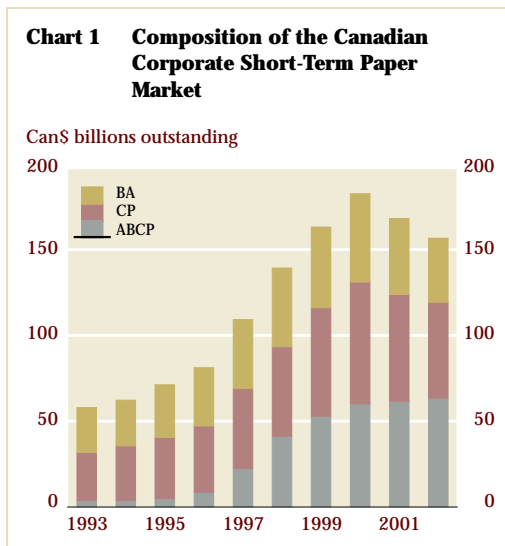


Developments and Issues in the Canadian Market for Asset-Backed Commercial Paper

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The market for asset-backed commercial paper (ABCP) in Canada has grown considerably over the past 6 years. It now accounts for about 40 per cent of the market for short-term corporate paper (Chart 1), and is the dominant form of asset-backed securities issued in Canada (Table 1). Asset-backed securities typically repackage large quantities of small, homogeneous assets into a “special purpose vehicle” (SPV) that issues highly rated securities. Typical assets include mortgages, credit card receivables, automobile loans and leases, and trade receivables.

The development of the ABCP market has been encouraged by complementary factors. Investors have been seeking to invest in highly rated short-term securities while, at the same time, the supply of government treasury bills has shrunk (Chouinard and Lalani 2001–2002, 19).

The big buyers of ABCP appear to be money market mutual funds, pension funds, corporations, governments, and financial institutions.¹ There is little foreign interest in the domestic ABCP market. The 10 per cent withholding tax levied on interest payments by Canadians to U.S. residents makes it uneconomical to sell securitized short-term corporate obligations, equipment leases, residential mortgages, and personal loans to U.S. investors.²

On the supply side, securitization provides firms with an alternative source of funding, potentially at lower cost than traditional sources. The alternatives include traditional commercial paper and bankers’ acceptances. Commercial

1. This buy-side information is based on informal surveys conducted by the authors among the Canadian banks active in the ABCP market.
2. There is some expectation within the market that the withholding tax will be lifted (Fingerhut 2003).

paper will usually be more expensive for all but the highest-rated firms, since the market demands a higher rate of return on instruments rated below typical ABCP. Bankers' acceptances effectively carry the guarantee of a top-rated bank and can be issued at rates that are competitive with those on ABCP, but after the bank "acceptance" charge is factored in, they would probably be more expensive.

Another important supply-side factor has been the capital taxes levied on corporations by the federal and provincial governments. Such taxes are paid regardless of whether the corporation is profitable, and differ from province to province, recently ranging from 0.225 per cent to 0.865 per cent of capital. For purposes of this tax, "capital" includes, among other things, capital stock, retained earnings, and liabilities.³ Hence, tax savings could result from paying down liabilities with the proceeds of securitizations. However, both the federal and some of the provincial governments have recently announced that they will be reducing these taxes in steps, so that by 2008 they should be completely eliminated.

The major banks account for the issuance of about 90 per cent of outstanding ABCP, with three of them accounting for over 75 per cent. In addition, some banks have been quite active in the U.S. ABCP market.⁴

Most ABCP issuance takes the form of a multi-seller structure, in which the sponsor, usually one of the major banks, seeks to provide financing to a diverse group of clients. Multi-seller ABCP provides funding on an anonymous basis, which could be important for some who might otherwise issue traditional commercial paper or bankers' acceptances.⁵ In contrast, in

Table 1
Outstanding Domestic Asset-Backed Securities^a
\$ billions

| | Asset-backed commercial paper | | Single-seller term | Total |
|------------------------------|-------------------------------|----------------------------|--------------------|---------------|
| | Multi-seller ^b | Single-seller ^c | | |
| Bank of Montreal | 19.476 | - | 3.587 | 23.063 |
| CIBC | 11.356 | 3.465 | 4.205 | 19.026 |
| TD Bank | 9.713 | 4.820 | 2.468 | 17.002 |
| Scotiabank | 2.681 | 0.534 | 5.561 | 8.776 |
| Royal Bank | 5.486 | 0.086 | 2.992 | 8.545 |
| Merrill Lynch | - | - | 3.709 | 3.709 |
| Coventree Capital Group Inc. | 3.342 | - | - | 3.342 |
| National Bank of Canada | - | 0.919 | 1.415 | 2.334 |
| Other | 1.862 | 0.058 | 0.488 | 2.408 |
| Total | 53.897 | 9.881 | 24.426 | 88.204 |

a. National Housing Act mortgage-backed securities (NHA-MBS) transactions are not included in the tabulation.

b. The multi-seller ABCP breakdown by institution is based on who sponsors the issuance.

c. The single-seller breakdowns are based on which institution provided lead structuring services.

