Mining firm digs in on ABCP ruling

By KEN MARK

Asset backed commercial paper (ABCP) investors may face yet another delay before seeing any money. Ivanhoe Mines Inc. will go before the Supreme Court of Canada in a bid to overturn the restructuring deal sanctioned by the Ontario Court of Appeal.

The restructuring will be further delayed if the Supreme Court agrees to hear the appeal. But if it turns down the request, the provincial judgement stands and the ABCP note restructuring will begin.

For the moment, lawyers for corporate investors are girding for another possible court battle. However, accountants will again be sitting on the sidelines waiting for the next judicial shoe to drop.

For practitioners, it will be steady as she goes.

"With the likelihood of further legal proceedings, auditors will have to soldier on trying to use appropriate methods of valuating such investments as they have in the past year," says Peter Martin, Toronto-based director of accounting standards for the Canadian Institute of Chartered Accountants (CICA). "It has been a difficult time establishing fair value for ABCP investments without a functioning market setting prices. What they need to do is to continue applying the existing standards in the CICA handbook."

But now the guessing game begins. Will the Supreme Court agree to hear the matter?

"When the court considers the request, two issues will guide its decision," says Ivanhoe Mines' Vancouver-based lawyer, Howard Shapray.

"One is that the request relates to a matter of national interest and the other is that there are conflicting views of two provincial appellate courts — Ontario and Quebec — regarding the CCAA (Companies' Creditors Arrangement Act), a federal statute."

Toronto lawyer Philip Anisman says the dollar amount involved in the case is not an element in the court's decision. "It may be relevant, however, if there are broader implications involved, such as market structure," he says. "For example, the recent BCE decision was considered to be major issue since it involved the responsibility of directors and by implication, shareholders and employees."

The key legal issue centres on relieving all third parties of liability regarding the sale of ABCP, except for clear cases of fraud. The Ontario Court of Appeal ruling concluded said that while such legal releases may be "distasteful", they can be used when necessary for the greater good, to have a restructuring proceed.

When the Supreme Court will hear the matter is uncertain. Ivanhoe Mines filed its petition well within the eight-week window after the Ontario Court of Appeal decision. "What the court has to decide is the significance of the appeal hearing," says Anisman. "If it concludes that it is indeed a matter of national importance, it can expedite its hearing."

Shapray said the Supreme Court set a precedent with its decision to speed up the recent BCE hearing.

If the Supreme Court grants leave to hear the appeal motion, the resulting delay may encourage firms that sold ABCP to start discussions with corporate investors about repurchasing the investments. "In the past, it put pressure on others to react responsibly to meet investors' demands," says Shapray. "Right now, the situation remains very dynamic"

If the Supreme Court overturns the Ontario decision, will it lead to chaos in Canadian financial markets? "That statement is way overblown," says Sharpray. "These securities have not traded for more than a year without disrupting the overall financial markets." He estimates that the total value of the ABCP held by corporate investors is between $1-1.2 billion.

According to Mississauga, Ont.-based independent financial analyst Diane Urquhart, had the Canadian banks originally taken back the ABCP investments they sold there would never had been a massive restructuring problem.

"Based on my research, they would have taken as much as a 25 per cent hit to their balance sheets," she says. "But they still would have been able to handle it. They all had the balance sheet capacity to accept substantial losses. No bank would have needed to be bailed out."

Whatever the Supreme Court decides, the financial markets will eventually have deal with the ABCP $32 billion pool of assets.

Like ancient Gaul, the outstanding ABCP pool of assets can be divided into three parts. "The most highly prized group consists of traditional securitized assets, credit card, car loans and conventional residential mortgages," says Daryl Ching, Toronto based vice-president of Canadian Hedge Fund Watch. Their values are relatively high and stable.

"The second involves CDOs (collateralized debt obligations) leveraged financial derivatives that that can be broken down in sub-categories A1 and A2 indicating different levels of quality."

Since many investors have simply lumped all CDOs together, initially some of them will attract very low bids. Other investors believe that if held to maturity – seven to nine years – they will pay out fully, along with accrued interest.

Ching estimates that the best CDOs might eventually fetch 80 cents to 90 cents on the dollar. Initially, sophisticated risk-takers will target an acceptable rate of return and discount their bids accordingly.

