Open letter to Stephen Harper and Mark Carney for November 10 Summit

Why the Bank of Canada should buy-back ABCP now

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Thousands of employees are not getting the full value of their pension because of the asset back commercial paper (ABCP) crisis since August 2007. Some are wondering why. Others don't know how they will manage their way out of this crisis. But none could have imagined one moment that they could not get what they worked for all their life. And now, they have become hostages of a legal imbroglio caused partly by the federal government. This is why the Bank of Canada should buy back all this paper from pension funds that is illiquid so that the pension funds can afford to pay out pensions.

The Canadian government came to the rescue of banks through the purchase of mortgages ($ 25 billion) and a new Canadian Lenders Assurance Facility for interbank loans ($218 billion). The Bank of Canada opened wide its lending and "repo" facilities to provide all the liquidity required by banks, accredited dealers and money market funds. Ottawa is now looking into ways to help life insurance companies and corporations. But nothing yet is in sight for pension funds. Retired persons have been put aside. Over 100 pension funds in Canada invested their cash in ABCP with an estimated exposure of about $16 billion. Small to large size pension funds have been contaminated, including Domtar Pension Fund ($455 millions), university pension plans of Western Ontario ($30 millions), Alberta (over $40 millions) and B.C., the Co-operative Superannuation Society Pension Plan ($60 millions), Ontario Teachers Pension Plan ($60 million), Canada Post ($27 millions) and over 20 pension plans of provincial and federal employees managed by the Caisse de dépôt et placement du Québec ($12,600 million) and the Public Sector Pension Investment Board ($1,972 million). The worst hit are those pension plans under liquidation. Time has come to provide liquidity to the pension funds so they can pay their monthly benefits to retired employees. But part or all of their funding is now in the deep freeze since August 2008, when all buyers fled the commercial paper market.

Sort out solvency and liquidity

ABCP under consideration now totals $32 billion ($3 other billion are left aside), issued by non-banking institutions in Canada but distributed by many bank affiliates to pension funds. Those securities, issued before August 2007, are afflicted by two problems: one of solvency and one of liquidity. The solvency issue refers to the fact that 20 trusts were suddenly unable to meet margin calls from international banks that are counterparties to credit default swap contracts entered into by the trusts and also unable to repay their ABCP creditors when the paper came due. The liquidity issue stems from the fact that ABCP holders can not sell their paper on the market upon maturity, because the marked-to-market net asset value of the paper is below its face amount and there is much uncertainty prevailing among market players about when credit and credit derivative market conditions will improve.

The liquidity issue is by far the most critical one for pension funds. The Crawford Committee solution has prevented a forced and massive liquidation of assets and credit default swap contracts within the ABCP trusts that would have caused enormous prejudice to hundreds of thousands of participants across Canada because of a tremendous loss of value that massive asset and CDS liquidations would have inflicted. However, that solution is still not bringing any real cash on the table.

Two swords of Damocles

On one hand, two swords of Damocles are still hanging over the restructuring of the ABCP market, which has its closing delayed to November 30, 2008. First, ABCP holders are still vulnerable to a margin call if the rate spread is triggered during the nine year term of the new notes. Such prospect seemed highly unlikely a year ago when nobody could imagine how big the financial crisis would become. However, the probability is inching day-by-day towards reality with the three-layer crisis (liquidity, credit and economic).

