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# COMMENTARY

FINANCIAL SERVICES

## The Canadian ABS Market: Where Do We Go From Here?

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### **In this issue...**

The asset-backed securities (ABS) market moved from the shadows and into the spotlight during the recent financial crisis. Regulators around the world are now focusing on the reform of this market. What should Canada do?

## THE STUDY IN BRIEF

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The asset-backed securities (ABS) market suffered a major setback during the financial crisis that began in 2007. Its role in the broader market collapse has been well documented, but the need to restore a healthy ABS market is equally clear. Indeed, North American policymakers have readily acknowledged that this market must play a major role in the global economic recovery and policymakers have recently moved beyond addressing the urgency of restarting the ABS market to considering its reform.

This *Commentary* provides historical context for these policy considerations, an analysis of current reform proposals and some suggestions for their application to a policy approach that reflects some unique Canadian market realities. Enhanced transparency and better accountability regimes are welcome steps but, pushed to the extreme, may constrain the return of full liquidity to the ABS market.

Based on current proposals, it is clear that reformers want to reduce the risk of systemic liquidity failures in the senior ABS market that result from an excessive reliance on rating agency assessments. However, if this objective is to be realized without discouraging broad investor participation in the senior ABS market, a more effective measure would be new regulations that ensure that knowledgeable and objective market participants acquire and retain a subordinate tranche of ABS backed by the same assets. We, therefore, recommend that a subordinated class of ABS be placed with a third party as a condition of accessing public markets for senior asset-backed medium-term notes.

This *Commentary* also raises unique Canadian considerations for ABS market reforms. Specifically, it would be prudent in the Canadian context to impose new disclosure requirements for all public market note issuance, not just for those wishing to access the market through a shelf offering.

Further, so-called monthly-pay pass-through notes, which “pass through” payments from their underlying assets, need special attention. Historically, the capacity of the market to absorb these securities has been problematic. However, since the fall of 2009, the Canadian market has appeared to be more accepting of these securities. Should this support falter in the future, a public-sector entity may be required to replace former funding sources (i.e., commercial paper conduits) that had supported the issue of bullet bonds (non-callable bonds with a fixed maturity date and interest rate) to finance portfolios of monthly-pay consumer and commercial credit products.

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INDEPENDENT • REASONED • RELEVANT

**A** sset-backed securities (ABS)<sup>1</sup> stepped out of the shadows and into the headlines in the aftermath of the recent credit crisis.

The role of the ABS market as a trigger and source of contagion for market collapse has been documented and acknowledged. However, North American policymakers have just as readily acknowledged the role that the ABS market must play in the global economic recovery. Both in Canada and the United States, public policy has spurred the initial, halting recovery of the ABS market. Recently, North American policymakers have moved beyond addressing the urgency of restarting the market to considering its reform.

For Canadian policymakers, the challenge is to weigh the merits of proposed reforms with the unique challenges presented by the domestic ABS market. In Canada, more monitoring and potential intervention may be required. This *Commentary* will attempt to provide a historical context for these policy considerations, an analysis of the reform proposals and some suggestions for a unique Canadian policy approach.

### *The Conceptual Underpinnings of Securitization*

The securitization market has been at the forefront of the global economic growth story of the past 20 years. The unprecedented 15-year surge in North American GDP growth between 1992 and 2007 corresponds almost perfectly with the accelerating rise in the pool of outstanding asset-backed securities in the US and Canada (see Figures 1 and 2). While coincidence does not prove causation, in this case the logical argument for linkage is not a hard one to make. By reducing the borrowing costs for providers of

consumer and commercial financing, securitization structures directly contributed to increasing levels of leverage throughout the economy, and particularly in North American households, given the dominant portion of the ABS market dedicated to the financing of residential mortgage portfolios (see Figure 3 and 4).

This same period was, of course, marked by a prolonged period of exceptionally low base interest rates maintained by central banks around the world. It was no wonder that the dominant, and ultimately most troubling, aspect of the extended period of exceptional GDP growth was the corresponding increase in leverage levels in US and Canadian households. Given the direct role that the availability of asset-backed debt played in facilitating that extension of credit, it is hardly a stretch to assign a starring role to the securitization market in the production of this bull market for credit.

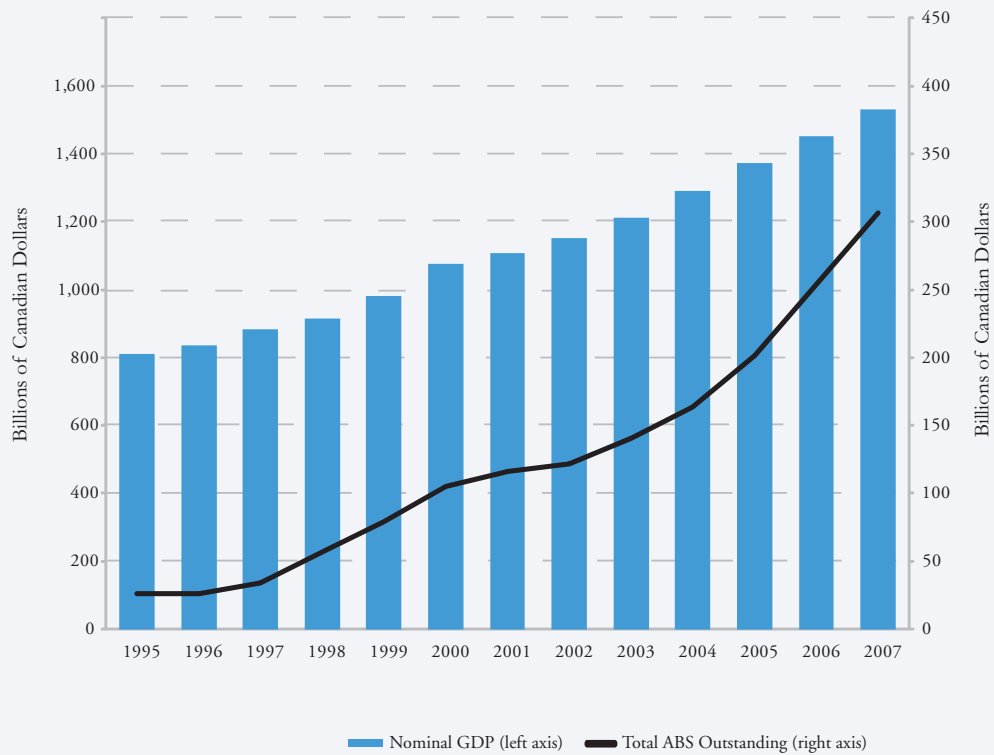
The conceptual basis for the leveraging of credit markets achieved through securitization structures is not a complicated one; it is only the process of executing the structures in the context of applicable accounting, tax and commercial law regimes that gives the market its opaque complexity (that and its seemingly endless glossary of acronyms that rivals only major league baseball sabermetrics). In its essence, securitization is simply a means of allowing commercial entities that originate pools of consumer and commercial receivables to finance those receivables in the capital markets directly in a manner that allows lenders to be secured by those receivables without any credit or recovery risk associated with the originator itself. It is distinct from secured lending in that it provides not only the ability to look through to the aggregated credit risk of the diversified pool of obligors by whom the receivable is owed (augmented, in most cases, by

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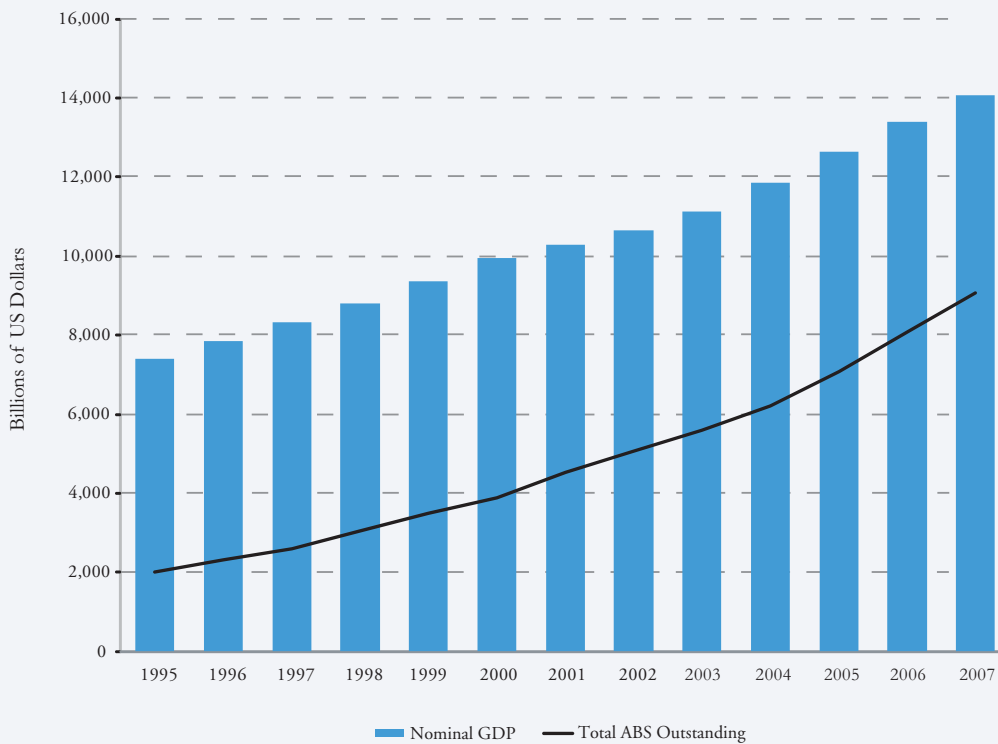
1 For the purpose of this paper, the term "ABS" will be used to describe all asset-backed securities, including those backed by mortgages. In other contexts, the term ABS is sometimes used only to describe asset-backed securities backed by non-mortgage assets and the term "MBS" is used to describe those backed by mortgage assets. Also, where the mortgages are backed by residential real estate, the more specific acronym "RMBS" is often used and in the case of mortgages backed by commercial real estate, the popular acronym is "CMBS."