However, more mainstream investors such as insurance companies and pension funds are likely to wait at least a year for the market to develop a track record.

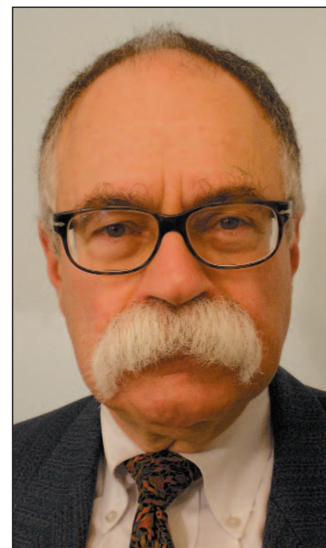
Then, there is the subprime segment. "This class appears to be totally toxic," says Ching. "Recently in the U.S., Merrill Lynch cleared out its inventory of such investments at 22 cents on the dollar."

And finally as Canadian investors await the Supreme Court decision, what is on their minds? "The public is now much more sophisticated about such things," says Urquhart. "They expect to see remedies when tainted food enters supermarkets or toxic chemicals enter the water supply. ABCP is simply tainted investments that got into the money system."

"These securities have not traded for more than a year without disrupting the overall financial markets."

Howard Shapray, lawyer

SHAPRAY



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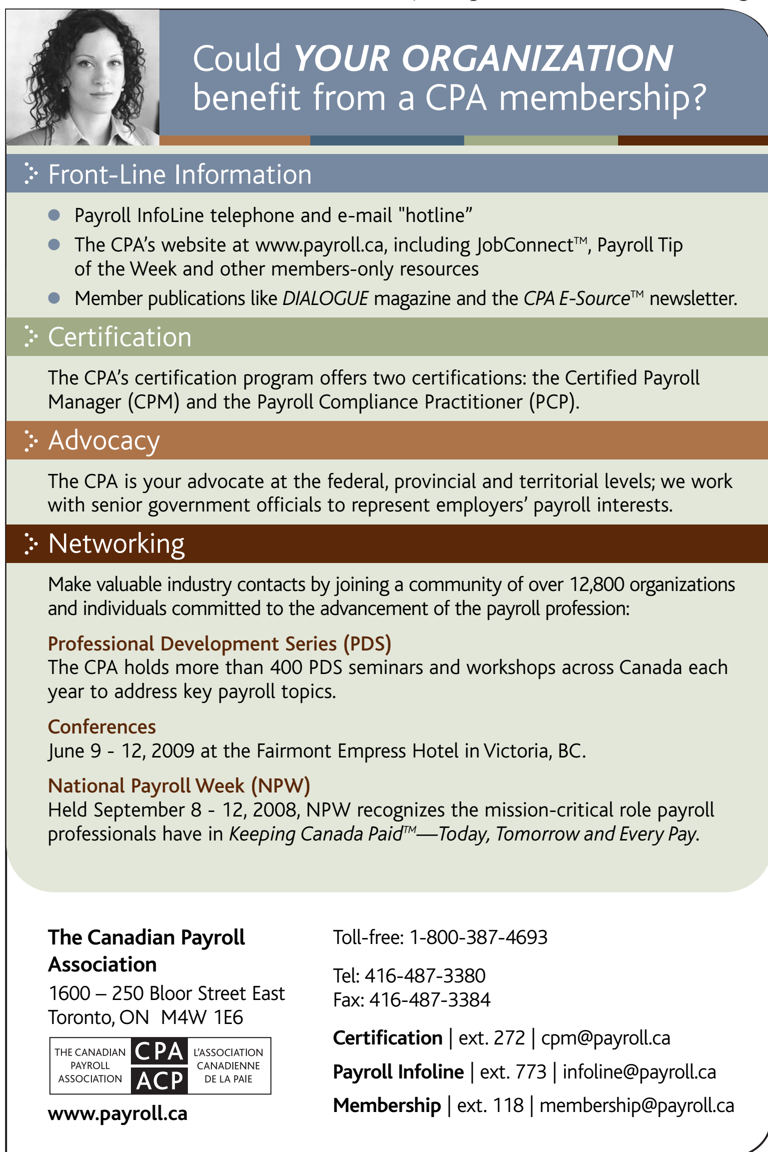

CANADIAN BUSINESS ONLINE
Your success is our business

A broken system

Jeff Sanford
April 14, 2008

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.

