31 March 2008

Proposed Criteria for Accepting ABCP as Collateral for the Bank of Canada's Standing Liquidity Facility: Summary of Comments Received

In response to its request for comments on the proposed criteria for accepting ABCP as collateral for the Standing Liquidity Facility (SLF), the Bank of Canada received written comments from 11 respondents. Overall, participants supported the initiative and were open to increasing the transparency of ABCP. Three key issues were raised: (i) exposure to securitized assets; (ii) close links between the pledgor and an ABCP program; and (iii) transparency requirements.

Securitized Assets

The comments indicated a concern regarding the Bank's exclusion of ABCP programs with exposure to securitized assets. Several respondents were of the view that the Bank should be concerned only with CDOs and other highly structured securitized assets. Some indicated that it is common practice for conduits to hold notes issued by other structures, including those from other conduits that they sponsor, as well as from conduits sponsored by other entities. It was suggested that excluding all assets that were securitized prior to acquisition by the ABCP conduit would exclude from eligibility a significant proportion of the outstanding ABCP. Only two respondents stated their support for modifying the criteria to include the acceptance of ABCP programs with a small percentage of securitized assets (subject to a higher margin requirement).

The Bank has adopted the definition of securitized assets as all assets that have been securitized prior to being added to an ABCP program, not just highly structured securitized assets such as CDOs. The Bank recognizes that the restriction on securitized assets would limit the subset of ABCP eligible as collateral. However, the lack of standardization in reporting as to the nature of securitized assets and degree of securitization in ABCP programs does not presently meet the transparency objectives of the Bank. Based on the additional risks and complexities inherent in securitized assets and on the desire to be efficient with respect to the operational resources required for due diligence, the Bank, at this point, is not prepared to accept ABCP programs with any actual or potential exposure to assets that have been securitized prior to being acquired by the ABCP program. In the event that the market for ABCP evolves to include more standardization and clarity in reporting, the Bank would reconsider this criteria.

Close Links

Several comments were received regarding proposed restrictions on close links between the pledgor and the ABCP program. One respondent expressed support for this condition. However, three respondents indicated that because of current market practices, this condition would result in very little ABCP being pledged as collateral for the SLF and would not increase the trading of ABCP in secondary markets. Bank sponsors in Canada hold only their own ABCP, and investors tend to follow a buy and hold strategy with respect to ABCP. Two respondents suggested that the close links restriction might prompt participants in the Large Value Transfer System (LVTS) to enter into bilateral arrangements to hold one another's paper for the purpose of pledging ABCP as collateral. Finally, two respondents proposed that the risks imposed by close links between the pledgor and the ABCP program could be adequately addressed through higher margin requirements.

In its 5 March document, the Bank stated that the presence of close links adds additional risks that are difficult to quantify, and thereby difficult to address sufficiently through margin requirements. In accepting ABCP as collateral, the Bank is pursuing its objective of facilitating the development of a well-functioning market by encouraging an active secondary market for these securities.

Transparency Requirements

Many helpful comments were received regarding transparency requirements, including suggestions for clearer terminology and for additional information that would be relevant for investors - for example, the average remaining term of program assets; the number of sellers and obligors for an asset pool; and asset performance triggers and consequences. The Bank has amended its eligibility criteria in light of these suggestions. A few respondents asked for clarification on the timeliness of disclosure following significant changes to relevant investment information. The Bank of Canada would expect that information that would have a significant impact on investors be disclosed as soon as possible so that optimal investment decisions could be made. Several comments were made regarding the means of providing relevant information to investors, and the range of opinions varied. While one respondent felt that no new disclosure documents should be required, i.e., the information memorandum would be sufficient; some felt that relevant investment information should be disclosed through other means. It was also suggested that non-investors be able to access this information in order to assess collateral-related risks to the LVTS. Finally, the issue was raised as to whether to publish a list of ABCP programs that met the Bank's criteria. Some indicated that this would be useful, while another respondent expressed concern regarding the potential for investors to rely on the Bank of Canada's assessment rather than performing their own due diligence. The Bank does not plan to publish a list of ABCP programs that are eligible as SLF collateral.

Other Issues

Two contrasting comments were made regarding concentration limits for ABCP. One respondent felt that limits far greater than 20 per cent should be applied by the Bank, given the quality of ABCP as collateral. Another respondent suggested that, in addition to concentration limits based on sponsoring institutions, limits might also be applied on the basis of asset class and the type of program. The Bank is applying a 20 per cent concentration limit to ABCP on the basis of the program sponsor, and this is consistent with the Bank's current policy for accepting other private sector securities as SLF collateral. The Bank will be monitoring ABCP that is pledged in order to assess the appropriateness of the concentration limit.

A number of comments focused on credit ratings. First, the point was made that requiring two credit ratings would impose significant costs on ABCP programs. The Bank recognizes this fact, but feels that complexities inherent in ABCP warrant more than one assessment of credit risk in order to mitigate any risks to the Bank that might be associated with accepting ABCP securities as collateral for the SLF. In addition, comments received from credit-rating agencies stressed that their ratings are based on different ratings scales, both in terms of ratings for sponsoring institutions and for ABCP programs. The Bank's 31 March notice clarifies its credit-rating criteria.