Figure 1 - Gross Domestic Product and Asset-Backed Securities Outstanding, Canada



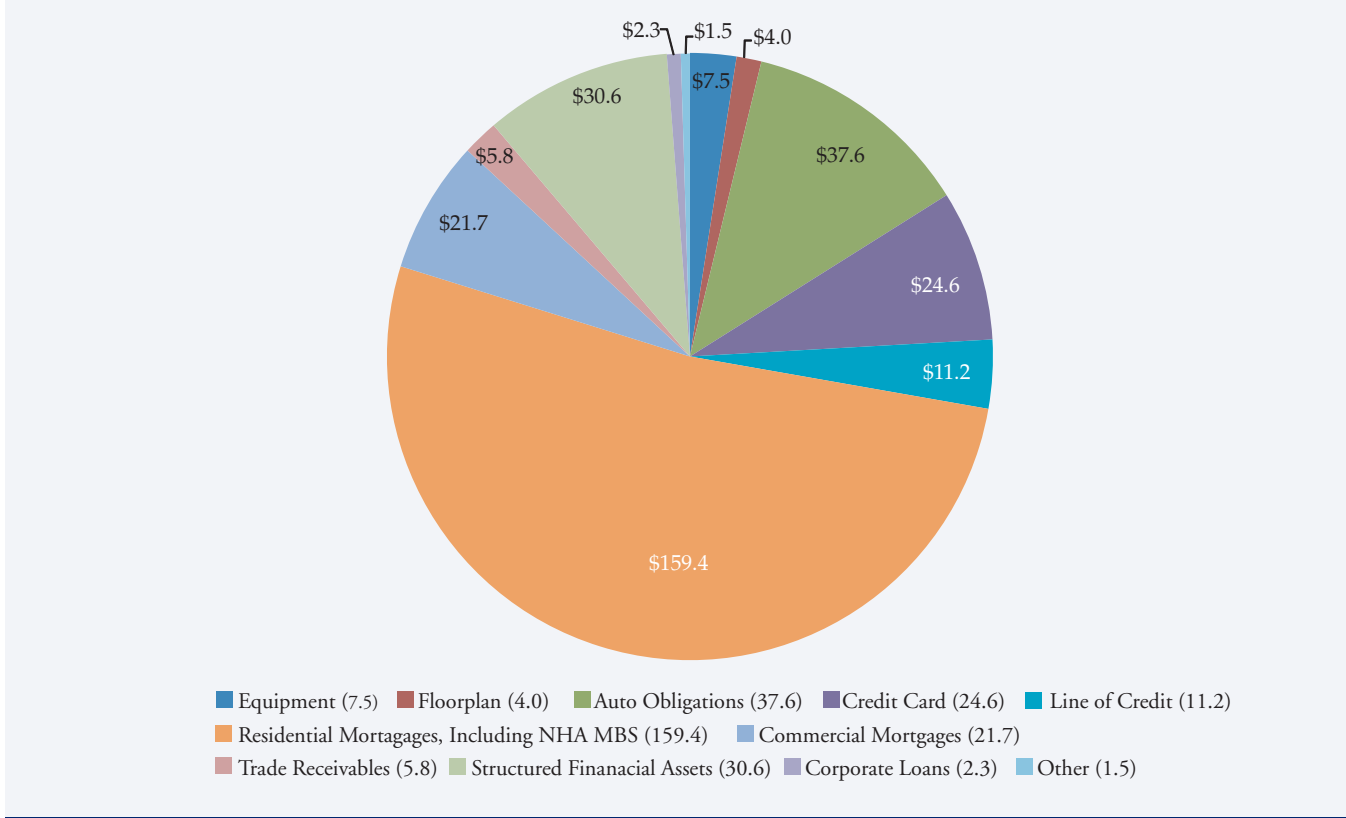
Sources: DBRS, Bank of Canada and Statistics Canada.

Figure 2 - Gross Domestic Product and Asset-Backed Securities Outstanding, United States



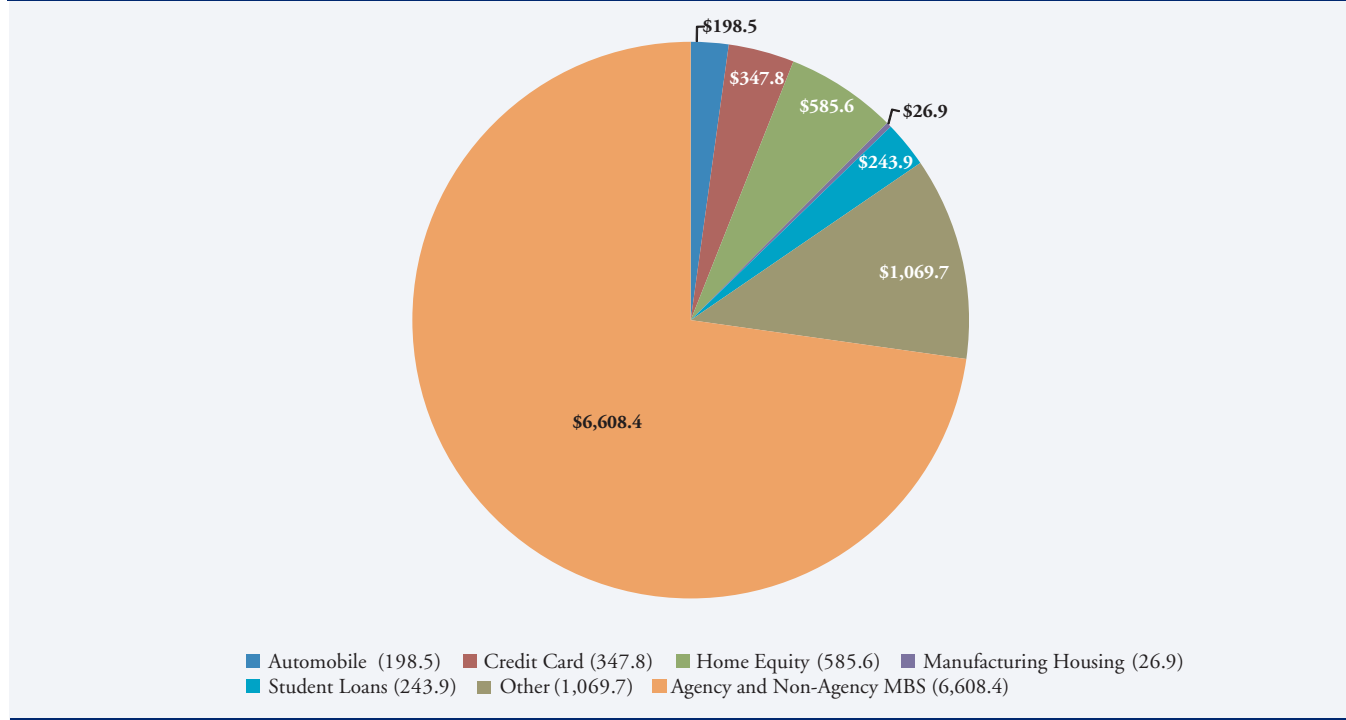
Sources: Bureau of Economic Analysis, the Securities Industry and Financial Markets Association and Inside Mortgage Finance Publications.

**Figure 3 - Asset-Backed Securities Outstanding by Asset Classes, Canada, 2007 (Billions of Canadian Dollars)**



Sources: DBRS and Bank of Canada.

**Figure 4 - Asset-Backed Securities Outstanding by Asset Classes, United States, 2007 (Billions of US Dollars)**



Sources: The Securities Industry and Financial Markets Association and Inside Mortgage Finance Publications.

additional cash collateral), but also ensures that the likelihood and timing of default and cost of recovery will not be impacted by credit events that occur in the interim with respect to the originator. With both a lower probability of default and higher and less procedurally complicated recovery given default, originators can access a broader pool of lenders with lower risk tolerance and thereby lower their overall cost of capital, which in turn leads to lower costs of credit to their customers.

Most of these structures result in debt issued in the capital markets bearing 'AAA' credit ratings (or the short-term equivalent in the context of asset-backed commercial paper, referred to as ABCP). At these ratings levels, the credit risk assessment associated with these securities are on a par with the sovereign risk of the most creditworthy nations, including both the US and Canada, and ahead of all but the most exceptional of corporate borrowers. However, just as the asset-backed market was instrumental in the spectacular rise of the global economy through 2007, its fingerprints were all over the financial crisis that began in 2007 and continues to echo today.

### *Securitization and the Credit Crisis*

So what went wrong? The tangled web of global market interdependencies that spread the recent crisis into every geographic and sectoral nook and cranny of the financial market is indeed complicated, but the role of the securitization market as ground zero for the crisis is not hard to describe. Low interest rates drove global debt investors to search far and wide for enhanced fixed income yields. Rated ABS were offered as low-risk liquid investment opportunities with the benefit of modest but meaningful complexity premiums over the yields available on equivalent-duration government bonds. In short order, investor demand outstripped the availability of traditional consumer and commercial receivables, and those complexity premiums contracted substantially.

This contraction in ABS spreads made its way into the pricing of consumer and commercial financing products, further stoking the red-hot economy. This effect was even more evident in

the United States, where public policies such as the deductibility of interest paid on residential mortgages made consumer debt even more affordable.

Throughout the boom, US policymakers, mindful of the widening consumption and wealth gaps between homeowners and non-homeowners, introduced measures that encouraged the extension of residential mortgage funding further and further down the credit spectrum. The boom in the availability of credit for home buyers spurred a rapid appreciation in the value of US residential real estate, creating more collateral for consumer spending subsidized through tax-deductible interest payments on mortgage advances. This increased spending further exacerbated the consumption and wealth gaps between homeowners and non-homeowners, intensifying the policy rationale for encouraging yet even broader residential mortgage eligibility.

The boom spread to the securitization market through the US subprime mortgage market. Subprime mortgages were mortgages extended to individuals who would not otherwise qualify for a prime mortgage offered by a bank. Initially, standard requirements such as minimum tenure of employment or residence were waived. Eventually, even verification of stated income was waived, so as to not exclude the self-employed.