Click for more on ABCP

The $100 million question: Will exposure to subprime market hurt taxpayers?

BY ROB FAULKNER
November 23, 2007

Nearly $100 million of taxpayers' money is in limbo due to a crisis surrounding a risky city investment.

Hamilton has $97 million of its $691-million investment fund in what's called asset-backed commercial paper, or ABCP, short-term securities made up of mortgages or other debt.

A crisis arose around this type of investment in August in part because of doubt about the value of ABCP, and exposure to the U.S. subprime mortgage market collapse.

What happens to next depends on a team of investors and banks, which agreed to halt trading of ABCP due to the crisis.

The city is expected to unveil a plan to restructure the security holdings on Dec. 14.

So, will the city take a bath when that happens?

"There is always that possibility whenever you make any investment. I remember when the banks were having problems in the '80s. That's why I've got white hair," said finance chief Joe Rinaldo, noting the city made millions in recent years on other investments.

"It is a solid paper," he adds of the security that came with a high rating equivalent to AAA.

Rinaldo did not speculate about what the $97 million might be worth now. He noted its risk is counterbalanced by other investments that are making money.

Hamilton has had 3 per cent to 14 per cent of its investments in ABCP in the past.

Rinaldo says the Dec. 14 plan may convert the security that was short-term to a five- or six-year investment that can't be converted to cash as quickly.

He maintains the debt in the ABCP is still well regarded, but at least one observer isn't so sure.

"It's a lot of money, and it's a high percentage," Mississauga-based independent financial analyst Dianne Urquhart says of Hamilton's ABCP holdings, which currently makes up 14 per cent of its investment fund.

Urquhart, noting some U.S. buyers are now only willing to pay 60 cents a dollar on ABCP debt, said the city shouldn't accept the long-term offering to come out of the Dec. 14 restructuring.

"There's no fault at city hall, and the treasurer shouldn't lose his job," she said. "They bought damaged goods," she adds, hoping the city will get all $97 million back in cash from the organization that sold the investment.

But Nick Bontis, associate professor in McMaster University's DeGroote School of Business, said Hamilton's investment mix is so conservative he calls it "capital preservation."

Not exactly a scary, high-risk mix.

To put its risk in context, he notes the Investors Group Canadian Balanced Fund held 59 per cent in securities, 30 per cent in safe bonds and 11 per cent in cash. The city has 14 per cent in asset-backed securities, 83.3 per cent in bonds and 2.7 per cent in cash.

"OK, we might not get full, realized capital gains on those securities," Bontis said. "But had we not invested there, people would be bitching that we have only a single-digit rate of return."

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City lowballing ABCP losses, says financial analyst

BY RACHEL DELAZZER

A financial analyst says Hamilton is seriously underestimating its losses in the asset backed commercial paper (ABCP) meltdown.

City finance manager Joe Rinaldo has estimated the loss at $14.4 million on an investment of $97 million, but Diane Urquhart, an independent financial analyst, says that number is likely much closer to $50 million.

In its 2007 financial report, the city has allowed for a loss of $14.4 million stemming from the ABCP market.

Rinaldo says that is a caution, that the city hasn't actually lost anything as the investment mess sorts itself out.

Last year, Hamilton put $97 million of its $691-million investment fund in ABCP.

The ABCP notes were a type of short-term debt security that had been considered relatively safe until demand suddenly evaporated last year due to actions in other areas of the financial market.

Municipalities normally invest in instruments that earn a bit less but offer greater safety.

The city's asset mix is approximately 37 per cent short-term 90 day investments (predominantly major Canadian banks) and 63 per cent long-term bonds.

The investments are primarily government and municipal bonds.

City investments are all regulated by the Ontario government, so Rinaldo's says Hamilton's investments are similar to other municipalities.

But, last August, ABCP investments plummeted in value, mainly due to instability in the U.S. subprime mortgage sector and a softening of the American real estate market.

In the late 1990s, the province gave municipalities permission to invest in ABCP notes because, at that time, Rinaldo said, they were triple A rated.

A group of investors is trying to renegotiate the ABCP notes into nine-year investments.

That would give some hope that they would recover and minimize losses.

