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August 1, 2002

Leap of Faith: Canadian Asset-Backed Commercial Paper Often Lacks Liquidity Backup

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Since 1993, outstanding commercial paper (CP) issued by asset-backed conduits in the Canadian market has grown from just under C$4 billion to the current level of C$57.5 billion. The reason for this growth reflects positive supply and demand considerations. For companies originating the assets, asset-backed commercial paper (ABCP) can provide economical and convenient financing, while providing an additional source of funding. For investors, ABCP helps satiate the large appetite for short-term money-market investments. In addition, the sponsorship of conduits also has been an attractive business line for the major Canadian banks active in this sector.

A peculiar feature of the Canadian ABCP market is that the conduit structures do not typically incorporate widely available backup liquidity facilities. This approach might currently reduce the costs borne by the conduit sponsors or issuers by allowing them to provide a very limited form of liquidity. Nevertheless, it remains for investors to understand this risk, and to satisfy themselves that there is a sufficient risk premium built into conduit CP yields.

The purpose of this commentary is to provide some elaboration on the nature of liquidity facilities for ABCP in Canada, and to offer some views on how this market could evolve in light of investor risk tolerances, bank capital regulations, and other influences.

The Allocation of Liquidity Risk

In assigning ratings to any CP issue, the preeminent analytical concern for Standard & Poor's Ratings Services is timely repayment of the obligation in full as uniquely specified in the terms of that issue. ABCP conduits finance assets that can range in maturity from days to decades. Given the CP issued by the conduits typically matures within 30 to 90 days, it is usual to continuously reissue CP over the life of the assets or program being financed. If there is any difficulty reissuing (or "rolling over") CP, liquidity lines play a key role by providing interim financing until CP can again be issued, or until the receivables in the conduit mature or can be liquidated.

ABCP liquidity facilities should cover temporary timing mismatches with respect to the receipt of cash flows from the underlying pool of assets and the ensuing contractual payment to the ABCP holders. Liquidity lines need not be expected to, and are not typically structured to deal with any and all underlying credit difficulties. Rather, fundamental credit quality is primarily sustained by pool-level and program-wide enhancements built into a conduit. This credit enhancement can take a number of forms, such as overcollateralization of additional receivables, a letter of credit, an insurance policy, a cash reserve, or a loan agreement, to name a few. Although in other markets there are some instances in which bank lines might be configured to deal with both credit and liquidity risks, it is conventional to use liquidity facilities to deal with liquidity risks, and to use other sources of adequately sized credit enhancement to absorb credit risks.

Without liquidity lines, there are other imaginable ways that a conduit could try to manage through a refinancing problem, such as asset sales, the sale of CP to another conduit managed by the same bank, or reliance on general support from the sponsoring bank. Each of these avenues requires a leap of faith that liquidity relief will actually be available, which is insufficient as a primary response to liquidity risk for a conduit to achieve an investment-grade

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CP rating.

Why This Liquidity Approach Has Taken Root in Canada

The Canadian market is unique in its acceptance of ABCP conduits with extremely limited-use liquidity support. Why has this situation evolved? The arrangement was initially implemented in 1994 as the sponsoring banks interpreted then-issued regulation B-5 of the Office of the Superintendent of Financial Institutions (OSFI). Since then, the practice has become institutionalized among market participants.

OSFI's concern is with ensuring banking system stability, and the capital adequacy of individual banks. To the extent a bank takes credit risk through the provision of a lending facility, OSFI requires the bank to hold capital against that exposure. In B-5, OSFI makes an exception for liquidity lines to ABCP special-purpose entities. OSFI allows zero-capital treatment for a liquidity line if it is cancelable or reducible and only available in circumstances of widespread market disruption.

The established interpretation of this, built into conduit liquidity agreements, is that for the credit line to be drawn, no CP can be issued at any price by any issuer within the Canadian market. This condition for a liquidity line advance is narrow to the point of being almost meaningless. More importantly, such a facility provides no benefit at all against the range of circumstances that a conduit needs to manage liquidity pressures, even assuming the conduit's credit fundamentals remain intact. These circumstances may include: reputational issues, event risk, credit concerns relating to the conduit administrator or enhancement providers, operational setbacks (for example, labor strikes, terrorist attacks, or product line contamination), adverse litigation, rumors, management impropriety, and the loss of market confidence in financial statement presentation, or operational disruption with the management or administration of a conduit. Given the material potential for a conduit to require liquidity in the absence of substantive credit deterioration, in the view of Standard & Poor's, a conduit with a Canadian-style liquidity facility would be rated no differently from a conduit with no contractual liquidity facility at all that is reliant on the noncontractual "moral obligation" of the program administrator.

In many Canadian conduits, the deficiency of the liquidity facilities is compounded by the incorporation of a ratings affirmation test (or "ratings trigger") as a condition precedent for drawing a liquidity facility.

Far from providing a sound mechanism to separate credit and liquidity risk, ratings affirmation tests have highly problematic implications, not only for issuers and investors, but even for ratings services. Some of the questions that could be raised by ratings affirmation tests include the following:

- Will a CreditWatch placement or marginal ratings action inevitably precipitate a more radical change in the ratings?
- Can a ratings service actually commit to a real-time ratings affirmation without any assurances that adequate information will be available when required?
- How should a ratings service take into account the likely actions of other ratings services on whom the liquidity draw also might depend?
- How much performance variability should the ratings service allow before changing the ratings on a conduit or program, and is this tolerance threshold understood clearly by the conduit sponsor and investors?