At its peak, even the demonstrable capacity of mortgagors to make the required monthly payments of principal and interest at then prevailing market rates ceased to be a requirement, with mortgages negotiated on the basis of "teaser rates" that reset after the first two years of what could be a 25-year mortgage. The rationale behind this seemingly reckless product offering was the expectation that the appreciation on the underlying real property during that first two years would generate sufficient equity either to allow the mortgagor to refinance into a prime mortgage or to monetize that equity appreciation to assist in making the higher interest payments once the rate had been reset.

These subprime mortgages were ultimately organized into pools that were structured to be financed in the ABS market. The problem was

that the assets backing these instruments lacked the historical data that had allowed rating agencies to reliably predict the performance of comparable instruments backed by traditional prime mortgages, credit cards or automobile loans and leases through a full credit cycle. Objective data analysis, the hallmark of securitization structuring, gave way to subjective theorizing. Those parties structuring ABS offerings supplemented the reassuring available short-term data on subprime products with “fudge factors” that were based on what were assumed to be wildly conservative multiples of the actual default and loss experience from traditional prime portfolios.

This approach was obviously fraught with peril, but the multiples assigned to the default and loss data were large and probably would have sufficed to offset the catastrophic defaults that were to come but for another more insidious assumption. The performance of ABS backed by prime residential mortgages had long benefited from geographic diversification. Residential real estate markets are inherently local, with movements in valuations driven by the dominant economics of specific areas. Local plant closings or openings, the popularity of tourist attractions waxing or waning, natural resource discoveries or depletions and demographic changes driving population shifts can dramatically affect local real estate values, but never before were such dramatic movements national in their impact.

Unfortunately, ABS structurers overlooked the extent to which the creation of a new financial product invalidated the predictive value of available historical data. The innovative offering of subprime financing created a national tidal wave of liquidity for US residential real estate. All boats rose with the tide, but the tide ebbed when the pool of available mortgagors was exhausted.

Having eliminated almost all income eligibility, there nonetheless came a point when there was an insufficient pool of potential home buyers that could make even the minimal teaser-rate mortgage payments. Without new buyers to drive house prices still higher, the prospects for the most recent buyers at the end of their teaser-rate period were grim. Without any appreciation of the value

of their properties, refinancing was impossible and default and foreclosure all but a certainty.

With those first foreclosures, stalled property values went into freefall. Soon, overleveraged prime mortgagors faced financial calamity as reduced loan-to-value ratios left them unable to refinance at rates available to other prime mortgage borrowers. Years of accumulated household net worth evaporated in a matter of months.

#### *The Credit Crisis and Canadian ABS Market*

The fact that Canada has to date weathered the financial crisis better than most other developed nations has generally been attributed to more conservative bank regulation, and there is certainly some basis for this conclusion, particularly in relation to our European counterparts. However, the significant performance gap between our largest banks and their American counterparts is materially attributable to the absence in Canada of the catastrophic elimination of US household net worth in the wake of the residential real estate market collapse.

While it is true that subprime mortgage lending had made some inroads into the Canadian market, it was a far different product than that seen south of the border. While non-bank lenders had introduced some higher loan-to-value mortgage products for borrowers with appropriate credit scores and some lower loan-to-value mortgage products for poorer credit risks (and the Canada Mortgage and Housing Corporation (CMHC) had responded with some softening of the eligibility requirements for funding through its government-guaranteed Canada Mortgage Bond program), the US-style low/no income eligibility and high loan-to-value rate reset products never made it into the Canadian market. Without interest deductibility, the threshold of affordability was set that little bit higher to dissuade demand for such products, and a more conservative credit culture precluded their offering.

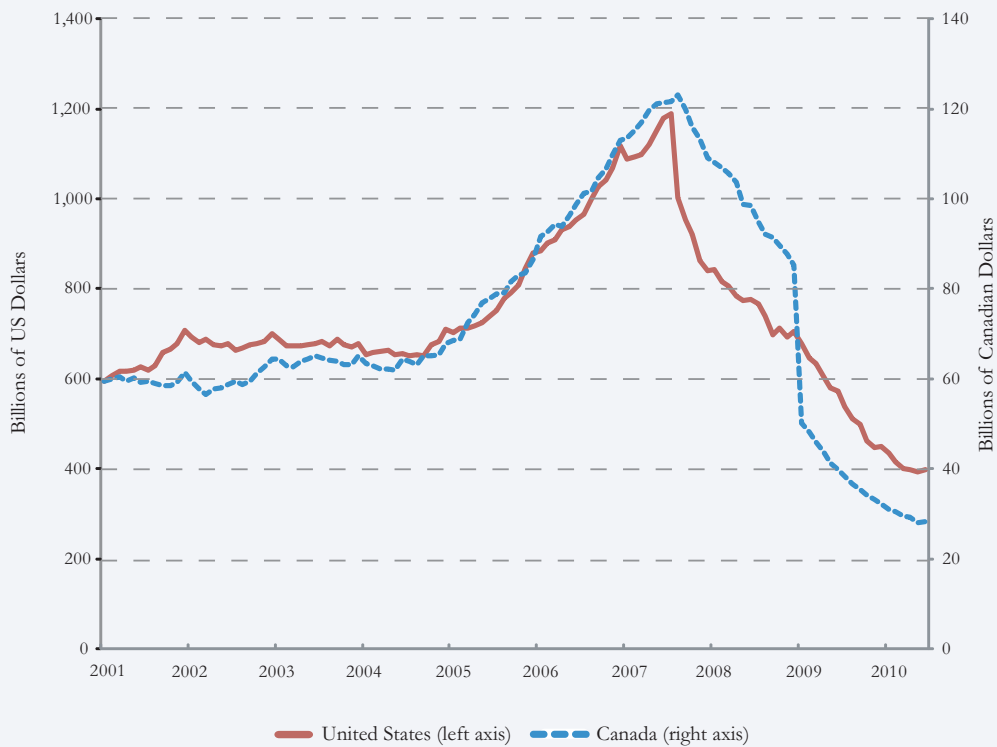
While Canada’s conservative credit culture may have spared us the worst of the damage, it did little to spare our securitization market. The

Figure 5 - Asset-Backed Medium Term Notes Issuance, Canada and United States



Sources: The Securities Industry and Financial Markets Association and DBRS.

Figure 6 - Asset-Backed Commercial Paper Outstanding, Canada and United States



Sources: DBRS and Federal Reserve System.



market panic surrounding exposure to US subprime residential mortgages first crossed into Canada through the C\$32 billion portion of the Canadian ABCP market that held exposures to such assets, either directly or through exposures to securities backed by other securities that themselves included exposure to US subprime residential mortgage portfolios.<sup>2</sup> As for all Canadian conduits, the specific nature of the asset holdings were unavailable to investors, who purchased these securities in the exempt market, relying on ratings that were provided almost exclusively by DBRS, Canada's only domestic rating agency.

As confidence in ratings dissipated around the world, liquidity for structured products contracted catastrophically throughout the summer of 2007, finally landing in Canada on August 13, 2007, when the market for non-bank ABCP evaporated. However, by that time banks around the world were beginning a slow and tortuous revelation of their own exposures to the massive ABCP market. Indeed, any market without full transparency was suspect and rapidly losing liquidity.

In short order, even the portion of the Canadian ABCP market sponsored by domestic banks was faced with liquidity challenges despite the absence of any evidence of exposure to the US subprime residential mortgage market. Only the timely conversion of the liquidity backstops supporting these ABCP programs from the

unique Canadian “market disruption-only” standard to the broader form of liquidity required by US rating agencies in every other global market spared the Canadian bank-sponsored conduits from the fate that befell their non-bank brethren.<sup>3</sup>

#### *The Policy Response to the Market Freeze*

At the same time that the ABCP market was being buffeted by transparency concerns, liquidity was disappearing around the world even for ABMTNs, which were subject to prospectus disclosure requirements in all markets, including Canada. Even in the case of ABMTNs<sup>4</sup> backed by assets demonstrably remote both in terms of asset class and geography from the US residential mortgage market, the market was immediately “no bid.” The structural complexity that had been so welcome as the basis for risk-adjusted yield premiums was suddenly suspect in a world where ratings had been proven to be horribly unreliable. As can be seen in Figures 5 and 6, ABMTN issuance immediately disappeared both in Canada and the United States in the wake of the financial crisis. At the same time, outstanding ABCP began a rapid and uninterrupted decline as underlying asset pools amortized without replenishment through new purchases.

Notwithstanding the immediate and wholesale rejection of these products by global capital markets, the public policy reaction to this

2 This portion of the Canadian ABCP market is often referred to as “non-bank sponsored ABCP,” which in its broadest terms is accurate, given that the assets backing the portion of the ABCP market issued by conduits sponsored by Canada’s “Big 5” banks did not include exposures to US subprime residential mortgages. However, the Canadian conduits whose funding froze in August 2007 included those sponsored by National Bank of Canada and some foreign banks. Notwithstanding this factual oversimplification, in the context of this paper we will follow convention and refer to this now-defunct portion of the Canadian ABCP market as “non-bank” ABCP.

3 Canadian bank regulations regarding the capital treatment of ABCP liquidity facilities have long been more stringent than the corresponding rules in most other OECD jurisdictions. Zero-risk weighting was available to Canadian banks only when the right to draw upon these facilities was restricted to those circumstances in which the illiquidity giving rise to the exercise of a drawdown of the facility was endemic to the ABCP market as a whole and not specific to one conduit program or a small group of conduit programs. Facilities meeting these criteria were referred to as “market disruption-only” or “Canadian style” liquidity. For US banks, zero-risk weighting was available so long as the bank providing the liquidity was relieved of the obligation to advance funds when the realizable value of the underlying assets exceeded the indebtedness that it supports, including the amount proposed to be drawn down under the facility. Facilities meeting these criteria are referred to as “global style” liquidity. This difference in liquidity standards dramatically increased the extent of the credit risk assumed by the provider of a global-style liquidity backstop. The absence of global-style liquidity supporting Canadian ABCP programs had historically precluded US agencies providing ratings for such programs.

4 The broader use of the term “ABS” is also used to describe both ABCP and asset-backed securities that are issued for terms in excess of one year. In this *Commentary*, where the reference is to this longer-term ABS and not to ABCP, the term “asset-backed medium-term note” or the acronym “ABMTN” will be used. References to ABMTNs do not include residential mortgage-backed securities that are subject to timely payment guarantees issued by Canada Mortgage and Housing Corporation.

phenomenon was surprisingly measured. Given the public outrage toward the excesses in the US subprime residential mortgage market, one would have expected an immediate and visceral policy response marked by a rejection of the “shadow banking” system built around policies supporting the re-intermediation of all credit activity by regulated financial institutions.

