

A broken system

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It was good to see Canaccord capitulate on the ABCP issue and announce that non-bank asset backed commercial paper it sold to clients will be re-acquired by the firm at par plus interest for all accounts under \$1 million. That will make a good portion of Canaccord clients whole again in terms of their original investments, and the plan should go some way toward restoring retail investor confidence in the Canadian securities industry.

But will this action, right and good as it is, restore confidence in the overall Canadian securities industry? Not unless some deeper questions about how this incident came to be get answered, suggests Diane Urquhart, an independent financial analyst and former senior securities industry executive who appeared last Thursday before the Parliamentary finance committee's hearings into Canada's frozen non-bank ABCP.

Urquhart was one of six witnesses to address the committee and appeared on behalf of a group of retail customers of non-bank ABCP (she also appeared with the support of the National Pensioners and Senior Citizens Federation). In a phone call after her testimony she addressed the Canaccord capitulation — which she said was good, but only addresses part of the problem — and went on to talk about the overall “financial assault” on Canadian retail investors that took place over the last couple of years.

According to Urquhart, the real story here — and this is a claim she made in her testimony — is that international and national banks seemed to have influenced to their benefit the Canadian regulatory regime around securitization. Key to the non-bank ABCP story is the unique amendment to Canada's Bank Act that was inserted in 1994 (and revisited in 2004) that defined how banks would have to pay out on liquidity agreements contained in securitized products in question.

According to Urquhart's testimony, the Office of the Superintendent of Financial Institutions (OSFI), the national bank regulator, gave the green light to a liquidity agreement that was not only out of step with global practice but reduced the liquidity requirements of those manufacturing these securities, a great benefit to the banks. “The Canadian style liquidity agreement had a general market disruption clause that the banks knew allowed them to walk away from Canadians wanting to have their commercial paper bought out,” says Urquhart.

She is now questioning how that amendment got in there and why. "Why would OSFI think it was wise to have a liquidity agreement to protect investors when they knew it would not do that? Why write a liquidity provision if there is no teeth on it?" she asks.

Her take is that it was put there on purpose and was, basically, "written for the banks," she said in a phone call. We know now, of course, that the big U.S. raters didn't rate non-bank Canadian ABCP because of the Canadian-style liquidity agreements, and that Standard & Poor's, the biggest U.S. rater, wrote a report pointing out the drawbacks to the investor because of these unique liquidity agreements. "But as soon as those changes were in the Act, DBRS began rating this non-bank paper," says Urquhart.

We also now know it was these positive DBRS ratings that drew many Canadians into non-bank ABCP. For those looking for money market or GIC-like products in the early part of this decade, the ratings seemed to provide the necessary green light. But when the market fell apart last summer the withered "Canadian-style" liquidity provisions meant that many retail investors were left hanging, while the big banks that created the non-bank ABCP market benefited greatly by not having to pay out to the affected investors.

In her testimony Urquhart mentioned that Deutsche Bank, which walked away on 60% of the liquidity agreements (plunging the market into crisis), is also counterparty to 50% of the credit derivatives inside the trusts under bankruptcy protection. As a player on both sides of these deals, Urquhart suggested some of these big banks have "executed the greatest squeeze play ever in Canadian business."

That squeeze play was helped along by the changes to the Act. As for what needs to be done to re-format the regulatory regime in the wake of this mess, the first step, says Urquhart, is to get the Canadian-style liquidity provisions out of the Bank Act.

She also recommends that complex structured products like the ones sold here should be sold by prospectus, not by a bond rating. A bond rating is fine for simple, traditional money market securities, but these securities were no such thing. They were complex instruments that in some cases contained leveraged credit derivatives. If there had been a prospectus (as is required under provincial securities law according to Urquhart) then some of these investors who were told these products were as safe as a GIC may have been able to see how potentially risky they were.

More so, says Urquhart, it's not right that DBRS provided inflated credit ratings while being paid a percentage of the outstanding ABCP. "Someone has to make sure that the profit does not supercede public safety — non-bank ABCP had no one anywhere who stood up to say the product is improperly engineered," Urquhart testified. "If securities regulators continue to allow prospectus exemptions when there is an approved credit rating agency, then the securities regulators have to provide supervisions over the integrity of the credit rating procedures performed."

As it is, the hearings have been a great way to get the story of non-bank ABCP out into the public sphere. "I think the politicians believe they have a bigger problem on their hands. I think they thought coming into this that these investors were coming into this market as investors and speculators, not just savers. I think the politicians were shocked by what they heard," Urquhart says.

In her testimony Urquhart explained how it was that this "government facilitated bank fraud" came to be. This wasn't a case of bad investment choice. These investors weren't speculating, they were looking for savings products for large chunks of their retirement portfolios and were hoodwinked by the industry that misrepresented this paper, she believes. That interpretation is confirmed by emails (passed along by Urquhart to Canadian Business) in which advisers recommend these products as being "as good as GICs" in terms of capital preservation, better than Treasuries, and, in the case of one adviser, this non-bank ABCP was said to be a security that was so safe it would only go down "if the whole financial system went down."

These utterances are the kind of overconfident, truth-inflated statements Canadians have, sadly, come to expect from their advisers. But in this case, especially in light of the fact U.S. bond rating agencies didn't rate this paper, and the rating of this paper by DBRS here in Canada broke with traditional practices around complex securities, these statements come close to outright manipulation. But what is most worrying is that Canada's regulatory regime seems to have been shaped in favour of the industry. John McCallum, the Liberal finance critic, recently commented on that idea in reaction to the ABCP issue. "I can't stand here today and say who's to blame, but we have heard disturbing allegations about regulators who may be in the pockets of the regulated," the former chief economist of RBC (and member of the federal finance committee), was quoted as saying after the hearings. "We need to find out what went wrong in this particular disaster and what we can do to make sure that future crises are less likely to happen."

The MPs on the committee voted for more hearings, so that's good. Hopefully we'll get to the bottom of how those changes to the Bank Act will be explained. We need to know what happened and be assured that changes in regulations are being driven by the common good, not the interests of foreign institutions. As for retail investors, they should be asking their adviser why, if as is apparently the case, investors have to look far more closely at the products being recommended and sold into their portfolio. If you have to check the paper yourself, as you apparently do, what are you paying the adviser for? "The banking industry really needs to work on their duty of care and professionalism," says Urquhart. After all, when it comes to banking, it's all about trust, and that has taken a hit here.



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