A judge must approve that plan and it would see investors, like Hamilton and even Ontario, receive its principal with interest over the course of the nine-year term.

Rinaldo says reporting an allowance amount for the possible loss is simply a requirement of financial reporting standards.

He says there are no implications for the city in having the money tied up for nine years as it has bought long-term bonds before.

The ABCP represents 12 per cent of the city's $691 million investment portfolio, so Rinaldo says, the city should have no issues in terms of liquidity and it can adjust its investments accordingly.

The city also has between $400 and $500 million in cash reserves.

Urquhart, a Mississauga-based independent financial analyst, believes it's unlikely the city will recoup its full principal.

She also says the city's estimated 15 per cent loss is too low and that a more accurate estimate would be between 25 and 50 per cent.

That could mean a loss as high as $49 million.

Urquhart bases that on a Superior Court valuation from March 4 that pegged the loss at 51 cents on the dollar.

Urquhart says other financial institutions have reported much higher writedowns.

DundeeWealth, for example, reported a writedown of 45 per cent and Desjardins Group had 25 per cent. Urquhart has spent 30 years in the finance industry, including 10 as head of equity research at brokerage firm Burns Fry Ltd. Rinaldo says the city's 15 per cent estimate is in line with those of most other ABCP investors. "The only ones I've seen so far that have used the higher rate are the banks themselves, but I think they have other exposures that are beyond the asset backs that they're incorporating in that."

Urquhart says that while most investors are indeed estimating writedowns of well below 25 per cent, they're off the mark. "There are others doing what Hamilton is doing but we're saying that's not realistic."

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With files from Daniel Nolan, The Spectator

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INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

January 2008

Are investment products lacking transparency?

If transparency is essential to preserve investor confidence, why isn't there more of it?

By Laura Bobak

Let's face it: many financial products leave clients perplexed. The fees behind principal-protected notes are confusing; mutual funds can be elaborate; the details of hedge funds are vague and opaque; then there's the complexity of asset-backed commercial paper.

Although some efforts are being made to clarify fees and the structure of widely used products such as mutual funds (which are also the subject of increased regulation), investor advocates and industry analysts say there's still a long way to go on the road to industry transparency.

Indeed, in a speech in Toronto this past month, outgoing **Bank of Canada** Governor David Dodge laid part of the blame for the past summer's market turmoil on lack of information: "Problems related to information contributed to the market turbulence. We have seen the emergence of increasingly complex structured products, which were developed in response to the demand for higher returns.

"And as these securities have become more complex and opaque, in many cases, it has become harder to assemble and understand all the information needed to determine what kinds of assets are backing the security, the quality of those assets and the counterparty risk involved."

If clients insist on greater transparency, they'll get it, Dodge says. Credit-rating agencies should explain more clearly how they rate highly structured products and that their ratings should not be used with the same degree of certainty as ratings for conventional, single-name issuers. Investors also need to be told, Dodge says, that certain instruments do not trade with the same degree of liquidity as others.

There's also the issue of some investors' mistaken belief that they are well briefed about their choices. In fact, many do not have the financial literacy to grasp what's being disclosed, let alone what's not. And that can result in purchasing products that do more harm than good to their financial situations.

"The best way to deal with risk," says investor advocate Ken Kivenko, who runs the

www.*CanadianFundWatch.com* Web site, “is really to understand what you are being sold, the fees involved, tax efficiency and how the fund fits into your portfolio’s asset allocation.”

Canadians are plagued by high fees and a shortage of straight facts, he says: “They’re stabbing you in the front, not in the back, with high fees and opaque disclosures.”

Some investor advocates also say that simply flagging questionable products for investors isn’t good enough. “Transparency is not a substitute for the investment industry’s duty to design products with minimal red flags,” says investor activist Diane Urquhart. “The financial advisor needs to market products without deception. In the retail market, financial literacy is not high. The complexity is so high, people don’t understand transparency, in any case.”

Here’s a look at some of the red flags raised by some of the industry’s murkier products:

Principal-Protected Notes. The lack of transparency in PPNs has led the federal government to announce that, as of April 1, it will require more disclosure both before and after the sale of these interest-bearing deposit products. Clients should understand that fees are high relative to the return, which is linked to the performance of underlying assets such as funds linked to stock market indices or commodities, say investor advocates.