However, the credit crisis devastation was so widespread that even that seemingly simple solution presented considerable challenges. Among the institutions worst hit by the crisis were the largest US banks that, despite their vilified role in the distribution of tainted securities, still managed to retain very large exposures to the most senior tranches of such assets.<sup>5</sup> With massive mark-to-market and credit losses on these exposures, their own capital bases had been critically eroded. Finding new capital to stabilize these institutions was already proving to be a daunting task; to ask these same institutions to raise sufficient capital to re-intermediate the trillions of dollars of lending activity formerly accommodated through the discredited shadow banking system was unrealistic.

The prospects for funding this gap through conventional debt issuance were no brighter. The debt crisis had accelerated the market awareness of “fallen angels,” the sudden collapse of large highly rated corporations into insolvency. Before the crisis, most mortgage originators that relied heavily upon the asset-backed market were low- to mid-investment grade companies who found incremental capital market capacity and a lower cost of funds in the ABS market. Further, three of the asset originators that fuelled the most prolific ABS issuance were the captive finance arms of the Big Three North American auto makers, two of whom have recently gone through insolvency proceedings and none of whom retain investment grade ratings. In this environment, the prospects for massively expanded conventional corporate

debt issuance filling the financing gap left by the discredited ABS market were very remote.

#### *The ABMTN Market Restart: TALF and CSCF*

Without practical alternatives for either immediate re-intermediation or increased corporate debt issuance, policymakers were left with few alternatives other than to revive the ABS market. However blameworthy and flawed one might reflexively conclude it to be, the ABS market would have to be immediately restored and, in the longer term, rehabilitated. The manifestations of this conclusion were seen immediately in both the US and Canada. In the United States, the Term Asset-Backed Securities Loan Facility (TALF) was announced in November 2008 and launched in March 2009, providing non-recourse government loans to finance as much as 95 percent of the purchase price of senior ABMTNs backed by a wide range of conventional assets, including auto and equipment leases and loans, credit card receivables, student loans, small business loans and, ultimately, commercial mortgage-backed securities (CMBS).

In Canada, the January 2009 federal budget announced the creation of the Canadian Structured Credit Facility (CSCF) that was intended to provide liquidity for ABMTNs backed by Canadian vehicle and equipment leases and loans. The ultimate design and administration of the program was left to the Business Development Bank of Canada (BDC), and the program was launched in June 2009 but did not advance any funds for the purchase by BDC of eligible senior ABMTNs until three months later in September 2009. Both TALF and CSCF closed at the end of March 2010, with the exception of CMBS eligible for the TALF program, for which the window remained open to the end of June 2010.

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5 Later in this *Commentary* we discuss the investor protection benefits of mandating that structurers and originators retain “skin in the game.” The failure of “skin in the game” in the form of senior exposures retained by bank-owned dealers in the context of the recent credit crisis may seem to negate the effectiveness of this reform concept. However, as also noted later, this form of “skin in the game” was ineffective because (i) it was at the senior level, where all participants relied upon ratings, and (ii) it was taken down in the context of distribution and, in some cases, management mandates with respect to junior tranches through collateralized debt obligation (CDO) structures in which the fees generated cloud the evaluation of the retained securities from a pure investment perspective.

In the case of both TALF and CSCF, the initial volume expectations for the programs far exceeded their actual activity levels. When TALF was announced, it was expected to support as much as US\$1 trillion of issuance in the moribund US ABMTN market, but TALF-eligible issuance was actually closer to US\$100 billion. Similarly, the CSCF was announced with a maximum capacity of C\$12 billion, with actual utilization falling slightly below C\$4 billion.

Nonetheless, these low utilization levels are not indicators of lack of success from a public policy standpoint. Both TALF and CSCF provided a benefit to their respective markets that went beyond their impact upon those availing themselves of the programs. What was critical was the impact of each on market spreads.

In late 2008, in both the United States and Canada, the debt crisis had initiated an inexorable upward spiral in the credit spreads attached to all structured products. Uncontrolled mark-to-market losses had spurred panic selling and precluded any primary issuance of ABMTNs. Even originators of asset classes that had survived the credit collapse without any downgrade or extraordinary loss found themselves without liquidity in the ABMTN market at any spread. ABMTN investors who until 2007 would have been happy to buy AAA-rated retail auto loan-backed ABMTNs at a spread over equivalent duration government bonds of 50 basis points shuddered to buy at 400 basis points for fear that they would face an immediate mark-to-market writedown as spreads continued to widen.

Given time, this disorder of market psychology would have righted itself, but not before continuing unavailability of consumer and commercial credit further stalled the North American economies. A discrete policy intervention was necessary to arrest this continuing spread widening that had become unhitched from any real credit apprehension. TALF and CSCF provided the required nudge to market dynamics, albeit in different fashions. In the case of TALF, the attraction of opportunistic investors to the ABMTN market rapidly expanded

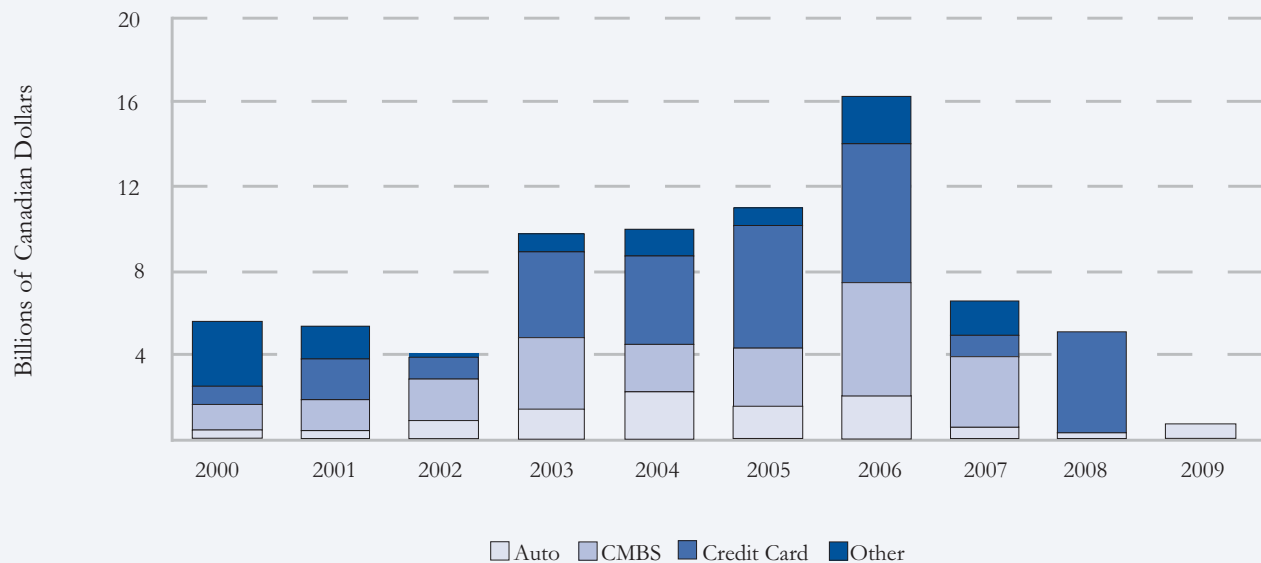
the universe of available buyers, replacing those that had invested purely on rating and lacked the credit expertise to take independent views of these complex instruments.

Armed with non-recourse leverage, hedge funds seeking yield found TALF-eligible senior ABMTNs as a compelling investment opportunity. As yields on TALF-eligible ABMTNs tightened, traditional ABMTN investors were forced into non-TALF issues, reversing the spread-widening trend. In a matter of months, prime retail-auto ABMTN spreads that had stood at over 500 basis points at the end of 2008 were inside 100 basis points, still well wide of their mid-2007 lows but at a level at which a meaningful volume of credit could be made available to support a resumption in auto sales.

In the case of CSCF, the method of market correction was more one of leadership than direct market stimulation. In June 2009, the CSCF offered funding for AAA-rated auto and equipment loans and lease-backed ABMTNs at a spread of 350 basis points, and originators claimed allocations exceeding the available C\$12 billion. Within days, a public ABMTN offering backed by Ford Credit Canada-originated retail car loans priced at a spread equivalent of roughly 375 basis points.

Investors coveting the credit quality of the portfolio finally saw a cap on retail auto ABMTN spreads. Ford Canada quickly sealed the deal, locking in a spread just above the CSCF-offered rate, presumably choosing to continue to develop its conventional investor base and avoid the necessity of modifying its global ABS platform to meet the eligibility requirements for CSCF funding. Before any other originator could use the CSCF-offered pricing, market spreads had tightened further, placing the CSCF funding option out of the money. In September 2009, BDC announced a further tightening in the offered spread to 150 basis points. However, the offer was not a free option; originators wishing to seize the opportunity would have to claim an allocation and pay a standby fee on the unused commitment. Take-up and utilization was less

