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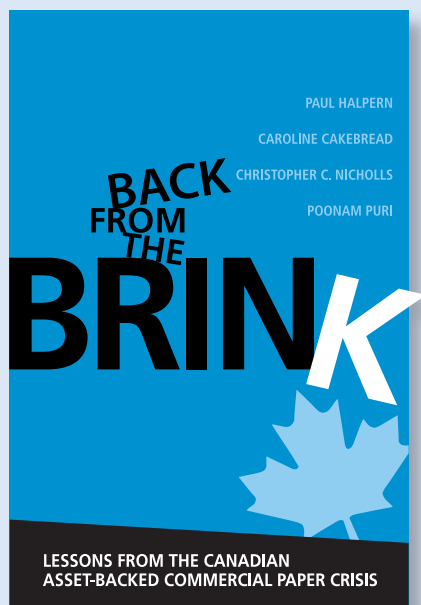
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DOES YOUR COMPANY
HAVE A SUCCESSION PLAN?



THE ART OF THE POSSIBLE

Victoria Barclay, CFA

Back From the Brink: Lessons From the Canadian Asset-backed Commercial Paper Crisis

by Paul Halpern, Caroline Cakebread, Christopher C. Nicholls, and Poonam Puri

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Trying to deal in asset-backed commercial paper (ABCP) during the financial crisis was like trying to fry an egg in a hurricane. Nothing would stay level long enough to cook, and there was a sense that, at any moment, everything could blow up. Now imagine trying to fry 18 eggs in the middle of a hurricane, and you'll get some idea of the challenges faced during Canada's third-party ABCP crisis.

Back From the Brink by Paul Halpern, Caroline Cakebread, Christopher C. Nicholls, and Poonam Puri attempts to give context to, and extract meaning from, those troubled times. The book is compact, ambitious, and clearly written.

In late 2006, the first rumblings of the subprime mortgage crisis were heard in the U.S. markets. In July 2007, Coventree, a leading seller of Canadian third-party ABCP, released a letter intended to reassure its dealers—but it had the opposite effect when some dealers forwarded it to clients. Coventree had an overall exposure to subprime of approximately four percent across all conduits; investors began to panic. Early in August 2007, giant Quebec pension fund the Caisse de dépôt et placement du Québec (the Caisse) decided to reduce its ABCP exposure. The spread between bank and third-party ABCP began to widen.

On August 13, 2007, the National Bank's CEO called Deutsche Bank to request liquidity lines for ABCP, but was denied. "The soft landing had failed," the authors write. At that dreadful point, the CEO "knew the ABCP market would collapse."

Thus began the ABCP crisis in Canada. After many phone calls, the Caisse and others discovered the problem was Canada-wide. (*Back From the Brink* provides a table of the conduits, sponsors, and the amounts eventually determined.) Two days later, the \$32-billion third-party ABCP market was at a standstill. Negotiators asked for a moratorium on liquidity and collateral calls until October 15, 2007, in an attempt to stave off huge losses in a forced liquidation. Ten of the biggest buyers and sellers of ABCP signed this moratorium agreement, known as the Montreal Accord.

Liquidity providers Deutsche Bank and Barclays refused to honour their agreements, "relying on the restrictive terms of the Canadian-style liquidity clause."

Purdy Crawford, as chair of the Montreal Accord investors' group, established the Pan-Canadian Investors Committee (PCIC), which grew to 12 members and held about \$21 billion of the book value. The court appointed an Ad Hoc Committee Investors' Group from smaller corporate investors. And a third group, calling itself the Ad Hoc Retail Investors Group, formed independently, chiefly made up of affected individuals.

The Montreal Accord wanted to convert third-party ABCP to notes that would mature at the same time as the assets. It also wanted to revise the margin provisions of certain swaps. In the meantime, however, credit default swap (CDS) spreads began to climb and global markets became even more skittish. Specialists working to piece together information on third-party ABCP were shocked to discover more than 2,000 retail investors were also involved.

These retail investors had been sold the product on the claim that it was "just like GICs." One such investor, Brian Hunter, marshalled his forces through social media. Their investments were small, relative to the dollar amounts of the Montreal Accord signatories, but these were the life savings of ordinary people and garnered lots of media attention.

Crawford set to work hammering out a deal. Along the way, one company tried to tempt holders with an offer to buy third-party ABCP at a 30 percent discount.

"The ABCP crisis during the fall of 2007 looked like a house of cards loosely constructed with competing interests: angry investors on the PCIC vied with asset providers, which, in many cases, also acted as liquidity providers. Both groups feared litigation....Standstill agreements were pivotal to the process: everyone...agreed they would not trade ABCP," the authors write.

The standstill agreements, shaky as they were, had to be renewed several times—in the midst of the tumult of the financial crisis.

How did Crawford ensure the final deal would not "fall apart in a barrage of lawsuits"? He turned to the 1985 Companies' Creditors Arrangement Act (CCAA). This law allowed for the reorganization of debt rather than a fire sale of assets—but it needed a supermajority of investors (both in numbers and dollars).

More than 10 proposals for restructuring were submitted to the PCIC and related bodies. *Back From the Brink* approaches these details with precision and clarity, including, for example, a spread-loss trigger matrix for a certain type of note (MAV II). The reader can empathize.