Source: Dominion Bond Rating Service. Data as of 31 December 2002.

3. For more detail on capital tax calculations, see McQuillan and Cochrane (1996).
4. According to Standard & Poor's, at year-end 2002, four Canadian banks were involved in US\$31.5 billion of U.S.-based multi-seller ABCP issuance. One bank is also involved in four European structured-investment vehicles (SIVs) with an outstanding value of US\$3.7 billion at the end of September 2002. An SIV is an asset-backed structure that buys high-quality medium- to long-term fixed-income assets and funds them with commercial paper.
5. Anonymity could be important to a borrower for whom the signal effects of a more visible funding operation might reduce its access to other funding sources.

single-seller ABCP issuance, the sponsor is securitizing its own assets. Although most single-seller issuance programs are operated by one of the major banks, several retailers and automobile companies issue ABCP directly.

The Mechanics of Credit-Risk Reduction

Ninety-five per cent of Canadian ABCP carries an R-1 (high) credit rating from the Dominion Bond Rating Service (DBRS). Few securitized assets would receive such a strong rating on a stand-alone basis.

To achieve this rating, the credit risk of the ABCP is reduced by way of various structural and third-party enhancements. The structural enhancements include transferring into the SPV assets with a greater aggregate value than the value of the ABCP issued (“overcollateralization”). Another popular enhancement is the issuance by the SPV of lower-rated securities that absorb the first defaults (“subordination”).⁶

Third-party credit enhancements typically take the form of letters of credit and surety bonds from highly rated financial institutions. The legal documentation for most ABCP specifies minimum ratings for such enhancers (usually AA (low) or R-1 (mid) by the DBRS), but the names of the enhancement providers are not always made known. In fact, in a typical multi-seller issuance program, the sponsor itself could be one of the credit enhancers.⁷

In addition to these concrete enhancements, “implicit recourse” to the originator of the loan may play a role in mitigating credit risk. Examples of implicit recourse include repurchasing assets from the SPV at an amount greater than fair value, as well as exchanging performing assets for non-performing assets. Implicit recourse is a form of moral or reputational risk mitiga-

tion. For example, should the originator’s reputation be tarnished by a poorly performing securitization, its ability to securitize cost-effectively in the future could be compromised. The originator therefore has an incentive to provide additional support. However, regulators look unfavourably on banks that provide such support to the issuance programs that they manage. For example, the most recent consultation paper on the Basel Capital Accord (BIS 2003) proposes severe regulatory penalties for banks that provide such non-contractual support.

Reduction of Rollover Risk⁸

Because the assets are typically of longer maturity than the ABCP financing them, some sort of liquidity buffer is required to protect against rollover risk and timing mismatches. Hence, ABCP issuance programs purchase liquidity protection. At a minimum, such protection must safeguard against what the Office of the Superintendent of Financial Institutions (OSFI) calls a “general market disruption,” which is defined by market participants as a situation in which “not a single dollar of corporate or asset-backed commercial paper can be placed in the market—at any price.”⁹

A general market disruption is a highly unlikely event, and Canadian liquidity facilities, which do not cover anything beyond this minimum criterion, have never been triggered. According to OSFI (1994), a bank providing liquidity protection that embeds protection against other risks, like credit risk, would incur regulatory capital charges that, when passed on to the issuance program, could make the ABCP less economical.

U.S. regulatory charges have, however, been lighter on liquidity facilities that offer some degree of credit protection. Hence, liquidity enhancement for U.S. ABCP programs typically covers more than just general market

6. See the article by Kiff in this *Review* (p. 33) for a more generic discussion of securitization and other methods of transferring credit risk.
7. Such “self insurance” helps to align the interests of the issuance-program sponsor (and originator in the case of some single-seller ABCP) and the ABCP holders. See Kiff, Michaud, and Mitchell (2003) for a more detailed discussion of incentive-alignment issues in securitization.