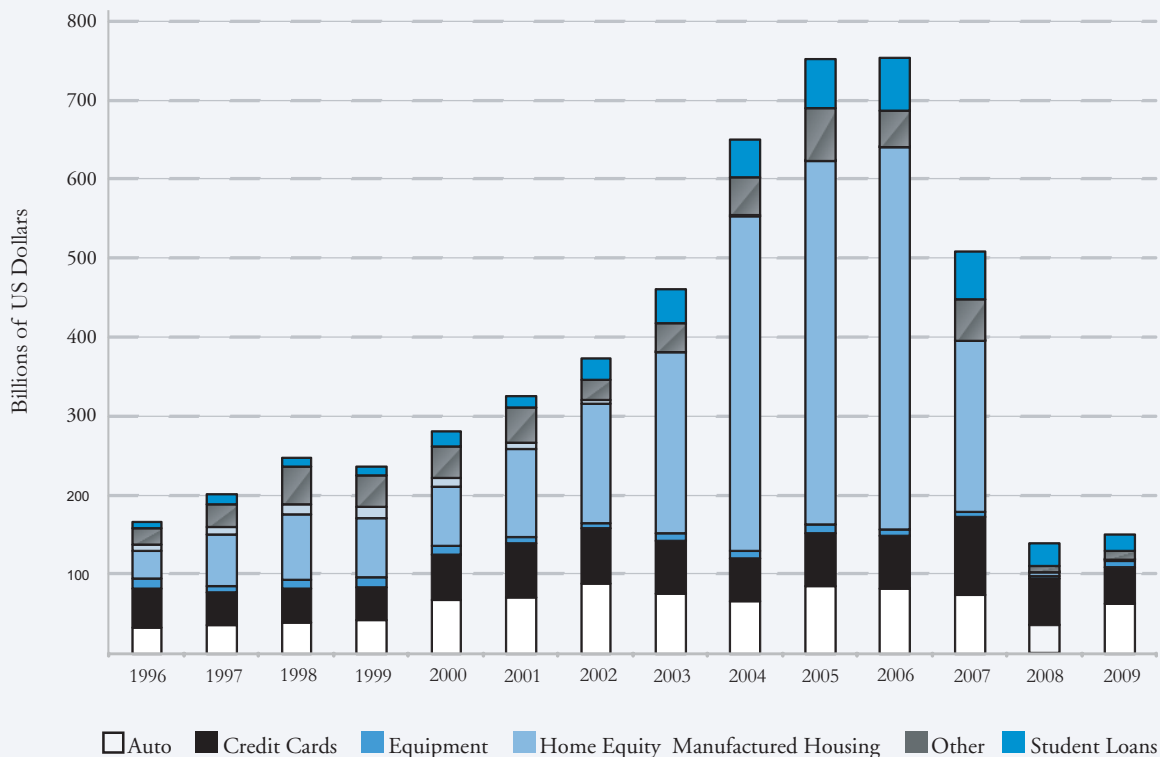
Figure 7 - Asset-Backed Medium Term Notes Issuance by Asset Classes, Public Issuance Only, Canada



Source: Scotia Capital.

Disclaimer: This graph reflects publicly available information compiled by Scotia Capital from a variety of sources and has not been independently verified. This information is being provided for general reference purposes only and should not be relied on for investment purposes.

Figure 8 - Asset-Backed Medium Term Notes Issuance by Asset Classes, United States



Note: Manufactured Housing data for 2009 not available.

Sources: The Securities Industry and Financial Markets Association.

than C\$4 billion, but the impact on spreads was significant. Within days, Ford Credit Canada priced a non-CSCF offering that was just beyond the new offered spread and 100 basis points inside secondary market spreads quoted just before the CSCF re-pricing.

In both the United States and Canada, these policy interventions helped restart ABMTN market issuance. In the United States, the TALF program was more aggressive in its stimulation of demand and broader in the asset classes to which it applied. As a result, the resumption of issuance activity was correspondingly broader, both in terms of asset classes and number of originators (see Figure 7 and 8).

In Canada, the CSCF program was a targeted program from the outset, reflecting an industrial policy overlay that was clearly focused upon the Canadian impact of the serious challenges to the North American auto manufacturing sector. Not surprisingly, the impact of the CSCF has been more muted. The rebound in public issuance outside of the CSCF has been led by multiple retail loan and floor plan receivable-backed deals from Ford Credit Canada, a single retail loan-backed transaction from GMAC, and credit card-backed ABMTNs from three of the major banks. Today, new issue spreads are markedly reduced and stable, but by no means can it be said that the breadth or volume of ABMTN issuance is at anything approaching pre-crisis levels.

In the United States, much of the reduction in ABS activity can be attributed to the new US consumer reality. The catastrophic collapse in residential real estate values gutted household net worth levels, and leverage capacity has been correspondingly reduced. In Canada, consumer confidence remains stronger, leaving a greater opportunity for a return to favourable lending terms through the re-engagement of the ABMTN market to generate a resurgence in demand for consumer products.

### *ABS Market Reform*

Having met with some success in restarting the ABMTN market, North American regulators have

turned their attention to market reform. The goal now is to restore confidence in the ABMTN market's potential as both a consistent source of liquidity for asset originators and a safe avenue for fixed income investment.

The reform proposals tabled to date extend to the entire ABS market, notwithstanding compelling evidence that the incidence of credit failure among ABS products was limited to US subprime residential-backed mortgage securities. Some would argue that the reform proposals are too broad and could unduly hamper the size and viability of the global ABS market. While there is certainly some merit to that criticism, it seems clear that securities regulators around the world are not inclined to accept a status quo in which the global economy is vulnerable to global illiquidity following a general loss of confidence in ratings assessments emanating from any seemingly isolated asset class.

To address this concern, the International Organization of Securities Commissions published new disclosure principles for ABMTNs on April 8, 2010. This effort followed one day after the release of a broader, more detailed and onerous set of reform requirements proposed by the US Securities and Exchange Commission (SEC). Parallel detailed embodiments of these reform initiatives are also found in the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010. In response to these international initiatives, the Canadian Securities Administrators served notice on June 21, 2010 that it intended to provide draft proposals for ABMTN market reform later in the summer. Since these proposals have yet to be published, we will instead focus on the themes of the SEC's proposed reforms.

The SEC suggests a two-pronged approach, restricting access to the ABMTN shelf-offering system to issuers that conform to a regime that contemplates both enhanced transparency for investors and greater accountability for asset originators and sponsors. However, what is at least as interesting as what is included in the proposed reforms is what is not. The proposals imposing

materially enhanced requirements for transparency clearly reflect the view that US ABMTN investors had been so dependent upon rating agency assessments that they dispensed with their own analysis. On the other hand, those portions of the proposals that require additional accountability requirements on the part of originators and sponsors address the notion that those parties hid behind the rating agency assessments in creating and promoting products that they knew or ought to have known were deficient. What is missing is any attempt at reform of the role of the agencies themselves.

It is hard to find fault with this approach. There are obvious and troubling conflict issues in a ratings model in which the issuers compensate the agencies that provide the ratings. However, as thorny as these conflicts are, they are neither the only nor the most fundamental barrier to imposing greater accountability upon rating agencies.

These agencies do not seek nor are they sufficiently capitalized to perform a fundamental gatekeeper role in the issuance of securities. Their ratings are intended to be opinions, shortcuts for the validation of independent views, not a substitute for them. Indeed, a business model that actively encourages the level of investor reliance that the most recent crisis has revealed would demand a far higher level of capitalization to backstop potential liability claims than is currently maintained by the rating agencies. The SEC proposals were right to look beyond the rating agencies in reform of the ABMTN market.

(i) **Transparency:** The dominant theme of the SEC proposals is improved disclosure. Unlike the ABCP market, public ABMTNs in both Canada and the United States have always been included among the classes of securities that are subject to regulation. However, few if any specific rules exist

that reflect the specific challenges imposed by securities like ABS whose creditworthiness are a function of asset quality rather than the issuer's independent ability to pay. It is this gap that the SEC disclosure proposals seek to address.

The proposals presume that uniform and detailed disclosure of all relevant data regarding a proposed ABMTN issue will allow investors to satisfy themselves with respect to the merits of such an investment. Clearly, such greater transparency would be a step forward. Investors troubled by the inability to rely on rating agencies will be provided with the relevant raw data so they can do the analysis themselves. Those without the experience or resources to confidently perform that type of analysis should not be buying such products. It is perfectly logical securities regulation.

But is it good economic policy? Economic growth relies upon vast amounts of leverage to allow financial players to put capital at risk to generate appropriate risk-adjusted returns in the offering of goods and services. The size of the senior debt component supporting global economic activity necessitates the participation of an enormous number of parties with widely varying levels of financial expertise.

While the expectations of expertise and sophistication on the part of senior ABS investors that is implicit in the SEC proposals may be reasonable in the context of the largest investors, such expectations may effectively preclude the participation of a broader class of senior debt investors, which would be extremely limiting to the efficient use of economic capital. Furthermore, even a chastened origination market will bring forward concepts, products and structures of a diversity and complexity that the most expert senior debt investor cannot master.

It is possible that the SEC does not wish to narrow the ABMTN market to such an extent. It

may instead expect that the availability of information that allows independent analysis will serve as a caution to unscrupulous sponsors and a check upon the competitive instincts of rating agencies. In this model, smaller or less sophisticated investors can “free ride” on the discipline provided by those that in fact use the enhanced transparency to perform the independent analysis.

But such an approach presents two risks that are problematic from a public policy standpoint. First, it imparts undue market authority to the largest investors, who have the ability to direct a great swath of liquidity as the less sophisticated and smaller investors free ride on their presumed diligence. Alternatively, it leaves open the risk that all investors become free riders, with each presuming someone else has done the required analysis, just as they had once relied upon rating agency oversight.

(ii) **Accountability:** It is reasonable to assume that SEC had some misgivings about these limitations of the transparency model given the inclusion of some new accountability provisions in the proposals. After all, from the perspective of a securities regulator, there is little that need be done beyond what is provided for under the proposed disclosure regime. If investors lack the sophistication or otherwise fail to use the information they are given, what more can be asked of a regulator, particularly where the very form in which the information is required to be provided points to the analysis that a qualified investor would be expected to perform? The inclusion of further accountability requirements can only be presumed to point to concerns over the potential of so limiting the market, or to the risks to the market that could be created by the presence of too many free riders.

(a) **Certification:** The accountability regime takes two forms: originator certifications and “skin in the game” requirements. The most striking proposed certification requirement is for the CEOs of originators. They would have to certify

that the assets and structure backing ABMTNs are sufficient to generate the scheduled payments to investors. Implicit in this requirement is the notion that the CEOs of companies that originated subprime residential mortgages knew or ought to have known that the securities backed by their originated assets could not have possibly paid out in accordance with their terms.

However, even given the litany of failings identified in the wake of the collapse of that market, this is an allegation that would be difficult to prove. It is unreasonable to assume that CEOs of companies engaged in mortgage origination would have the requisite expertise to credibly ratify the conclusions of rating agencies. As a basis for investor confidence, such an assumption is even more flawed than the rating agency reliance it purports to supplement if not replace.