Once the restructuring was concocted, Crawford went on a four-city "road show" to present it to investors. Retail investors turned out to jeer and heckle; meanwhile "some investors were giving in to despair—by now, there had been one suicide and several threats of suicide." Finally, Canaccord and Credential offered a buyback to some retail investors.

After more fine-tuning, the PCIC had to get the new paper rated by DBRS and then take it to court for approval. A battle erupted over the fraud "carve-out."

By August 2008, the liquidity crisis had deepened to a full-blown credit crisis. The fiascos of Fannie Mae, Freddie Mac, Lehman Brothers, and AIG all make cameo appearances in the book. The restructuring that had been so painstakingly crafted started to weaken—again.

Around this time, the Caisse reported a \$40-billion loss, and was itself in a serious bind. Some members of the PCIC clamoured to change the deal yet again. The asset providers, themselves highly leveraged, grew restless.

Days before the final extension deadline (December 30, 2008) the restructuring had to be reworked.

Would the feds step in? Mark Carney, soon-to-be governor of the Bank of Canada, said, "Canada can afford to see the failure of a proposed rescue for \$32 billion of ABCP." Tough love, indeed.

The parties knew they had to stay focused and complete the restructuring. And they did.

But the story does not stop there; *Back From the Brink* also explores the aftermath of the crisis. Liquidity has returned to the ABCP market, albeit with greater reputational risk. Some market participants have gone on to profit from the restructured notes. The primary sellers are the note holders (pension funds, governments, corporations); the buyers are the market makers, brokers, and hedge funds. The book explains how an unexpected source of liquidity has been the unwinding.

And what about the regulatory fallout? It seems obvious the dealers should not have lumped together the two types of ABCP (bank and third-party); the risk profiles are different. Arguably, the Ontario Securities Commission (OSC) didn't take prompt enough action. The book discusses some big-picture questions that have resulted from the fallout: Is the enforcement of Canadian securities too lax? Should Canada have a single national securities regulator?

The OSC eventually brought four allegations against Coventree regarding public disclosure and a misleading statement to the market; and, ultimately, the penalties against Coventree and its principals were very light. For this, *Back From the Brink* provides explication—if not juicy vindication.

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Quibbles

As much as I enjoyed the book, I have three quibbles. In addition to the Notes and Index, I would suggest a List of Acronyms. At one point, I was swimming in LSS, MAV, MDE, MFF, and more. Although most terms can be found in the index, some are listed first by the spelled-out form, whereas others are listed by acronym first. The index shows "MFF (margin funding facility)" and "market disruption events (MDEs)."

Second, the index is uneven. The index points to "BGI" on page 28, but it's not there. Topics (such as E*TRADE, GTAA, and suicide) appear in the text but not in the index.

Finally, in the chapter on winners and losers, DBRS mistakenly appears in the "losers" sub-section. The authors themselves note that DBRS was "off the hook," despite its misleadingly high ratings, and was recently bought by a private equity company for US\$500 million.

Kudos

For a complex topic, the book is a model of clarity. It explores multiple facets of numerous problems and yet does not get bogged down. Devonshire Trust and Barclays, for example, had a lively side dispute due to an agreement "byzantine in its complexity," according to the judge presiding. The authors provide a crisp, readable summary and move on.


The sections are well organized. A statement is made—sometimes a controversial one—and the next few statements dissect the nuances. Consider the exemption from legal liability, for example: one party said, "This exemption must apply across the board." The other party said, "No, we must be able to sue persons engaged in fraud." (This became known as the "fraud carve-out.") The authors are able to explain why, perhaps surprisingly, the fraud carve-out didn't occur.

Five Factors

Overall, the authors point to five factors at play in the negotiated restructuring.

1. The collective interest of saving the assets was the overriding goal.
2. The Canadian solution was a private sector solution that didn't involve direct government intervention.
3. Two entities dominated the negotiations: the Caisse, which had billions invested; and Deutsche Bank, which was the largest asset—and liquidity—provider.
4. Legislation intended to provide a smooth landing for creditors of a single company going bankrupt, the CCAA, was applied to an entire industry: the third-party ABCP.
5. The underlying assets in the trusts were mostly sound.

Back From the Brink has more ups and downs than the Calgary foothills. It gathers together news fragments and the inside stories of participants, from "the day Montreal stood still" until the restructuring of notes was completed and the ABCP market was restarted.

As Crawford often said, all negotiation is "the art of the possible." I often heard news items about the Montreal Accord at the time, and I wondered how it would end. *Back From the Brink* explains and provides context for the compromises that were made. Best of all, it suggests how we may learn from the mistakes. 

Victoria Barclay, CFA, is a Toronto-based risk manager and has no relation to Barclays Bank. One of the book's co-authors, Caroline Cakebread, was editor of *The Analyst*.

THE ABCP DEBACLE: FIVE LESSONS LEARNED

Adapted from the final chapter of *Back From the Brink: Lessons From the Canadian Asset-backed Commercial Paper Crisis* by Paul Halpern, Caroline Cakebread, Christopher C. Nicholls, and Poonam Puri.

1. We need a more competitive landscape for credit rating agencies—investors need to check their over-reliance on ratings.
2. Consider the role of the Investment Industry Regulatory Organization of Canada and the question of broker fiduciary standards.
3. Financial companies need a risk management investment framework.
4. Financial companies need board-level risk engagement.
5. Securities regulation must require disclosure and transparency.