The Asset Backed Commercial Paper market in Canada

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There has been significant media coverage paid to the consequences of investing in Asset Backed Commercial Paper (ABCP) in Canada. This note is intended to clarify some of the misconceptions surrounding this money market asset class, and explain the differences between the category which ran into trouble and one which continues to perform without problems, all with a particular focus on how the suite of RBC money market funds approached this issue. Included is a description of what ABCP really is and an explanation of the essence of what is happening in the market.

A brief history:

The ABCP market was introduced to Canadian investors in the late 1980s, and took on prominence in the mid 1990s as a series of events allowed this asset class to grow. ABCP is a structured asset that involves setting up a "special purpose vehicle" or trust, which in turn buys various assets that produce income streams. Such investments may include mortgages, home equity loans, auto loans, trade receivables and so forth. ABCP differs from regular commercial paper in that it is not a legal obligation or loan of a single corporate issuer, but rather a pool of assets that produce income. The trust (otherwise known as a conduit) funds the purchase of these various assets by issuing commercial paper, hence the name Asset Backed Commercial Paper.

Most of the early growth in this asset class was enjoyed by the Canadian banks, who sold various assets off their balance sheets into these arms length conduits. The benefits of doing this were numerous, including releasing capital for higher margin businesses, rebalancing their balance sheets if they considered they had too much of one particular asset class, and creating a new and profitable business by encouraging their corporate clients to sell their receivables (and other assets) into the banks' conduits for a fee. Of course, it also helped that there was investor demand for this paper as it enjoyed top ratings, was liquid, and offered higher yields than most other money market assets.

The advent of third party ABCP:

Eventually, the success of this asset class attracted new players into the market. These "third party" institutions solicited assets from various sources into their own proprietary conduits and competed against the banks' conduits. By 2005, the success of this asset class was so evident that the assets underlying these conduits started running out. With investors still lining up to buy this paper, a new source of income producing asset was needed to meet the demand for ABCP. This was accomplished by creating conduits populated with derivatives that paid out an income (but were also highly leveraged), held offshore loans such as U.S. sub-prime residential mortgages, and exotic assets such as collateralized debt obligations (CDOs), credit default swaps and other instruments. For about two years, these new conduits (technically called structured finance conduits) traded like the older, more established conduits, attracting increasingly more buyers seduced by the fact that they held ratings equivalent to government paper, were highly liquid, and were treated exactly like the more solid bank-sponsored conduits which continued to hold only real, measurable, and identifiable assets. Up to this point, the bank sponsored and non-bank sponsored trusts were held in equal esteem by both buyers and distributors.

The Meltdown:

In August 2007 investors became aware that the growing trouble coming out of the U.S. sub-prime market was washing onto Canadian shores through these non-bank sponsored conduits. With the largest of these sponsors, Coventree, admitting to holding "some" sub prime paper, the market for non-bank paper seized up and with no ability to roll over maturities (in essence losing the funding for these conduits) the third party sponsors were forced to ask the banks that were to provide liquidity support to step in and help. Some banks refused, which brought us to the current issues in the market.

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The biggest distinction to understand is that the bank sponsored conduits never failed to fund their operations. Buyers of this paper, including RBC money market funds, understood that the banks had reputational risk in this business, and would be highly unlikely to step aside should a liquidity event impact one of their conduits. The third party sponsors, however, didn't have either the deep pockets to support their conduits, or any particular reputational risk to worry about. Their liquidity protection was subcontracted out to (mostly) foreign banks, some of whom used a legal loophole to avoid having to provide liquidity. Further, the information that we demanded of potential conduit providers was woefully inadequate from the third party sponsors. Accordingly, the lack of proper and transparent information coupled with the fact that we believed liquidity was never truly there, led us to conclude one thing; **we could never invest in the non-bank conduits**.

Today the media is filled with stories about investors ranging from governments to corporations to pension funds holding non-bank sponsored ABCP, which is frozen for the time being as a consortium organized to find a way out of the mess works on a solution. Most of the underlying assets continue to perform, but because there is a serious lack of transparency in what the assets really are, and what they're worth, the valuation of these conduits is highly problematic. Consequently, holders of this paper are using different assumptions and writing-off their investments by varying amounts. The RBC money market funds don't have this problem because all their ABCP holdings are of the bank sponsored variety, which have solid liquidity backstops, have absolutely no exposure to sub-prime loans, and continue to be populated by assets that are measurable, identifiable and easy to understand.

RBC Money Market Funds – key points related to holdings

Below are some key points to remember about the holdings of all RBC money market funds in light of all the news around Asset Backed Commercial Paper.

- All RBC money market funds invest in high-quality, short-term (< 1 year term to maturity) securities.
- All RBC money market funds invest in securities rated a minimum R-1 (Low) or higher as rated by Dominion Bond Rating Service* (DBRS). The rating scale ranges from R1 (the highest credit quality) to R5 (highly speculative).
- ***None** of the RBC money market funds has had exposure to the non-bank sponsored ABCP*, the type of ABCP that continues to make the headlines
- All Asset Backed Commercial Paper (ABCP) holdings are of the bank sponsored variety with:
  –Global liquidity backstops
  –High degree of disclosure about underlying assets

* Or other accredited ratings agencies