Perhaps the proposal’s real value is as the basis for recourse in the event of any defaults, effectively withdrawing the non-recourse feature of asset-backed funding that forms the basis for the incremental credit capacity purportedly created by ABS structures. If so, the SEC’s proposed CEO certification may have the undesired effect of precluding the incremental debt capacity that forms the most essential policy rationale for the re-launch of the ABMTN market.

The SEC proposals also would require independent auditor certification in cases where a trustee has asserted a breach of covenant or asset-eligibility representation and warranty that would trigger an originator repurchase obligation. The intent of this provision is to sharpen the originator accountability for asset eligibility that already exists pursuant to the representations and warranties to which the new requirement pertains. Fundamental to the performance of ABMTNs is the expectation that the assets underlying the issue are in every way representative of those tested in the modeling conducted by the rating agencies and described in the relevant offering document. Issuers and originators are required to represent that this is so, further requiring that if it is found to be not so with respect to any asset backing the

ABMTNs, the originator will be required to buy back the asset at the value at which it was purchased by the issuer, regardless of its market value at the time of repurchase.

The new rule proposed by the SEC would create a requirement for early third-party verification to resolve disputes between trustees and originators with respect to the breach of such representations and warranties. This proposed measure reflects the realization that verifying such breaches only after a default is often of marginal benefit. Given the correlation between the solvency of originators and the credit standing of the assets that they have originated, it will often be the case that recovery for a breach is impossible once a default has occurred. Therefore, enforcing the repurchase obligation at the earliest suspicion is desirable.

Nonetheless, the proposed provision only adds a procedural expediency to a legal right that already exists. Where a trustee suspects the breach of an eligibility representation, it has both the right and obligation to pursue the remedy of specific performance of the repurchase obligation. The effect of the proposed SEC rule is only to mandate compulsory arbitration of such disputes through an independent audit.

While this procedural efficiency is not without value, the far greater impediment to assertion of such rights is the ability of trustees to identify such breaches. One would assume that upon the establishment of this mandated right to audit, trustees would be effectively obliged to require eligibility audits with respect to any assets that are reported as defaulted (or perhaps even only delinquent) to ensure the best available protection for investors. Such a practice would be a costly one, as in the context of most asset classes, at least some assets are noted as delinquent or defaulted every month. Given this reality, it would make

more sense to address the risks relating to asset eligibility by requiring third-party audits as a condition of closing a purchase rather than as an ongoing right.

(b) **“Skin in the Game”**: Notwithstanding some marginal benefits, the new certification requirements are little more than window dressing. Instead, the heart of the self-regulating elements in the SEC proposals lies in the requirement for “skin in the game.” For more than two decades, the market has presumed that ABMTN investors were protected by the vigilance of rating agencies. The SEC proposals themselves are an indictment of that presumption. Investors, in the estimation of the SEC, delegated an unhealthy level of the credit assessment function to these utilities. The new transparency requirements reflect the expectation of a greater degree of self-reliance on the part of even senior investors.<sup>6</sup>

ABMTN structures and the resulting securities are complex; effective gatekeepers need to be more than qualified and well-intentioned. They must have the visceral and adrenal acuity that is found only when one faces material economic risk based on their own assessment.

In retrospect, more shocking than the 2007 ABS market collapse is how well that market functioned over the preceding 20 years. While the market may have relied upon public ratings for the imprimatur of liquidity, the true gatekeepers of creditworthiness were not the rating agencies. For every asset class, there existed a specialized group of investors that brought an “at-risk” discipline to the asset composition, structure and monitoring of ABS issues.

The gatekeepers for ABMTN issues were investors in investment-grade mezzanine tranches backed by the same portfolios supporting senior

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6 The SEC’s review of the role of the rating agencies in the collapse of the US subprime residential MBS market that precipitated the credit crisis has identified issues with respect to the transparency of rating methodologies and potential conflicts of interest and the SEC has offered practical proposals for reform. However, the SEC did not find systemic fraud, negligence or even incompetence on the part of the rating agencies.



tranches of AAA ABS.<sup>7</sup> These “mezz” investors had specific expertise and experience with both the underlying assets and the structures created to securitize the risks. They made their purchases on the basis of a thorough credit review equivalent to that conducted by rating agencies, but with the added rigour of true exposure to risk of loss. As these mezz investors became more successful and the risk-adjusted returns became known to the market, the search for yield brought third party investors to funds under the management of these experts.

While this development seemed a great opportunity for both the managers and a yield-hungry investor market, the devil was in the details. One needed to look no further than the compensation structure. Managers invariably received fees based on both assets under management and performance. They were thus incented to do two things: maximize the size of the fund and defer recognition of losses that would undermine reported performance. In time, the dilution of the mezzanine debt holders’ gatekeeping function became even more insidious, as mezz pieces were restructured into tranching funds that in turn relied upon the liquidity of AAA tranches to feed growth. In effect, the real gatekeepers came to hand off large portions of their role to the nominal gatekeepers, the rating agencies. There was, in the parlance of the Wizard of Oz, no man behind the curtain.

The SEC proposals seek to restore vitality to the gatekeeping function. Sponsors seeking to avail themselves of the benefits of shelf offering would be required to retain a minimum of a 5 percent slice of the securities offered in any ABMTN issue. Note that the requirement is not to hold a five percent exposure junior to the offered securities, but rather that the sponsor hold that percentage of each class of securities that are the subject of the shelf offering.

Under a typical ABS structure, the originator holds a non-offered first-loss position equal to

roughly 10 percent of the book value of the underlying assets. A second loss position is created and offered in the form of a high-investment-grade rated mezzanine tranche of roughly 5 percent, which is the amount required to qualify the remaining senior tranche as an AAA security. In the context of this typical example, the SEC requirements would leave the sponsor holding a mezzanine tranche representing only 0.25 percent of the total book value of the underlying assets, a portion of junior risk that would likely be smaller in dollar value than the total fees available to the sponsor for distribution or other functional roles that it might play in the transaction.

The requirement of a vertical slice rather than a subordinate position is clearly intended to address an alignment-of-interest risk that can arise in structured credit offerings. If the sponsor’s position is entirely subordinate to that of the senior creditors and that sponsor plays an ongoing monitoring or reporting role, there exists the potential for the sponsor to be influenced by considerations contrary to those of the senior investors. This is particularly true when there is a risk of significant losses on the underlying portfolio. When events develop that could result in losses to the junior tranche but not the senior tranche, the holder of the junior tranche might be motivated to see the portfolio serviced in a fashion that allowed delinquent obligors more time and opportunity to work their way out of delinquency, even if that meant putting at risk the recovery available from collateral seizure and sale. The holder of the junior tranche has nothing to fear from intensifying the size of the potential loss from default because even a small loss would wipe out its position. Senior lenders, on the other hand, are motivated to reduce, not eliminate, losses, since their positions are protected by the first-loss exposure held by the originators and the second-loss position held by the holders of the mezzanine ABMTNs.

<sup>7</sup> In the context of ABCP funded programs, banks providing liquidity were the source of this credit control, reflecting the ultimate loss accountability imposed by global style liquidity, in the context of conduits outside of Canada, and the soft hammer of reputational risk, in the case of Canadian conduits and their former “market disruption only” liquidity lines. Of course, the Canadian conduit market has now fully converted to global style liquidity, with broad availability terms that ensure that in any reasonable scenario of potential loss, the liquidity provider, not the ABCP holder, would bear the risk.

This sort of conflict became a source of contention with some collateral debt obligations (CDO) leading up to and during the market meltdown in cases where CDO managers had asset management discretion on behalf of senior investors with respect to portfolios in which they also held a subordinate interest, either directly as the holder of a junior securities issued as part of a mezzanine tranche or indirectly through the right to performance fees related to the levels of reported defaults and losses in the underlying portfolio. The requirement for sponsors to hold a vertical slice prevents this misalignment of interests, but at the expense of meaningful loss exposure on the part of the sponsor. There is instead a more direct way to address this potential conflict between senior investors and those providing monitoring and discretionary management. First, anyone who retains management responsibility on behalf of an investor class should be prohibited from holding any subordinate interest in the portfolio. Secondly, the calculation and payment of any performance fees to discretionary service providers based on defaults and losses should be required to be deferred until after the maturity of the relevant senior notes. Once freed of the risks associated with this misalignment of interest, the question of the quantity and form of skin in the game can be addressed on the merits of the focus that it can bring to the application of judgment in the selection, monitoring and management of the portfolio.

That leaves two questions; how much subordinate risk retention is necessary to augment the new transparency to ensure that a broad class of senior investors can return to the ABMTN market without undue reliance on rating agency risk assessments and who should hold that risk? Addressing the second question first, the most obvious candidate is the originator. In most asset classes other than CMBS, originators already bear the expected loss risk with respect to their

portfolios through the retention of a first-loss exposure. This makes obvious sense; no one should be buying any ABMTNs backed by assets for which the originator is not the party best able to estimate and manage the expected loss. However, originators will too often underestimate the probability and impact of unexpected systemic loss in their business. Truth is, individuals that are cautious analysts of systemic risk are poorly suited to the leaps of faith required of business operators.

The essential gatekeeper is the mezzanine investor who has the requisite level of specific asset class and structural expertise to determine a level of first-loss protection that can deliver an investment grade ABMTN. Buyers of instruments bearing such mezzanine risk do not rely upon rating agency assessments in this credit determination. As mentioned above, the primary objective in obtaining ratings for such instruments is to support secondary market liquidity. However, it is the rating agency that determines the size of the mezzanine piece that is required to support the issue of senior AAA ABMTNs. The mezzanine investor will seek to maximize the leverage on its returns by minimizing the size of the tranche. Still, under the present regime, it is only the discipline of the rating agency that pushes back to ensure that senior investors are properly protected.