“By and large, even if the PPN has a few good years, those fees just eat away at you,” says Kivenko, who points out that often the underlying products linked to PPNs are Canadian mutual funds, which are themselves plagued with high fees. “If there are fees on top of that for the note, what chance do you have?” he asks.

And although the principal is guaranteed, PPNs are not as low-risk as a GIC because they are not covered by deposit insurance. In addition, clients may not be aware that only a relatively small portion of the amount invested is placed in products with upside potential: the rest is used to cover the principal returned at maturity.

“PPNs are opaque,” Kivenko says. “People don’t have a clue what they’re buying. The people selling them are not always professionals. If it were a mutual fund, you’d have to be a registrant. But we don’t know who is selling PPNs. It could be some guy in the branch in his office with no professional qualifications.”

Kivenko also says it’s unclear who regulates PPNs: “We wrote the government and we said: ‘Who is it?’ We didn’t get an answer — yet.”

Some firms have improved disclosure, Kivenko says, but he’s still concerned, especially since the new regulations proposed by the federal government are principles-based, not mandatory requirements.

“If there’s one product that needed absolute uniform ways of communicating to retail investors,” he adds, “this would be the one.”

Mutual Funds. In comparison to some other products, mutual funds are reasonably good about disclosure, says Dan Hallett, president of Windsor, Ont.-based fund analysis firm **Dan Hallett & Associates Inc.**

Unlike PPNs, which, Hallett says, have fee disclosure in irregular and illogical places such as in a section entitled “net asset value,” a mutual fund prospectus is easy to compare with documents from other funds.

“If you’ve gone through a few of them, it’s very easy to compare them,” Hallett says. “There’s a lot of irony that regulators continue to pound away at mutual funds and segregated funds, and they are just getting around to PPNs.”

However, Hallett complains that mutual funds no longer have to release statements of portfolio transactions, which in the past could be requested by an investor or through the System for Electronic Document Analysis and Retrieval online at *www.sedar.com*. Hallett

argues that without this information, it's hard to tell if a portfolio manager is actually sticking to his or her stated investment policy.

Recent regulatory efforts are also falling short, Hallett says. In his view, the proposed two-page Fund Facts document for mutual funds and segregated funds recommended by the **Joint Forum of Financial Market Regulators**, an umbrella group set up in 1999 to co-ordinate the regulation of financial products, doesn't improve disclosure in a meaningful way in the areas of "risk" and "suitability." Hallett says investors could understand their risk level better if shown a chart showing rolling returns or past declines in the fund's benchmark; this would be preferable to the six-point scale rating risk from very low to high.

Investors also need to know how the advisor is compensated through commissions and trailer fees; whether there is a deferred sales charge; and how high the management expense ratio is compared with other funds in the same category. Clients are also likely to have questions about non-MER expenses, which include trading fees, brokerage commissions and taxes on distributions.

Urquhart says there should be a Web site to which clients can go to see mutual fund portfolio transactions: "You should have the right to receive it if you choose."

Hedge Funds. These funds should not be sold to retail investors unless these funds are prepared to issue a prospectus in the same manner as mutual funds, Urquhart says.

"It's an absurdity for a country to allow that to occur," she adds, speaking of the current regulations allowing minimal disclosure through an offering memorandum. "I don't want accredited investors to have to play Where's Waldo."

Urquhart also suggests that clients who are not privy to the investments held by their funds need to ask questions. How long has the fund been in business? What are the qualifications of the fund managers? How much leverage will the fund take? To what extent will derivatives be used? What are the fees (which are usually 1%-2% plus 20% of the profits above a certain risk-free return, Urquhart estimates)?

"They get 20% of the upside," she says of fees, "but are they going to pay you back when they lose your money?"

Income Trusts. These trusts are not required to disclose their calculations of distributable cash in a standardized format, an item normally dealt with in the publicly traded companies' management discussion and analysis.

The murkiness of income trusts has been questioned by the **Canadian Institute of Chartered Accountants**, which has recommended that trusts be required to use standardized methods of reporting distributable cash. But as of November, only a few trusts have begun using the standard format. The CICA recommends that trusts disclose from what source distributable cash is coming (income, investor capital or debt), and whether the trust's capital spending is adequate to maintain its operations.

