Bottom Line
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NEWS: Roadblock looms for restructuring
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An innocent-looking amendment looks like it could lead to problems for the asset-backed commercial paper restructuring deal. A crucial part of finalizing the documentation under the Companies' Creditors Arrangement Act (CCAA) requires having a group of foreign banks sign off on the restructuring plan. If they do not, it would jeopardize meeting the targeted completion date.

"The amendment places the foreign banks outside the reach of Canadian courts," says Mississauga-based independent financial analyst, Diane Urquhart. "That's because when it was passed in November 2007, the amendment removed derivative contracts such as credit default swaps (CDSs) from the list of assets automatically stayed or frozen when firms seek bankruptcy protection under CCAA."

In other words, during court-supervised bankruptcy proceedings, derivative counterparties could settle their contracts without waiting for a judge to unfreeze such assets and apportion them between debtors and creditors. ABCP trust issuers hold CDSs since they have sold them to counterparties, i.e. the foreign banks, as a form of a hedge defaults of the trusts'' assets.

Until the foreign banks sign off on the restructuring plan, "all noteholders will have to wait in purgatory," says Urquhart. "If the banks sign, they will be in heaven because the restructuring plan will go forward and they will get paid."

All signatories to the final restructuring agreement waive the right to sue. But, "if the banks don't sign, it's hell because all the parties will start suing each other."

Without the power of the courts, the foreign banks' decision to sign is essentially voluntary.

"What's missing is someone with a hammer to bring the foreign banks to the table and sign," says Karim Jamal, University of Alberta accounting professor in Edmonton. "I don't foresee Ottawa getting involved with a bailout. The election is over and ABCP never came up as an issue.

" That was the time for noteholders to raise a fuss and get some reaction. But the election is over and their leverage is now gone."

Purdy Crawford, chairman of the Pan-Canadian Investors Committee for Third-Party Structured ABCP, was unavailable for comment, but released a statement saying: "We continue to work with the plan participants and major stakeholders to finalize the documentation and move forward with the closing process and we expect that the restructuring plan will be completed by the end of November."

Since August 2007, $32 billion in ABCP has been locked up after market demand for such investments evaporated. The restructuring plan crafted by the Pan-Canadian Investors Committee gained court approval in mid-September after the Supreme Court of Canada refused to hear an appeal of a lower court decision.

But continuing delays compound the pain and frustration of so-called retail investors – defined as individuals, family trusts or personal investment holding companies. According to Urquhart, they number about 2,500 and collectively hold $371 million in toxic paper.

Vancouver-based Canaccord Capital Inc. and other sellers of ABCP to retail investors have signed agreements to make them whole. However, the arrangements do not kick in until the Pan Canadian Committee's restructuring plan is finally approved.

To keep up the pressure, many of the retail investors have been constantly lobbying federal agencies; departments and other institutions on the latest twists and turns.

When Wynne Miles, a retail ABCP investor in Victoria, wrote to Bank of Canada Governor Mark Carney outlining her concerns, the governor's office sent her a reply containing the explanation, "This delay is no doubt a reflection of the great complexity that underlies the plan itself. Nonetheless, it is encouraging that the committee has expressed its strong commitment to move forward on this issue as quickly as possible. Indeed, this is its obligation as a result of the ruling confirmed by the Supreme Court."

Miles was left unimpressed with the bank's response. "To me, this illustrates a lack of understanding of the fact that the international banks are not subject to the authority of the CCAA," she says.

The Bank of Canada refused to comment on individual cases. In an e-mail to The Bottom Line, Jeremy Harrison, senior media relations officer, stated: "The bank is not going to reply via the media to the direct inquiries of individual Canadians to the governor."

Since some of the participating foreign banks including the Royal Bank of Scotland (RBS) and Deutsche Bank are victims of the global market meltdown, they have become partial financial wards their shareholders after purchasing huge equity stakes in them.

Other such as Merrill Lynch and Wachovia have been taken over by rivals.

The survivors and acquirers are now in dire need of liquidity to stay in business. As CDS counterparties, they can raise funds by making collateral calls on ABCP trusts, which are underwater because their value has dropped below the spread-loss-trigger. In fact, RBS has already made such a call requesting $60 million from a satellite trust of Structured Investment Trust III, only to retract it later. But there are lingering fears that RBS could make more collateral calls in future. Or, if the value of underlying $230 million asset falls severely, RBS could take the next, and more drastic step of seizing the asset and selling it at fire-sale prices. In a declining market, such sales would further depress prices for similar assets.

Oddly enough, the U.S. Federal Reserve Bank’s continuing efforts to stabilize security markets are tied to a similar amendment to U.S. bankruptcy laws providing safe harbour exclusion for derivatives held by financial firms filing for Chapter 11 protection.

“The U.S. security industries lobbied Congress in 2005 to bring in the amendment to protect large Wall Street firm such as Bear Stearns, Lehman Brothers and AIG that were actively selling CDSs to counterparties, mainly to hedge funds,” says Franklin Edwards, a Columbia University (New York City) finance professor. “The sellers wanted protection against a counterparty seeking bankruptcy protection which would require the CDSs to be stayed or frozen until released by a judge.

“As it turns out, it was the sellers who got into trouble. After forcing Lehman Brothers into bankruptcy, the Federal Reserve realized that it could not do the same to AIG since it was the major counterparty to CDSs and other derivatives. It had to keep AIG solvent to ensure the orderly disposal of the derivative contracts that it had put together.”

The Federal Reserve has recently upped its investment in AIG to US$150 billion from its original US$85 billion stake. The new funds will be used to meet collateral calls from counterparties. In a separate move, the Federal Reserve also plans to invest US$70 billion to set up a separate Fed/AIG facility to buy up CDOs (collateralized debt obligations) from banks and others enabling AIG to unwind CDSs it has written and take them off the table.

In contrast, with the fate of ABCP still uncertain a cloud hangs occur Canadian securities market. “If the international banks do not sign the agreement, it will result in to an implosion of the ABCP restructuring plan,” says Toronto international finance lawyer Henry Juroviesky.

“And that will lead to an everyman-for-himself litigation environment.”