Policymakers can shift the intricacies of the tranche thickness negotiation away from a mezz investor-rating agency dynamic to one involving the mezz investor and the first-loss provider (who is likely the originator). They can achieve this goal by requiring the placement of a mezzanine tranche of a specified minimum size (referred to as “tranche thickness”) with an arms-length third party as a condition for senior ABMTNs accessing public markets.<sup>8</sup> The logic is straightforward. If the regulated minimum mezzanine tranche thickness is conservatively set

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<sup>8</sup> To avoid any gaming of the requirement, it would be prudent to require the third party to certify its independence and to provide a representation that it is not receiving any financing for the purchase from any party not at arms length with the originator and that there are no put rights available to it with respect to the security.

at a level larger than that which would be required to enhance the creditworthiness of a bare investment-grade portfolio (say BBB rated), then the risk is only that the AAA tranche would be over-enhanced.<sup>9</sup> If, for example, the minimum mezz tranche thickness was 5 percent and the rating agency determined that only 3.5 percent above the first-loss protection level was required to support a AAA rating, senior ABS investors would be overprotected. However, since such over-enhancement would negatively impact the efficiency of ABS funding for asset originators, it would be incumbent upon the mezz provider and the issuer to offer the mezz tranche at a spread that reflected the 30 percent of the mezz tranche that was, in the rating agency's view, AAA risk. It would be the mezz holder, equipped with the expertise and experience to confirm and price this risk, and not the senior ABMTN holder, who would be left to assess the reliability of the rating agency view as reflected in the offered spread on the mezz tranche.

## Unique Canadian Considerations for ABS Market Reform

With new requirements for the placement of minimum sized mezzanine tranches with third party investors, a new basis for broad participation in the senior ABMTN market would be established. In the context of the SEC proposals, the proposed regulatory reforms are anticipated to be introduced as conditions for accessing shelf issuance. While the timing advantages of accessing the shelf offering system are considerable, it may be unwise to ignore the possibility of issuers seeking to obviate the reforms simply by sticking with the more arduous requirements of long form issuance. This is particularly relevant in the context of the Canadian market, where the lower frequency of issuance and the more arduous distribution process already offset some of the timing advantages otherwise available through shelf offering. In the

Canadian context at least, it would seem prudent to impose new requirements for ABMTN issuance as conditions of accessing the public market altogether, not just shelf offering.

There are other unique aspects of the Canadian market that must be considered. Market disruption liquidity supporting the ABCP market was not the only unique feature of Canadian ABS funding. The Canadian debt market has long struggled with its capacity to support the funding of monthly-pay amortizing assets. In the earliest days of the Canadian ABS market, during the early 1990s, vehicle and equipment leases and loans were the asset class most often brought to the ABMTN market. These monthly-pay amortizing assets generated a monthly cash flow that blended payments of principal and interest.

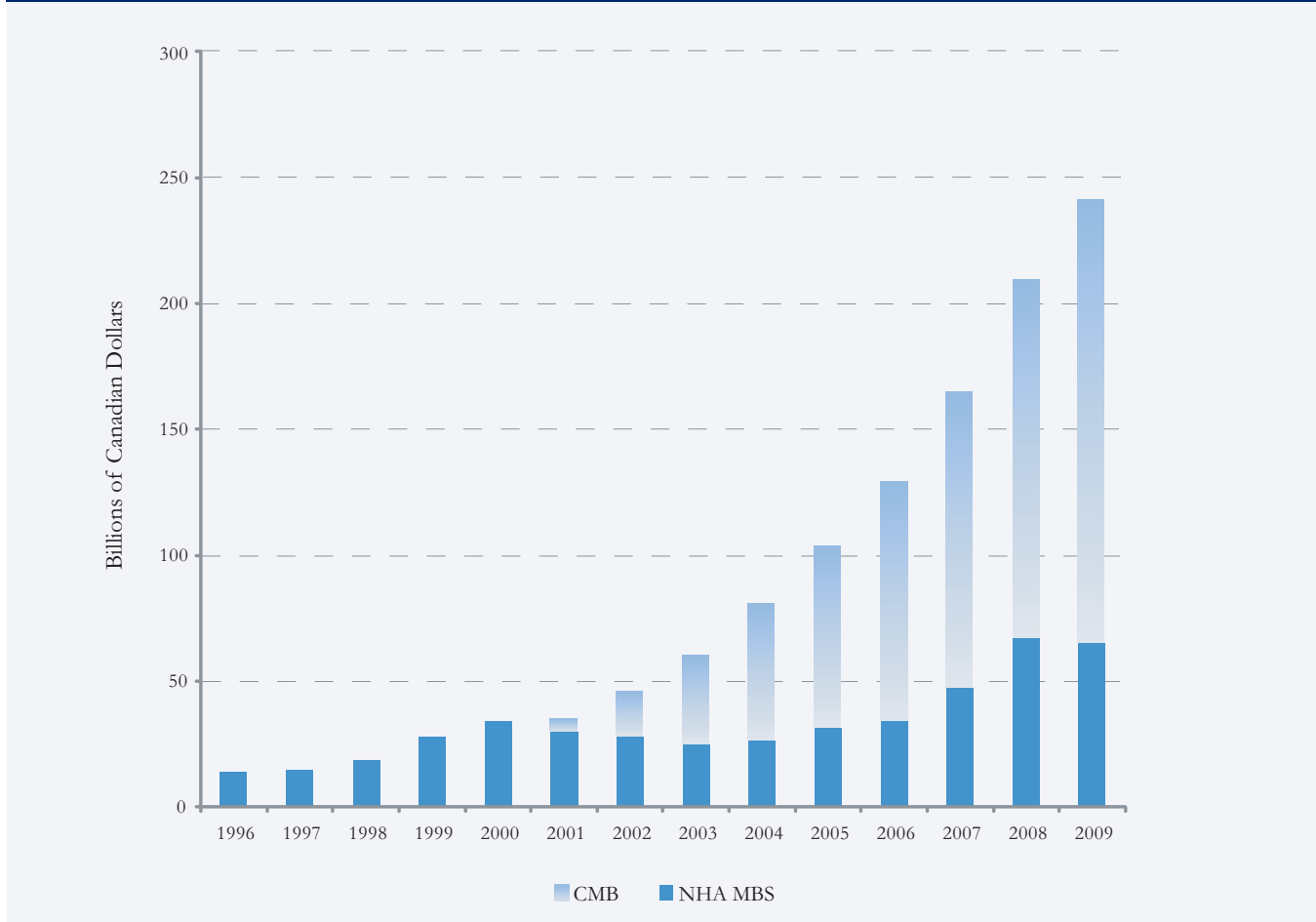
In the case of loans, the asset amortized to zero over the term of the securitized loan agreement. In the case of leases, the asset amortized to a specified residual value and either required a balloon payment from the lessee at maturity (in the case of an open-end lease) or sale by the lessor and application of the proceeds to the remaining financed cost of the underlying asset (in the case of a closed-end lease).

Further along that spectrum was the residential mortgage market, where the assets also provide a monthly stream of blended payments of principal and interest, but with an even greater balloon payment required at maturity. Even further along that spectrum are commercial mortgages, where the monthly payments are usually blended payments of interest and principal (but can sometimes be interest only) but with even larger balloon payments required at maturity.

In the US ABMTN market, these monthly-pay amortizing assets were generally funded with the issue of pass-through securities. Pass-through ABMTNs have no specified monthly payments but instead simply pass through to each investor a pro rata share of the principal and interest paid by the various underlying borrowers, lessees or

<sup>9</sup> The minimum mezz tranche thicknesses would probably have to be set on an asset class-by-asset class basis reflecting the amount of additional intervening loss protection required to enhance a BBB portfolio of assets from that asset class to a AAA standard. There may even have to be sub-categorizations within asset classes to reflect portfolios with different characteristics (prime vs. non-prime, large ticket vs. small ticket, etc.) to minimize the degree of funding inefficiency and the resulting scope of price negotiation between originator and mezz investor.

**Figure 9 - National Housing Act Mortgage-Backed Securities and Canada Mortgage Bonds Outstanding Guaranteed by CMHC**



Note: Amounts outstanding reflect the amount of outstanding guarantees in force for CMHC securitization. The NHA MBS figures are net of purchases under the Insured Mortgage Purchase Program.  
 Source: CMHC Annual Reports.

mortgagees. The ABMTN investors thereby assume the slow-pay risk associated with delinquencies and the fast-pay risk associated with prepayments, providing perfect asset-liability matching for the originators.

From the Canadian ABMTN market's beginnings in the early 1990s, this sort of match funding proved to be a challenge. The appetite for true pass-throughs was limited, and the spread concession required for placement was considerable. The earliest originators, who were generally the Canadian subsidiaries of investment-grade US originators with experience as ABMTN issuers in the United States, were unimpressed with this limitation of the Canadian market. The disinclination of Canadian fixed income investors to pass-through securities was generally attributed to a combination of laziness and a lack of

sophistication on the part of Canadian fixed-income investors.

There was some basis for that impression. Most of the early ABMTN investors came to the product reluctantly only when regular government bond issuance slowed dramatically with the deficit reductions of the 1990s. The cash management regimes and reinvestment schedules for most Canadian fixed income investors were entirely built around government and high-grade corporate issuance of securities that paid interest semi-annually and repaid principal as a bullet at maturity.

However, the habitual passivity of Canadian fixed-income investors was not entirely to blame for the relatively small Canadian market. The reality was that for all but the largest investors, the small monthly distributions from monthly-pay

pass-through ABMTN issues were too small to efficiently reinvest in the month received. Most often, several months of periodic distributions needed to be accumulated to be reinvested at anything approaching the yield on the ABMTN issue from which it was generated.

Accordingly, investors in pass-through ABMTNs had to absorb or otherwise offset a significant amount of reinvestment inefficiency that made even the complexity premiums from such issues uncompetitive with more mundane semi-annual-pay investment opportunities. This was not the case in the United States, where smaller investors generally had portfolios that were, reflecting the population and GDP differences between the two countries, at least 10 times larger. These investors could, accordingly, reinvest the proceeds of their pass-through ABMTNs book without the same risk of inefficient reinvestment.

The contrasting market depth for semi-annual pay bullet ABMTNs over monthly-pay pass-throughs became clear in 1999 when Canadian Schedule 1 banks became frequent issuers of bullets to fund their credit card portfolios.<sup>10</sup> Overnight, markets that strained to accommodate \$300 million in single monthly-pay pass-through ABMTN issues backed by vehicle and equipment leases and loans were suddenly capable of absorbing \$1 billion-plus of semi-annual pay bullet bonds backed by credit card receivables (see Figure 7). While it is true that some of the enhanced appetite for these bullet bonds reflected the market preference for Canadian Schedule 1 banks as originators and servicers of assets backing ABS issues, there was no doubt that the funding format contributed the bulk of the incremental demand.