8. Important contributions to the discussion of rollover risk were made by Andrew Kriegler, Huston Loke, and Maria Rabiasz.
9. OSFI (1994) provides details on the Canadian regulatory rules that apply to bank securitization activity but does not explicitly define the term general market disruption. Kriegler et al. (2002) provide the market’s generally accepted interpretation given here.

disruptions, offering some elements of protection against credit risk.¹⁰

In fact, a couple of U.S. rating agencies have questioned the adequacy of Canadian-style liquidity enhancement. Their position is that if the rollover protection is not at least somewhat specific to the issuance program, then “timely payment”—an essential element of a top-tier rating by their standards—is not guaranteed. A recent report by Standard & Poor’s points to circumstances when, even in the absence of a general market disruption, liquidity problems could arise although there was no substantive deterioration in the quality of the ABCP program’s underlying assets. These circumstances include rumours and reputational concerns regarding the program sponsor, as well as temporary program-specific operational problems (Rabiasz and Connell 2002). Moody’s has drawn a parallel with the partial market disruption that occurred in the United States following the 11 September 2001 attacks on New York City, noting that Canadian liquidity lines are currently so restrictive that they could not be invoked, even if such a clearly non-credit event caused the liquidity crisis (Kriegler et al. 2002). Because these types of events are not covered by Canadian-style liquidity enhancements, it becomes difficult for Standard & Poor’s and Moody’s to give even investment-grade ratings to Canadian ABCP.

However, the DBRS argues that Canadian ABCP is already fully protected against timing mismatches and credit-deterioration problems, via the program’s credit enhancements and operational practices. Hence, they say that it would be redundant to add U.S.-style supplemental credit-risk protection to the liquidity facility, and they give most Canadian ABCP their highest rating, R-1 (high). In a recent discussion paper, Moody’s has also proposed that the quality of the underlying structure be taken into consideration when determining liquidity-enhancement requirements for top-tier ratings.¹¹

Moody’s suggests that while it is possible for liquidity enhancement to be completely separated from credit enhancement, doing so effectively requires a costly assessment of the stand-alone credit quality of the ABCP program.

As an alternative that does not require liquidity enhancement, some ABCP issuance programs offer “extendible commercial paper” (ECP), which gives the program sponsor the option of extending the term of an issue up to a cumulative maximum of 365 days. The extendibility feature replaces the liquidity facility, essentially passing the liquidity risk, and the compensation for bearing this risk, on to the investor. ECP accounted for about 5 per cent of the Canadian ABCP market at the end of 2002.

Legal Risks Associated with the Securitization Process

The legal structures that support ABCP programs are complex compared with those for conventional debt securities, and there is little standardization of the legal documents that make up their structures. The situation in which ABCP is most likely to be subject to a legal challenge is one where the originator becomes insolvent and its creditors seek to bring the securitized assets back into the estate of the originator to satisfy the claims of the creditors.

The key legal risk is the risk that the transfer of assets into the SPV may be found not to constitute a “true sale,” thereby leaving the securitized assets within the estate of the originator. The legal documentation supporting an ABCP program must be carefully crafted to produce a legal sale of the assets rather than a loan. Although there have been few court challenges of asset securitization in Canada, the recent decision of the Ontario Superior Court of Justice in *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.*¹² demonstrates the strict tests that the courts will apply in determining whether an asset securitization is a true sale. In this case, the Court looked beyond the wording of the contract that created the asset transfer (which clearly showed an intention to create a sale) to examine the conduct of the parties, as well as traditional indications of true sales, including transfer of ownership risk to the purchaser; which party has the right to any

10. Proposed changes to the Basel Capital Accord (BIS 2003) would require the credit risk embedded in U.S.-style liquidity enhancements to be reflected in capital charges. However, implementation of the new Accord is not expected until year-end 2006. These changes are not expected to affect OSFI’s treatment of Canadian liquidity facilities.

11. See Adams (2001) for the DBRS viewpoint and Kriegler et al. (2002) for that of Moody’s.

12. [2003] O.J. No. 128

surplus arising from the collection of the receivables; whether the assets are clearly identified; whether there is an identifiable purchase price for the assets; and which party is responsible for collecting the receivables on whose behalf. In this case, however, a true sale was deemed to have taken place.

