



BETWEEN THE LINES

Bad paper

Someone committed a \$7-billion Canadian-made goof. But is there anyone who will take responsibility for it?

by **Al Rosen**



I hope you've been watching the fallout from the latest Canadian-made financial fiasco. Since mid-August, the market for non-bank asset-backed commercial paper (ABCP) has been frozen, meaning holders of the investments can't get their money out. The Canadian non-bank ABCP market has been estimated at a total of \$34 billion, and some major public companies are large holders of the illiquid paper. National Bank of Canada has roughly \$2 billion, Nav Canada has \$368 million, Transat has \$155 mil-

lion, and the list goes on. For the time being, enough major players have agreed to stand pat while a national restructuring effort is underway. Nevertheless, those companies now face taking some significant writedowns. A return to liquidity simply will not restore full value to the investments.

ABCP was previously thought to be a highly liquid cash investment that offered a few basis points of interest more than alternatives such as banker's acceptances. Few holders of the paper, however, understood the significant risk that

accompanied the marginally higher investment return.

ABCP is short-term paper issued to fund investments in longer-term assets such as car loans, mortgages and various types of credit receivables. As it turns out, many were also highly invested in credit default swaps providing excessive leverage and risk. For investors to be paid out on their ABCP holdings, new ABCP must be issued (called a rollover).

Back to my point, it should be noted that the Canadian and U.S. markets have some notable differences. While apparently not much of the Canadian paper had direct exposure to sub-prime U.S. assets (which have been defaulting in record numbers), the opacity of the ABCP caused investors to balk. Basically, no new investors could be found to roll over the paper to fund the longer-term assets. At that point, the safety net should have kicked in, and Canadian and international banks should have provided the funds to keep the process rolling, as many Canadian investors assumed they had agreed to.

Instead, the banks took a page from the insurance industry, similar to when you pay premiums for years, and your insurer screws you over when disaster finally hits. The banks, despite collecting the fees when times were good for providing the liquidity backstops (necessary for good credit ratings on the ABCP), basically told investors to suck it up. But only in Canada, that is.

In Canada, the backstop agreements contained an out for the banks, unlike in the U.S. and internationally. They only had to provide the liquidity in the event of a general market disruption, which they collectively decided had not occurred. Adding insult to injury, some of the Canadian banks that refused to provide the liquidity were the same banks that had sold the ABCP to their customers.

Which brings us to today. It's

three months into the process, and many holders of the ABCP have no idea what it's worth. Canadian Pacific Railway recently wrote down the value of its ABCP by nearly 15%, Sherritt by 10% and Cameco by 15%. Other holders, such as HSBC Bank Canada, have taken "immaterial" writedowns on their ABCP holdings. Of course, HSBC is being sued by at least one company that says the bank misled it about the nature of the investments, so you might regard the bank's estimated impact as somewhat tainted.

I happen to think 20% is a reasonable discount to apply in valuing the ABCP today, given the dearth of transparency, the proposed restructuring makeup, and the liquidity needs of some current holders. Applying that to the \$34 billion total means that someone is

Unlike in the United States, Canadian banks basically told burned investors to suck it up

responsible for a \$7-billion Canadian-made goof.

So far, DBRS (which provided the top-tier credit ratings on the failed paper) has escaped unscathed. And the regulator of Canadian banks, the Office of the Superintendent of Financial Institutions of Canada, has blamed foreign banks for the freeze-up. My bet is that nobody ever takes the fall for this one, and we continue to pretend nothing is wrong with investor protection in Canada. What's another \$7 billion anyhow?

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