Critics of trusts, such as forensic accountant Al Rosen of **Accountability Research Corp.** , have complained that many clients don't understand that they are often merely getting their own money back when trusts make their distributions.

Another scenario, according to Urquhart, is the income trust mutual fund: in a hypothetical example, such a fund could be billed as having a 16% return, when in fact the real return — the amount that remains when the investor's own money or funds from other sources of financing are subtracted from the amount being paid out — is 5%. And of that 5%, a further three percentage points might well be eaten up by MER fees.

"The customer would not buy that if they knew about the fees," Urquhart says. "People construe it to be income, and they might be willing to pay higher fees than they should.

You shouldn't have to pay fees to get your own money back."

Asset-Backed Commercial Paper. One of the reasons investors lost faith in ABCP is that the companies peddling the product released very little information about the underlying assets; this led some investors to stop rolling over their notes.

Hallett says that when he tried to find out about a few ABCP trusts being sold by Coventree Inc. , the firm at the heart of the summer liquidity crisis in Canada, he found very little about the creditworthiness of the underlying assets in the ABCP "information statements" released to investors.

"The disclosure is lacking significantly," Hallett says. "There's really no description of the assets."

As with PPNs, there is also a troubling range in the quality of disclosure among ABCP notes. "It's not that great," Hallett says. "That's the reason we hit this wall of liquidity — because there is no transparency." **IE**

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ABCP - AMF investigation on the commercial paper

FRANÇOIS DESJARDINS

Thursday, 11 September 11, 2008
Autorité des marchés financiers (AMF)

The AMF has launched an investigation into the sale of commercial paper held in Quebec in the week before the crisis occurred in August 2007, said yesterday the CEO of the regulatory body.

"After our investigation, we will see whether any administrative or legal action are needed," said Jean St-Gelais during a speech before the Circle of International Finance at Hotel which focused on financial crises and combating economic crime. He offered no detail.

"These are products that were sold as liquid, completely guaranteed," said St-Gelais in an interview on the sidelines of his speech. "People found themselves in difficult situations. There are groups who still today claim before the Supreme Court that there was malfeasance."

The commercial paper backed by receivables, also known ABCP, was issued by non-bank entities. Presented as a safe, it was an investment that yields reported slightly higher than the government securities. These returns were generated by debts of credit cards, cars leases, mortgages, etc.. It was particularly in the mutual fund market.

Only one rating agency, DBRS, had expressed an opinion about the Non Bank ABCP. This view was favourable.

In August 2007, large institutions began to fear that the ABCP is linked too closely to the sector of U.S. mortgage. The pool of buyers dried up, and the crisis of confidence was so severe that the only solution was to freeze all 35 billion Non Bank ABCP in Canada.
The ABCP is being converted into long-term obligations, thanks to a plan approved by a hundred large institutions and small investors around 1800. This plan, however, is the subject of dispute before the Supreme Court by companies including Groupe Jean Coutu. In the meantime, investors and companies are still unable to resume their activities.

"The investigation focuses on the distribution and sale of these products there in Quebec, on events that took place in the weeks before the crisis broke out," said St-Gelais. "We request information from financial institutions in the wake of the crisis." He included consideration of the National Bank, which sold paper to commercial clients and to certain mutual funds. The Bank has bought ABCP for two billion dollars after the crisis. Elsewhere in Canada, Canaccord Capital sold ABCP. ABCP was also in mutual funds managed by other major institutions.

Mr. St-Gelais did not want to specify the institutions concerned. "We investigate all players in Quebec, and if you do the tour it is not very long," he said. A spokesman of the National Bank

refused to comment. "If there is an investigation, it will co-operate," said Denis Dubé.

The National Post wrote in May that instead of it investigating, the Ontario Securities Commission has delegated that task to the Canadian body regulating trade in securities.

"This investigation by the AMF is good news, because it is nice to see that the government is doing it," said financial adviser Diane Urquhart, who advised the 1800 small investors. "We are of the opinion that people have been sold a defective financial product on the basis of misrepresentations.”

FINANCIAL POST

Desjardins outlines its ABCP activities

Barry Critchley
Financial Post

Monday, November 19, 2007

The plan was done to look after its own clients, but this week's decision by Montreal-based Desjardins Group may end up affecting customers of its larger Toronto-based bank competitors. And that would be a good thing, according to some analysts, particularly as it may be a solution to the asset-backed comercial paper mess.