While the need to structure the ABCP program as a true sale is the most important legal risk associated with ABCP, there are other significant legal risks. These include the risk that the SPV may not be properly structured as a legal entity separate from the originator, thus failing to make it “bankruptcy remote;” the risk that the transfer of assets to the SPV may be set aside as a fraudulent preference and, in the case of mortgage-backed securities, the risk that the rights of the holders of the commercial paper could be subordinate to the claims of creditors who have registered assignments of the mortgages on title.

The only way that the legal risks associated with ABCP can be controlled is by careful crafting of the legal structure for each securitization program. Security holders can take some comfort from the fact that an issue that has obtained a minimum rating of R-1 (high) from DBRS has likely undergone some due-diligence examination of the underlying structure. In this context, holders decide whether a high credit rating from one rating agency is sufficient comfort as to the underlying legal structure of an issue or whether further examination of the structure is needed.

Disclosure Issues

The fact that securitization is a complicated process involving many participants would seem to argue for a high degree of disclosure. But the market is relatively opaque.

Transaction Details Are Hard to Come By

The rating-policy decisions taken by Standard & Poor’s and Moody’s mean that the sole source of details regarding securitization transactions in the ABCP market is the DBRS. Like all commercial paper, ABCP is exempt from the prospectus and other disclosure requirements of Canadian securities law. As a result, no documents pertaining to most of the big multi-seller

issuance programs can be found on SEDAR (the System for Electronic Document Analysis and Retrieval).¹³ Thus, an investor who wants a “second opinion” is currently constrained, although some relevant details may be available directly from the sponsor or underwriter of the issuance program. Furthermore, what little detail is publicly available is often silent on which banks are providing credit and liquidity enhancements and on the composition of the asset pool.

Although the rating agencies publish some of this information, many details are held back because of confidentiality policies. The DBRS has expressed concern in this regard:

Much more detailed information on pools and sellers, and better statistics on asset quality and enhancement levels are needed. DBRS already publishes some information on each pool monthly, but much more information is available (Schroeder and Loke 1998, 10).

Nevertheless, in the case of multi-seller programs, increased disclosure regarding the asset pool would have to be mindful of the desire for originator anonymity. There are, however, no obvious reasons why information about credit and liquidity enhancement should not be made available.

Unclear Degree of Real Risk Transference

Real and effective transfer of risk is one of the premises upon which securitization is based. From the little information available on individual issuance programs, however, it appears that the originating institutions can choose to retain a fair degree of exposure to the assets they are securitizing. For example, in the case of some Canadian multi-seller issuance programs, some banks may have credit-risk exposures to the assets in the SPV. It would be useful if more information on such matters was disclosed.

Improvements may be on the way, thanks to moves by the Canadian Accounting Standards

13. SEDAR is managed by CDS INC., a subsidiary of The Canadian Depository for Securities Ltd. (CDS). All Canadian public companies and mutual funds must file on SEDAR all documents required by the various bodies that regulate securities markets.

Board of the Canadian Institute of Chartered Accountants and the U.S. Financial Accounting Standards Board (FASB) to improve disclosure standards for all securitization activity. These new standards may also require banks to include in their balance sheets some of the assets in the multi-seller ABCP issuance programs that they sponsor. The question of how much exposure is to be brought onto their balance sheets (i.e., consolidated) may depend in part upon the amount of credit-risk protection embedded in any liquidity enhancements provided by the sponsoring bank. It seems likely that some Canadian banks will have to consolidate the exposure that pertains to their U.S.-based programs, where liquidity protection sometimes goes beyond general market disruption. The degree of consolidation required for their Canadian-based programs is less clear, given the more restrictive nature of the liquidity enhancements.¹⁴

In addition, “Pillar 3” of the new Basel Accord will require increased disclosure of credit-risk transfer in general, although implementation is not expected to take place until the end of 2006.

Summary

The Canadian market for ABCP has grown from near zero in 1985 to \$63.7 billion at the end of 2002, and most ABCP carries a top-tier credit rating. The market has played an important role in providing low-cost corporate funding and in filling the gaps in the high-quality, short-term paper market left by the shrinking issuance of government treasury bills.

Although ABCP poses potential legal and liquidity risks that are inherent in the securitization process, the Canadian investment community seems comfortable with them. On the other hand, current disclosure of transaction details leaves much to be desired, and information that reveals the extent to which risk has actually been transferred by the originator and where it has actually gone is lacking. This last concern is being addressed by recent initiatives introduced by accounting and regulatory authorities.

14. See Mountain (2003) for more on the FASB guidelines and Parfeniuk and Azarchs (2003) for speculation regarding the potential impact on the balance sheets of Canadian banks.

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