were subject to the capital rules of their home countries.

Citing the fact that the federal government needs to have a strong presence in the regulation of Canada's capital markets, the Hockin Report's central recommendation is that Canada needs a single securities regulator with a strong, decentralized structure that recognizes Canada's unique make-up and regional and local expertise.

The report also recommended the establishment of an independent adjudicative tribunal dealing only in securities and capital market issues.

Finally, the report recommended the regulation of exchanged traded derivatives be prescribed in securities legislation. In addition, for over-the-counter derivatives, the report recommended that the

newly formed Canadian Securities Commission have sufficient policy depth and resources to determine the best path for the regulation of over-the-counter derivatives in the future.

On January 28, 2009 the federal government introduced a proposed national securities regulator as part of its budget.

After almost 18 months, the ABCP restructuring has finally been completed, albeit with minimal assistance from the federal government and three provincial governments. Nonetheless, the restructuring appears to have been completed successfully.

The report of the investment dealers highlights the significance of the releases which form part of the restructuring package and recommends sweeping changes and the method, process and procedure used by investment dealers when dealing with these esoteric financial instruments.

Finally, there is a significant movement to have Canada create a National Securities Regulator to put forward one Canadian regulated position with respect to capital markets and to have further and better controls over the derivatives market in Canada. ■