On Thursday, Desjardins provided the market with more information about its ABCP activities, including details about what it referred to as "assumption of assets held in the form of non-bank-sponsored asset-backed commercial paper to protect members and clients from prevailing market uncertainty."

In its latest quarter, Desjardins made two ABCP decisions: It assumed the non-bank-sponsored ABCP held in certain mutual funds, and it also assumed the non-bank-sponsored ABCP acquired in connection with the securities custody and lending activities undertaken by Desjardins Trust on behalf of institutional clients for whom Desjardins had not originally assumed the risk.

Those two decisions affected $1.2-billion of ABCP held by clients. On top of that there was a further $700-million held by Desjardins for its own investment purposes. Desjardins has taken a $160-million writedown on the $1.9-billion of ABCP.

Alban D'Amours, chief executive of Desjardins group, said the decision was made because "it was in the best interest of our members and clients that we assumed these securities held on their behalf. Given the complexity of this issue, we felt that it was more appropriate under the circumstances to manage the overall situation from the perspective of the entire Desjardins Group so that our members and clients would not have to be concerned about the situation."

In August, National Bank said it would acquire all of the ABCP held in mutual funds and pooled funds of subsidiaries of the Bank, all of the ABCP currently held by all its individual retail clients as well as

certain other clients, at 100% of the acquisition cost plus accrued interest.

So what are the implications of Desjardins decision? Diane Urquhart, an independent analyst, said the decision to reimburse its institutional clients "sets a benchmark for make-whole offers from the sponsors and the banks/ investment banks that manufactured or distributed the third-party ABCP to both retail and institutional clients, regardless of whether they were accredited investors."

She argues that the banks and/or investment banks that are counter-parties to the credit default swaps and signatories to the limited use liquidity agreements are "co-maufacturers" of the third-party ABCP, along with the sponsors. As such, they are different from some other investment banks that distributed the third-party ABCP, but were not manufacturers of the paper they sold. "These distributors should also expect to contribute to accommodating settlements with all their retail and institutional clients, whether they are accredited or not, since they too were part of the negligence or deceit in the provision of this defective product to Canadian pension funds, governments, corporations and thousands of retail customers," she said.

Desjardins is a member of the Montreal accord, the group trying to set the conditions for the resumption of normal activities on the Canadian non-bank-sponsored ABCP market. That group has a Dec. 14 deadline.

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Yukon government investments not risk free

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By Chris Oke *Special to the News*

Premier Dennis Fentie answers the opposition during
question period at the Yukon legislature on Thursday.

The Yukon government failed to adequately research its $36.5-million investment in two high-risk asset-backed commercial paper funds [ABCPs].

The funds were frozen on August 17.

It's not clear when investors can expect to get their money back, or how much they stand to lose.

The Yukon is not expected to lose any money in the collapse of the asset-backed commercial paper market, said government officials.

However, write-downs stemming from those funds are already occurring in publicly traded companies.

A write-down signals the companies are expecting to lose money in the deal and have adjusted their books to show that.

“Those that own the paper and are obliged to make public disclosures are writing down as much as 15 per cent,” said Diane Urquhart an independent Financial Analyst.

“The write-downs made by investment banks that were involved in the packaging and have more information, are between 20 and 35 per cent.

“If they were sold on the market, my thinking is that there would be a 25 to 35 per cent loss.”

Not only will the investors lose the interest they were expecting to receive but also as much as one third of the original investment.

That’s more than $12 million for the Yukon government.

A company called Parameter Financial in Toronto is in the process of setting up an electronic market to sell the papers at the appropriate loss.

This is much to the chagrin of a consortium of banks, asset providers and investors that are currently attempting to reach a settlement agreement.

The group is attempting to extend the payback period to between five and 10 years and has promised to deliver the terms by December 14.

Two asset-backed commercial paper funds were bought by the Yukon government in July and August of 2007. They were supposed to mature 30 days later.

The asset-backed paper schemes can be confusing.

They hinge on asset-backed loans — that is, loans issued to buy cars, corporate mortgages and other things.

These loans are collected in trusts, which then look for investors. Those investors buy into the trust and profit from the interest paid on the loans.

In theory, the diverse loan holdings are supposed to lessen the risk.

