THE LONGWAVE ANALYST

Ian Gordon Economic Forecaster & Interpreter of the KONDRATIEFF CYCLE

Those who cannot remember the past are condemned to repeat it. Santayana

Volume 1 Issue 2, January 19, 2009

WINTER WARNING

If You Aren't Skeptical, Then You Are Liable to be Gullible

After 17 months of a market freeze for non-bank asset backed commercial paper (ABCP), the Ontario Superior Court has approved the final plan of the Montreal Consortium to fully compensate about 1,800 retail investors for their ABCP holdings and issue 8-year notes to most institutional investors, in exchange for their ABCP holdings. This financial travesty should never have unfolded within the Canadian commercial paper market because this non-bank securitized paper should never have been issued in the first place. In any event, there is no shortage of culpability to be shared by many market participants.

The Credit Rating Agencies

Many years ago, both Moody's Investors Services and Standard and Poors, the dominant American credit rating agencies, both refused to rate this Canadian ABCP, citing liquidity loopholes under certain market conditions. However, a Canadian credit rating agency, Dominion Bond Rating Service (DBRS) embraced a different, indeed, opposite viewpoint which foresaw no liquidity problems and it proceeded to issue credit ratings for non-bank ABCP. Obviously, this meant that DBRS had a virtual monopoly on rating this sector of the Canadian commercial paper market. I must mention, at this point, that unlike their American counterparts, Canadian rating agencies are unregulated.

Ultimately, as the size of the ABCP market grew, issuer credit rating fees were not only, coming in the front door at DBRS like a lion, but also, subscription fees were steadily coming in the side door from subscribers. Over time, the problem which evolved was that DBRS began to assign AAA credit ratings to various ABCP issuers which were totally unwarranted. There is no way that non-bank asset commercial paper should have received credit ratings comparable to straight bank paper, or, other highly rated corporate issuers. DBRS knew better and if it didn't, then it had no business being in the credit rating game. Indeed, as recently as April, 2008, DBRS said that it expected to assign a AA rating to the new 8-year notes; but as of December 30th. it has reassigned a provisional A rating to the new notes. Obviously, the credit rating issue remains suspect, if not controversial.

The Stockbrokers and Investment Advisors

I think it is a fair comment that most stockbrokers and investment advisors are primarily stock market-oriented, as opposed to being bond market-oriented, people. As was evident in 1981, when the Canadian bank rate peaked at 21.5% and Canada Savings Bonds were issued at 19.5%, thousands of Canadian stockbrokers and investment advisors discovered that western economies basically functioned on credit and that interest rates represent the price of credit. They also learned that when Federal and Provincial Government bond yields, together with corporate bond yields, trade in the mid to high teens, the economy will cease to function normally and a recession will likely ensue.

I suggest that 26 years later, history has repeated itself. A new generation of Canadian stockbrokers and investment advisors sold non-bank asset backed commercial paper to their clients because they relied on the DBRS credit rating as the gospel. **Mark my words, a DBRS credit rating is not the gospel; it is only an opinion!** Any seasoned bond trader worth his salt could have told them that for a fact. The problem is that most stockbrokers and advisors were either incapable or, not interested in performing their own due diligence on ABCP, so their retail clients suffered the major inconvenience of being stuck with illiquid, unmarketable commercial paper for a year and a half.

The Institutional Investors

Recipients of the new 8-year ABCP notes include many sophisticated institutional investors including life insurance companies, pension funds, investment counselors, corporations, government funds, etc. Two of the prominent institutional ABCP investors are the Caisse de Depot et Placement du Quebec and the Alberta Treasury. Despite their high profile in the marketplace and since these institutional investors are supposedly staffed with experienced, well compensated traders and dealers, they also succumbed to the ABCP web of credit rating misallocation.

The Securities Regulators

Ever since the ABCP market froze in August, 2007, every Canadian regulatory agency has been keen to distance itself from any association or interest with this sector of the Canadian commercial paper market. Indeed, from the Office of the Superintendent of Financial Institutions (OSFI) to the Ontario Securities Commission (OSC) and from the Investment Dealers Association of Canada (IDA) to the B.C. Securities Commission (BCSC), all securities regulators have been quick to backpedal from even offering any moral suasion on the issue. When a similar situation concerning sub-prime mortgage securitized paper erupted in the United States last year, the Securities and Exchange Commission (SEC) ordered all the securities to be bought back by the issuers.

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FORWARD WITHOUT FEAR

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The Federal and Provincial Governments

The final version of the restructuring agreement was only approved by the various stakeholders after the Federal Government and the Ontario, Quebec and Alberta Provincial Governments, agreed to provide a $3.5 billion (CAD) line of credit to backstop potential margin calls on complex credit derivatives underlying the ABCP.

We observe that, despite exposure to non-bank ABCP by Canaccord Capital, Credential Securities (credit union brokerage arm) and Citizen's Bank of Canada (VanCity Savings subsidiary); **the Province of British Columbia was not a participant in this backstop guarantee, because in no way, can private sector exposure to non-bank asset backed commercial paper be deemed a taxpayer responsibility.**

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