Secondly, to make matters worse, Ottawa removed last November 2007 all credit derivatives from the list of staid instruments under the control of the court in cases of protection against creditors. By changing the Companies' Creditors Arrangement Act and Regulations (CCAA), Ottawa said in summary that credit derivatives should be overseen by securities regulators rather than dealt with by a piece of creditor protection legislation. Such removal allowed liquidity providers, the same banks who were insured by ABCP trusts, to walk out of the CCAA court after the expiry of their standstill agreements with the trusts and impose their own conditions on any settlement. The problem is that once these instruments were taken out of any court's jurisdiction, they should have been transferred immediately to the responsibility of the provincial securities commissions. But nothing was really done so that ABCP holders

A $22 billion Trigger

We often forget that the ABCP crisis of $32 billion involves total assets worth $231 billion, once corporate credits insured by credit default swaps of 20 ABCP trusts are accounted for. The banks that finally pulled the plug on the ABCP market in August 2007 were the ones to purchase those swaps. If those credits turn sour, the trusts will have to give up all the collateral against which the insurance premiums were paid through credit default swaps (CDS) by those same banks, that were supposed to provide liquidity. Quite an imbroglio! In other words, the ABCP owners cash invested served as a backstop for bank assets worth seven times more, thanks to the magic leverage of CDS's. Meanwhile the CDS's escaped all forms of regulation since their inception about ten years ago.

The Crawford Plan made public on March 17, 2008 and approved by the Ontario Superior Court of Justice on June 5, 2008, involves a court stay over the ABCP creditors and there is a standstill agreement between the international bank asset providers and the ABCP trusts under CCAA. Upon failure to renew the standstill agreement, the CDS bank counterparties could force a collection of part or all the $22 billion worth of collateral under their CDS contract terms. Under the current climate, a 10% loss of the $221 worth of insured credit would wipe out the associated collateral within the trusts. The compromised margin trigger under the Restructuring Plan is a maximum spread of 3.93% above the 3-month Libor rate in a CDS index for investment grade North American corporate debt . On March 4, 2008 when JP Morgan assessed the level of that spread, it stood at an already high 1,80%, or less than 50% of the threshold triggering a full recall. Since September, that spread sprang to 2,7% or close to 70% of the trigger. If the spread reaches the top, Deutsche Bank (who's owed two thirds of the total), Merrill Lynch, HSBC, UBS, CitiBank, CIBC, Royal Bank of Canada and the other international banks shown in Figure 1 could take over the full $22 billion. And most of the pension plans would be left with the eyes of their members to cry!

are now sitting between two chairs. The securities regulatory issues will only be handled by the provincial securities commissions and the Investment Industry Regulatory Organization of Canada over the coming months, way too late for a restructuring to happen under normal and equitable conditions. Without such exemption, no court would have treated ABCP holders as they were since March 2008. The Crawford agreement is imposed by banks on non-bank trusts and the ABCP owners! In short, the ABCP CCAA Restructuring Plan still remains uncertain hanging on the thread of a gentleman's agreement controlled by the banks.

On the other hand, the ABCP liquidity pressure prevents many pension fund managers from managing their portfolio under optimum conditions and meeting their full fiduciary responsibility. Indeed, even if they could sell the new restructured long term notes, the $22 billion out of $32 billion involved with synthetic assets through credit default swap contracts were worth only about 40% last March or less than $10 billion. The market-to-market situation is worse today. Even though the Canadian Accounting Standard Board relaxed the mark-to-market rule last Friday to allow for long term conditions to be considered in fair market value, pension funds have to manage their benefit payouts and asset mix decisions on the basis of current market valuations. But this accounting ostrich play won't revive the ABCP market by any means. If the restructuring of ABCP into longer term notes goes through, there will be only a single credit rating by DBRS, following the refusal of US rating agencies to add their stamp - although two were promised to holders. The new long term notes may be the illiquid for up to nine years. These face-lifted assets will cause the following problems for pension plans:

- Limited cash to meet other liquidity requirements (for example, call margins or because the Canadian dollar continues to drop);
- Heavy stress to rebalance their portfolio periodically in order to reflect their policy in light of violent market changes;
- Don't have enough liquid assets to take advantage of investment opportunities following major market falls.

In short, each of these situations could impair portfolio returns in a significant way not because of the market but merely because of portfolio constraints.

Moreover, a liquidity shortage could force some investors to sell assets at the wrong time, for instance following a sudden market drop, in order to meet some of their obligations. Pension plans that must undergo significant cash outflows to pay pension benefits are in this situation, especially those under pure liquidation with no more contribution to support treasury needs.