Investors generally buy the papers for 30- to 90-day periods. When that deadline is reached, the investor can choose to sell the paper or continue to hold it, “rolling them over,” and collecting interest for another period.

The Yukon government has been investing in similar funds for 10 years.

In August, investors looking to sell could not find buyers for their asset-backed papers.

That caused a panic, which cascaded through the 22 such trusts.

Investors expected the investment banks to buy them out. But they didn't.

"For investors to suggest that they do not own a piece of paper that has significant exposure to market-to-market losses is incorrect," said Urquhart.

"Thankfully, none of the trusts we invested in were exposed to the subprime market," said Clarke LaPrairie, director of financial systems.

However, 77.8 per cent of ABCP is backed by something known as collateral debt obligations.

Basically this is a package of securities or derivatives sold on the international markets, said Urquhart.

"It's a blind pool — people don't know what's in those," said Urquhart.

"And those collateral debt obligations are, in fact, more serious than the US subprime mortgage (market) itself."

The money enters what is known as the credit-default swap market, where investors bet on the risk of default on loans.

Because the money is leveraged, even a small percentage default is magnified 20 times in your loss, said Urquhart.

The Yukon's Financial Administration Act is written to protect public money from losses in risky investments.

It states investments must adhere to specific guidelines.

They must be guaranteed by Canada or a province, guaranteed by a bank, or receive the highest rating from at least two recognized security-rating institutions.

The two funds bought by the Yukon government, Newshore's Symphony and Opus funds, were not guaranteed by any government.

And they were not rated by two institutions.

Dominion Bond Rating Service was the only agency that rated the investments.

"They were the only credit-rating agency willing to do so," said Urquhart.

“Standard & Poor’s refused to rate it and wrote a report in 2002 called Leap of Faith in which (it) expressed extreme concern about the high risk.

“They refused to rate it at all, they wouldn’t even give it a low rating.”

Why did DBRS hold a different opinion?

Because it was receiving a percentage of all the papers sold on the market as a provision for the research it did on the rating, said Urquhart.

Normally rating agencies get paid a flat fee for their services; this was one of the first times that percentage payments were used.

“It was extremely lucrative, and it also led (it) to be more optimistic than (it) otherwise would be,” said Urquhart.

“It’s a conflict of interest.”

Without two high ratings, the government’s Finance department depended on a guarantee from the bank.

“We viewed it as guaranteed,” said LaPrairie.

“In case they can’t sell the commercial paper, which is what happened, the banks were supposed to step in.

“The banks backed off the guarantee.”

But there was no internationally recognized guarantee.

“They had liquidity agreements, but they were weak liquidity agreements, not guarantees,” said Urquhart.

“With a full-fledged guarantee, if there is more than one commercial paper that cannot be sold, then the bank is forced to buy it.”

In this case, all of the commercial paper in the country could not find a buyer and the banks refused to pay because they didn’t have to.

The banks announced that if the paper was manufactured by anyone other than themselves then they would not honour the liquidity agreements, said Urquhart.

The funds the Yukon bought were compiled by third parties — entrepreneurial companies that weren’t in the position to offer any kind of moral guarantee.

And Newshore explicitly refused to give any guarantees in the information memorandum they issued for the funds.

“The banks were paid premiums so that the sponsors and vendors who sold this paper could say that there was a liquidity agreement,” said Urquhart.

“But they knew that the chances of them ever needing to provide the cash to purchase back the paper would virtually never happen.

“The investment bank that sold this paper to the Yukon government should not have done so, it was too high a risk.

Generally top quality commercial paper is 0.5 per cent higher than a government-issued treasury bill, which is considered to be the safest investment possible.

However, the asset-backed commercial paper is 0.55 per cent higher.

There is a slightly higher risk, and subsequent higher yield from investment, because the securities are created by private, third-party firms and only sold through the banks.

“In first year economics you learn that higher risk means higher reward,” said Canadian Taxpayers Federation spokesperson Scott Hennig.

“By virtue of the payout, these things have to be a higher risk.”

Hennig also believes that investing $36.5 million, 15 per cent of the government’s investment portfolio, into these papers is not a safe investment.

“Why is the government doing savings anyway?” he added.

“If individuals want to invest, that’s their choice. Why not give the money back to the taxpayers and let them decide?”