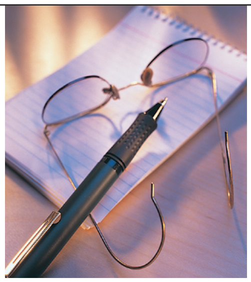
GETTING IT TOGETHER

The ins and outs of the ABCP restructuring deal.



BY MARLENE PUFFER

The restructuring of the market for $35 billion in 47 series of Canadian third-party Asset-Backed Commercial Paper (ABCP) is arguably the most important and complex transaction to occur in the Canadian fixed income markets. A lack of transparency in complex structures left investors uninformed about the exact assets in some products and resulted in fear that subprime mortgages were a bigger factor than they actually turned out to be in Canadian ABCP. Leverage embedded in many structures through Levered Super Senior (LSS) credit default obligations (CDOs), meant that margin call triggers were approached or breached as credit spreads widened generally, whether or not underlying assets were defaulting. Approximately $17.4 billion of the $26 billion in synthetic assets underlying the affected ABCP were LSS.

Another key factor for Canadian ABCP and other structures was that long-term assets were financed with short-term liabilities. Rating agencies disagreed on the structural features needed in the event that investors were unwilling to refinance. The evolution from bank-sponsored ABCP to third-party sponsored ABCP increased the importance of structural integrity, including liquidity backstop agreements that were supposed to kick in if investors declined to refinance. As subprime risk increased in the summer of 2007, investors became concerned and fearful about risk embedded in all structured products. Credit spreads widened globally, triggering or threatening to trigger margin calls. As at March 10, 2008, 77% of the margin triggers on existing synthetic contracts would have been breached or would have been within 10% of being breached. If no standstill had existed, $13.2 billion of assets would have been at risk of being liquidated, probably at very low prices.

Investors refused to refinance ABCP, some liquidity providers for third-party ABCP did not step in to provide support, and the third-party ABCP market froze with existing investors unable to liquidate.

The Montreal Accord gave all parties time to restructure the market and avoid liquidation of underlying assets at fire sale prices. Investors and asset providers agreed not to make margin calls on LSS during a standstill period that has been extended multiple times as negotiations and legal proceedings continue. Negotiations were complex since many parties were involved and some had multiple roles. Negotiating parties included asset providers, noteholders, advisers to the Investors' Committee, including Goodman's legal counsel and JP Morgan among others, and Canadian banks. Others involved included rating agencies, trustees, conduit sponsors, asset and trust administrators, and a monitor. Regulators, the Canada Revenue Agency, and other government departments were consulted along the way.

The cooperation of the asset providers and banks in the negotiations was assured due to the provision of releases intended to protect them from future legal action. The releases became the focus of contention among retail investors and some institutional and corporate investors. The legal avenue for the restructuring was the Companies' Creditors Arrangement Act (CCAA). The plan required approval of a majority of investors by number, and 66 2/3% by principal amount. In order to achieve the majority by number, in negotiations conducted outside the plan, retail investors with less than $1million in notes were offered their full par value plus accrued interest plus expenses. Although the required approvals were received on April 25, 2008, with over 96% voting in favour of the plan both by number and value, at time of writing, some noteholders are arguing in court that they merit similar treatment.

The principal objectives of the plan are to preserve value for the benefit of all noteholders and to ensure fair and equitable treatment of noteholders. There are three key elements of the plan. First, affected ABCP will be exchanged

Marlene Puffer is managing director, Twist Financial Corp. and advisor to NAV CANADA, a member of the Pan-Canadian Investors Committee for Third-Party Structured ABCP.

We are likely to see a return to simpler structures with high-quality assets in the near term.

for longer-term notes that will be issued by three new Trusts, called Master Asset Vehicles, that are designed to match the maturities of the underlying assets, with different classes of notes depending on the nature of the underlying assets. Second, the new notes will be protected against margin calls since investments are pooled and cross-collateralized, margin triggers are restructured to be more remote, and margin funding facilities will be provided by existing investors as well as asset providers and banks to provide further protection from margin calls. Margin triggers were changed from mark-to-market triggers that relied on valuation of the specific assets in the conduits, which can be highly subjective in volatile markets, to spread-loss triggers that rely on independent standardized index spreads relative to treasury bonds. The triggers were reset to be much less likely to be breached, decreasing the likelihood that the new structure will need to access the funding facilities. Finally, all parties to the agreement will receive legal releases that protect them from future legal action, although the exact form of these releases is yet to be determined.

There are three new Master Asset Vehicles (MAVs). MAV1 and MAV2 contain combinations of high-quality traditional and non-traditional assets to be backed by new margin funding facilities. MAV1 investors will provide their own margin funding, while MAV2 margin funding is provided by asset providers and banks at a cost. ABCP backed by U.S. subprime assets or other home equity loans that may be subject to significant risk of suffering losses are "Ineligible Assets." Tracking notes with matching maturities will be issued by MAV1 and MAV2 for the portion of the underlying assets that are ineligible, with an interest rate based on net returns on the corresponding ineligible asset. MAV3 does not require margin funding since it contains only traditional assets, and various classes of tracking notes will be issued to track the performance of these assets.

MAV1 and MAV2 will issue four classes of senior and subordinated notes. The amount of each class of notes to be issued to each noteholder is determined by a relative contribution analysis performed by JP Morgan as of March 4, 2008, and depends on the structure and quality of the specific notes held prior to the restructuring.

WHERE TO FROM HERE?

The restructuring is expected to introduce liquidity into the market for the new notes, but secondary market activity will likely differ depending on the specific notes. MAV1 and MAV2 Class A-1 and A-2 notes are expected to receive AA ratings from DBRS, while subordinated and MAV3 notes will be unrated. Full transparency and legal documentation will be provided to facilitate due diligence and detailed valuation by all investors and traders. Many current noteholders anticipate holding the notes to maturity, but there will be a segment of the market that may prefer to liquidate at the right price, probably to highly sophisticated buyers. Pricing in the initial months after the deal closes will likely include a discount from the underlying asset value to reflect the value of liquidity as well as a discount to reflect the complexity of the transaction.

Since MAV1 investors are contributing directly to the new margin funding facility, their desire and ability to trade is likely to be low. MAV2 has a margin funding facility provided by third parties that facilitates trade in the notes. The large size of the new MAV2 Class A-1 and A-2 notes will motivate prospective investors and traders to analyze the structure and potentially make markets. Lower classes of notes will be unrated, have smaller issue size and a higher risk profile, so these secondary markets may be thin.

As for ABCP and structured credit in general, the global market is recovering as credit and liquidity conditions improve. We are likely to see a return to simpler structures with high-quality assets in the near term. Structures based on synthetic assets will return once the price of counterparty risk settles down and rating agencies sort out their process, but leverage levels will remain low as investors remain cautious. Rating agencies are re-evaluating their approach to structured credit, and will be more conservative regarding their models and the types of structures they are willing to rate. If the major agencies decide not to rate structured credit, liquidity and new issuance will remain low and possibly never recover. Regulation will likely evolve to promote greater transparency and potentially closer oversight of lending practices for underlying assets. ∎