What the Bank of Canada could do

Under such a situation, we ask the Prime Minister and the Governor of the Bank of Canada to recognize the liquidity needs of other players in the Canadian capital markets, besides just the banks. The injection of $16 billion to unlock the ABCP market would make a significant contribution. But that should not impair the cash settlement made or in progress with retail holders owning $371 million of Non Bank ABCP according to the Canadian dealers' self-regulatory organization, IRROC." This is why central banks of so many countries have repurchased ABCP to liquify the market once again.

So why wouldn't the Bank of Canada do the same?

Such a measure would have three advantages for investors, especially pension funds:

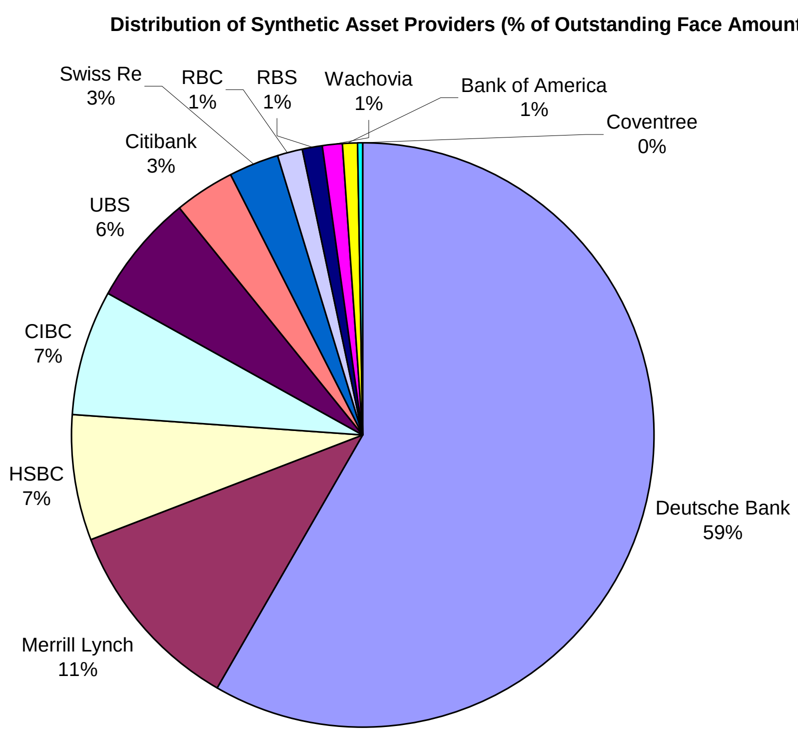
(1) optimize the management of their portfolio;
(2) inject precious new liquidity in the system; and
(3) reassure pension plan sponsors and beneficiaries and restore confidence in the pension portion of the financial system.

Governor Carney, no bank or securities regulator prevented Canadian bank affiliates from selling toxic APCP to pension plans. Yet, your bank came to the rescue of those intermediaries. Why couldn't this rule be applied equally to pension plans that became victims of this paper?

This would not cost much to the central bank, since this program should not relieve the pension funds from the ultimate credit risk. The bank would only guarantee the liquidity of those securities and would not absorb ultimate capital loss as it will have recourse to the current pension fund owners. . Such a decision could have a tremendous leverage effect to use a key word in finance (the effect of which caused so much of a nightmare!). There would be improved confidence of citizens towards their capital markets and retired victims will recover their rights to a full pension.

Figure 1: Distribution of Non Bank ABCP Synthetic Assets By Provider (% Face Amount)

Non Bank ABCP Synthetic Assets = Credit Default Swaps



Collateral Assets Face Amount - $22 Billion

Reference Credit Portfolios Face Amount - $221Billion

Source: JP Morgan Report on Restructuring March 14, 2008