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Ratings Triggers

Even if the liquidity facilities were themselves satisfactory, a ratings trigger similar to the ones in use by some programs would likely be incompatible with an investment-grade rating. If a limited rating adjustment arising from conduit performance issues would lead to the cancellation of liquidity facilities, despite continuing asset performance commensurate with an investment-grade rating, the consequent withdrawal of liquidity facilities would require a further reduction of the rating, likely impairing any future refinancing. In the presence of such a ratings trigger, incremental changes in fundamental credit quality of necessity lead to precipitous changes in ratings because of the credit cliff dynamic. Although such a ratings trigger can help a bank avoid capital charges, a trigger is highly detrimental to the investors' interests. In recent months, Standard & Poor's has been making efforts to identify and defuse ratings triggers given the potential operation of such triggers to the detriment of stable credit conditions.

ABCP liquidity arrangements should be available to fund nondefaulted receivables, thereby providing reassurance that the lines are there for liquidity and not credit protection. Such definitions of nondefaulted receivables and the availability of the liquidity lines to support them should all be clearly prespecified and documented in relation to the performance of the assets themselves at the time of initial structuring. Relying on such documentation, the approach of other regulatory systems is that the separation of credit and liquidity can be clearly defined, but that if a liquidity provider has made an irrevocable commitment to provide funding--even for 'AAA' rated assets--then there is a capital exposure (albeit small on a risk-adjusted basis).

Interestingly, the overall effect of B-5 may be to exacerbate, not limit, bank-system exposure to credit problems. Were a conduit able to rely on timely liquidity as funding support, this could preempt a conduit-specific default, and avoid market confidence contagion to other conduits managed by the same sponsors, or to conduits in general. Nevertheless, given conventional Canadian liquidity support limitations, the liquidity might not be available, and a conduit facing operational difficulties or incremental performance deterioration could face a ratings downgrade. This, in turn, could lead to an outright default because the unavailability of liquidity facilities coincidental with faltering market confidence would cause the conduit to be unable to roll over maturing ABCP.

Some investors might have the impression that bank sponsorship of ABCP conduits implies bank credit support. In the absence of a specific and formal sponsor role in conduit credit enhancement, bank exposure to these conduits is limited to the terms of the liquidity agreement, and any assumption of broader recourse would run afoul of OSFI's capital adequacy regulations and incur a possibly punitive regulatory response. Realizing it or not, Canadian investors effectively hold extendible paper.

The global CP markets, because of a growing recognition by investors of the importance of liquidity and the heightened risk of credit quality deterioration, are highly confidence sensitive. Given the size and importance of the ABCP market in Canada, any developments to add stability and transparency should be welcomed by all participants.

The Way Forward

Given certain dynamic aspects of the Canadian money market, investors' attitude toward liquidity will surely continue to evolve in the near term.

A growing proportion of Canadian investors understand the liquidity risks assumed with much of the available

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conduit CP issuance. Some have responded by omitting ABCP from approved lists, and others invest with the view that liquidity risk is sufficiently compensated. Given ABCP's substantial share of the Canadian money market, and the limited degree of differentiation among conduits, some investors find it difficult to bypass ABCP exposure altogether. Heightened investor concern over liquidity, coupled with a general desire for expanded scrutiny of conduit performance and disclosure, will likely lead to a broader range of choices for investors in terms of conduit structures and relative soundness.

Currently, OSFI's capital charge treatment of liquidity lines is "all or nothing." If liquidity lines meet the stringent general market disruption condition, there is no capital charge. Any apparent credit exposure entails a full capital charge (100% of the standard reserve requirement). Under the proposed New Basel Capital Accord, pure liquidity lines may be eligible for 20% risk weighting of the standard reserve requirement. In conjunction with this, OSFI may recognize that a broader test for pure liquidity would not counteract their policy objectives. The application of a more lenient capital charge could allow sponsors to incorporate meaningful liquidity into the conduit structures, with the favorable investor response more than offsetting the negative economic impact of a marginal regulatory capital charge. Anticipating the new Basel Accord, U.S. regulators are apparently moving ahead with plans to make banks hold commensurate capital in reserve against the liquidity lines they provide to CP conduits.

It has been asserted elsewhere that a virtue of the Canadian liquidity convention is that it necessitates a thorough review of underlying asset quality as well as pool- and program-level enhancement. Conversely, the argument goes, liquidity lines designed to actually provide meaningful liquidity must lead to an offsetting reduction in focus on asset quality. This is a somewhat misguided argument in that the enhancement of asset quality even to the 'AAA' level does nothing to address the basic need for liquidity for refinancing purposes, it strictly addresses underlying credit risk. Unless bank facilities are specifically designed also to provide credit enhancement, an appropriately devised liquidity mechanism does not displace the need for a thorough analysis of conduit structure and asset quality. Using this logic as a basis to view Canadian liquidity structures as a "preferred alternative" is unpersuasive. Investors should settle for nothing less than appropriate asset/program enhancement, and adequate liquidity to cover adverse refinancing scenarios.

Although efforts have been made by Standard & Poor's and others to reconcile Canadian liquidity structures with globally recognized standards, the unique nature of entrenched liquidity conventions in Canada is, for the time being, a fundamental obstacle to increased ratings coverage of the Canadian ABCP sector. Extension of ratings coverage for Canadian conduits is likely to depend on some combination of OSFI policy easing or clarification, definitional changes to the maturity terms of ABCP notes, and the crystallization of investor insistence on meaningful mitigation of liquidity risk.

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