The reality that this experience forced on the ABMTN market was most notably conceded in the introduction by Canada Mortgage and Housing Corporation (CMHC) of the semi-annual bullet bond Canada Mortgage Bond

program in June 2001. The program was an immediate hit with both Canadian and offshore investors, providing an effective cost of funds to mortgage originators that eclipsed every other available source of financing for insured mortgages, including CMHC's monthly-pay pass-through funding structure, the National Housing Act Mortgage-Backed Securities program. Figure 9 shows the dramatic impact of this new program on issuance volumes for CMHC-sponsored mortgage programs.

With the Canada Mortgage Bond program, the die was seemingly cast for the Canadian ABMTN market. The most prolific source of monthly-pay amortizing assets, the pool of insured residential mortgages, was cast into a semi-annual pay bullet funding format. Whatever potential there might have been to generate the transaction flow required to develop liquidity for pass-through ABMTNs in other asset classes disappeared. Bullet bonds became the only viable funding format for Canadian ABMTNs.

Originators in other monthly-pay amortizing asset classes quickly adapted to this reality. New structures were created to fund monthly-pay vehicle and equipment leases and loans. Bullet ABMTNs were carved out of the monthly-pay amortizing cash flows. Monthly payments and prepayments were absorbed by an amortizing tranche that was in turn funded through Canadian commercial paper conduits that had the capability to adjust their funding to reflect the monthly principal payments.

When the time came for retirement of the issued bullets, funds would be raised by the conduit holding the amortizing note (usually called a variable funding note or a variable payment note) to provide the required principal repayment. The only technical limitation was the inability of the conduit to provide a forward commitment to re-advance to retire the bullets. However, this limitation proved to be of little

<sup>10</sup> Credit card portfolios are short-term receivables that are structured to finance a revolving portfolio of receivables for a specified term. "Bullet" bonds are issued to finance the portfolio. These bullet bonds use the yield on the card portfolio to fund a semi-annual interest payment on the issued bullet ABMTNs and accumulate principal repayments in the few months prior to the maturity of the ABMTN to fund the repayment of the face amount of the ABMTN at maturity.

consequence, as both issuers and investors accepted the risk of the ABCP market illiquidity. In an era of exponential ABCP growth (see Figure 6), neither rating agencies nor investors saw this risk as sufficiently material to preclude issuing AAA-bullet ABMTNs.

The assumptions supporting this successful structure held true until the summer of 2007. In August 2007, following the crash of the non-bank ABCP market, bank-sponsored conduits were challenged to roll over their outstanding balances; they were in no position to issue additional ABCP to fund maturing ABMTN bullets. Several bullets defaulted, and the structure that had permitted non-mortgage monthly-pay asset originators to access bullet ABMTN funding ceased to be viable. No matter how quickly or robustly the ABCP market recovered, the assumptions that had made that funding structure viable would never be accepted again.

When liquidity haltingly returned to the Canadian vehicle and equipment retail lease and loan-backed ABMTN market with the encouragement of the CSCF program, it did so in the form of monthly-pay pass-through securities. So far, the market reception has been encouraging. Table 1 shows the Canadian transactions that have been completed since the market crash without resort to CSCF funding through BDC that have funded monthly-pay assets with pass-through notes.

However, the market limitations described above with respect to the single issue and total market capacity issues for monthly-pay pass-through ABMTNs cannot be presumed to have been solved in the wake of the market collapse. It remains to be seen whether the Canadian fixed-income market will prove to have sufficient liquidity to meet the needs of the recovering vehicle and equipment receivable origination market. The total market capacity requirements are even more acute given the shrinkage of the Canadian bank-sponsored conduit market from \$80 billion in the summer of 2007 to just under \$30 billion today. This contraction reflects a dramatic reduction in origination rates for vehicle and equipment leases and loans as consumers and

businesses sharply curtailed borrowing in the wake of the recession.

However, it would be imprudent to assume that conduit capacity will rebound to pre-crisis levels with a resumption of demand from consumer and commercial borrowers. The appetite of Canadian Schedule 1 banks for large conduit holdings, now that they are required to backstop these conduits with more capital-intensive global-style liquidity, will be more modest than it had been when such programs were backed by “market disruption-only” lines. For the monthly-pay pass-through ABMTN market to meet demand, it must demonstrate sufficient liquidity to accommodate not only the return of traditional ABMTN issuers but also the issuance needs of monthly-pay asset originators who have been squeezed out of the conduit market.

As the economic recovery continues, demand for consumer and commercial credit should be hoped or expected to ramp up to pre-crisis levels, challenging the capacity of the Canadian ABMTN market. The continuing re-emergence of this market, backed by monthly-pay amortizing assets, should be closely monitored. If the market capacity for monthly-pay pass-through notes is not sufficient to meet that demand, intervention to stretch that capacity may be needed. In those circumstances, one potential public policy approach would be to consider de-emphasizing the successful Canada Mortgage Bond program with a view to encouraging more funding through the monthly-pay pass-through National Housing Act Mortgage-Backed Securities program. In redirecting the insured mortgage market, the largest source of monthly pay amortizing assets, back toward this funding format, it is possible that the resulting incremental issuance volumes (and corresponding monthly cash flows to investors) could offset the issues with reinvestment efficiencies that have historically discouraged the participation by smaller Canadian investors in the pass-through ABMTN market and thereby encourage a significant increase in market capacity.

Market capacity for monthly pay pass-through securities is already being tested. Since October 2009, six offerings of conventional monthly-pay pass-through National Housing Act Mortgage-

Table 1 Overview of Recent Non-CSCF Asset-Backed Medium Term Notes Transactions

Issuance Date	Asset Class	Originator	Amount (Millions)	Public /Private	Type
April-09	Auto Receivables	Ford	\$600	Private	Pass-through
June-09	Auto Receivables	Ford	USD\$1,300	Private	Pass-through
June-09	Auto Receivables	Ford	\$597	Public	Pass-through
Aug-09	Auto Receivables	Ford	\$1,000	Private	Pass-through
Sept-09	Auto Receivables	Ford	\$950	Private	Pass-through
Sept-09	Auto Receivables	BMW	\$300	Private	Pass-through
Jan-10	Auto Receivables	Ford	\$518	Public	Pass-through
Feb-10	Auto Receivables	GMAC	\$694	Public	Pass-through
April-10	Auto Receivables	Ford	\$270	Private	Pass-through
May-10	Floorplan loans	Ford	\$355	Public	Bullet
May-10	Credit Cards	RBC	\$1,283	Public	Bullet
May-10	Credit Cards	CIBC	\$1,152	Public	Bullet
July-10	Credit Cards	National Bank	\$587	Public	Bullet
July-10	Floorplan loans	Ford	\$120	Private	Bullet
August-10	Credit Cards	CIBC	\$647	Public	Bullet
Sept-10	Auto Receivables	Ford	\$669	Public	Pass-through

Sources: DBRS, SEDAR and authors' calculations.

Backed Securities have been issued by Canadian Schedule 1 banks. While these new offerings could be interpreted as evidence of growing market capacity, their pricing suggests otherwise. The most recent of those issues was executed at a spread above the then-equivalent-duration Government of Canada bond yield that would have replicated the economics of purchasing a five-year bullet Canada Mortgage Bond program bond even if the investor generated no yield on the periodic principal repayments received. These are not economics that are indicative of a growing receptivity to pass-through securities, at least not in the context of insured residential mortgage-backed issues.

On the basis of this historical and more recent experience, it is reasonable to conclude that a dramatic recalibration of CMHC's funding programs would likely be disruptive to the Canadian residential mortgage market.

Accordingly, should intervention to restore liquidity for Canadian monthly-pay amortizing assets be deemed necessary, other policy prescriptions should be considered. If the lack of liquidity is believed to be a function of the capacity limits of the market for monthly-pay pass-through ABMTNs, intervention to permit the funding of non-mortgage monthly-pay amortizing assets with semi-annual-pay bullet bonds should be undertaken. A government-sponsored entity or Crown corporation (BDC, perhaps) might be required to provide funding commitments to hold the variable funding notes that were formerly financed through Canadian ABCP conduits.

The structure of these bullet-bond funding programs could follow the pre-crisis templates, with one exception. The ability to draw down funds under the variable funding notes from the government funding entity would have to be on a

committed basis to satisfy the needs of the private holders of bullet-bond tranches. While this would represent a significant government funding commitment for the ABS market, it would otherwise maximize private ABMTN capacity and still fall well short of the fully government-guaranteed Canada Mortgage Bond model already used in funding the Canadian residential mortgage market.

## Conclusion

The credit crisis from which we are now emerging provided ample evidence of the pervasiveness of the ABS market in financing consumer and commercial credit around the world. While tempting to consider, stuffing the ABS genie back into the bottle offers no short or long term benefit to the global economy. North American policymakers have already recognized this reality and quickly put in place programs to accelerate the re-start of this critical market.

However, the credit crisis exposed the risk of systemic liquidity failures based on temporary catastrophic losses of confidence in rating agencies. In response, regulators are demanding that the ABS market demonstrate resiliency based on credit ratification derived from more than just ratings.

To date, the emphasis in reform proposals has been upon greater self-reliance by investors, supported by sharply elevated expectations of transparency. These transparency requirements carry with them expectations of a breadth of capacity and expertise that only the largest and most sophisticated senior investors can satisfy. If senior ABS market capacity is to be maximized, a regulatory approach mandating the participation of alternative market gatekeepers in addition to, or in place of, transparency may need to be considered.

The introduction of policy initiatives that require and encourage the participation of mezzanine investors in ABMTN structures would ensure that private market participants that face material economic risks perform this crucial gatekeeper function. At the same time, close monitoring of the adequacy of the market appetite for monthly-pay pass-through ABMTNs should be maintained. Should market capacity appear to be constraining origination activity, further market intervention may be necessary to encourage adequate liquidity for Canadian originators of non-residential mortgage monthly-pay amortizing assets, including particularly vehicle and equipment loans and leases.



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