



Backgrounder

OSFI's Role in the ABCP Market Issue

Introduction

There have been a lot of statements made in news reports and elsewhere surrounding the role of the Office of the Superintendent of Financial Institutions (OSFI) in the Asset-Backed Commercial Paper (ABCP) market issue. OSFI has prepared this backgrounder to help clarify the factors related to the non-bank ABCP market and OSFI's role in relation to it.

OSFI's Mandate

OSFI is the primary regulator and supervisor of banks, federally registered trust and loan companies, insurance companies, and private pension plans. We monitor and examine these for solvency, liquidity, safety and soundness. There are about 450 financial institutions and nearly 1400 private pension plans that fall under our authority.

Under the *OSFI Act*, OSFI's mandate is to:

1. Supervise federally regulated financial institutions and private pension plans to determine whether they are in sound financial condition and meeting minimum plan funding requirements respectively, and are complying with their governing law and supervisory requirements;
2. Promptly advise institutions and plans in the event there are material deficiencies and take, or require management, boards or plan administrators to take, necessary corrective measures expeditiously;
3. Advance and administer a regulatory framework that promotes the adoption of policies and procedures designed to control and manage risk;

4. Monitor and evaluate system-wide or sectoral issues that may impact institutions negatively.

The *OSFI Act* notes that in pursuing its objects, the Office shall strive to protect the rights and interests of depositors, policyholders and creditors of financial institutions, having due regard to the need to allow financial institutions to compete effectively and take reasonable risks.

This means that for banks, OSFI's primary job is to protect the interests of depositors. In other words, when Canadians deposit money into their bank accounts, they expect that the money will be safe, secure and available when they need access to it.

Non-Bank ABCP

OSFI does not oversee the firms that created the non-bank ABCP. These firms are not subject to OSFI guidelines, such as OSFI guideline B-5. Guideline B-5 also does not apply to the offshore banks that negotiated the bulk¹ of the liquidity lines to non-bank ABCP conduits.

The firms that created the non-bank ABCP, like any firm offering securities to the public, have to abide by securities rules administered by provincial securities commissions (banks issuing ABCP to investors also must abide by securities rules).

OSFI's Capital Rules

Banks hold capital as a reserve for unexpected losses. OSFI's capital rules are developed for Canadian banks, and are designed to reduce the risk that banks will fail by insisting they be well capitalized. This is very important since banks hold the life savings of Canadians.

Because banking is global, and Canadian banks compete internationally, OSFI sets bank capital rules in tandem with other global regulators, via the international Basel Committee on Banking Supervision.

In 1988 -- 20 years ago -- the first international capital agreement (Basel I) was reached. As part of that agreement, all lending commitments of a duration of less than one year carried a zero capital charge (i.e. banks did not need to set aside capital for those commitments). The thinking was that

¹ Close to 90 per cent of the banks that these non-bank entities were dealing with were offshore foreign banks and the rules under which they operate are not set by OSFI.

short-term obligations are less risky than long-term obligations².

After the Basel I agreement was struck, securitization started to grow rapidly and OSFI became concerned about increasing risk to the banking sector. OSFI was especially concerned about the fact that no capital was being held for some types of liquidity lines, under which banks would lend to conduits with deteriorating asset quality or buy problem assets from the conduit. These liquidity lines, known as “global style lines”, would ensure that if the cash flow to investors was impaired for virtually any reason, the bank would provide cash to the conduit so that investors would be paid. OSFI took the position, as it does for all credit risk, that capital was needed to back the risk. This was at a time when other regulators still had no capital charges for liquidity lines under the 1988 Basel 1 Accord.

OSFI also took the position that it would only continue to support a zero capital charge if the liquidity line was for pure liquidity purposes. Such liquidity lines already existed. A pure liquidity line, subsequently known as a “general market disruption” line, was considered to be a line that could only be drawn if the entire market was subject to an event that caused problems to the normal functioning of all conduits and thus prevented rollovers (i.e. investors could not buy asset backed commercial paper, even though they might want to do so, signifying that asset quality was not the source of the disruption). It was thought that such a disruption might include a 9/11-type event.

OSFI also told the Canadian banks that it would recommend to the Basel Committee an increase in capital required for liquidity lines that posed a risk to the banks. These discussions led to our international colleagues agreeing that a zero capital charge was inappropriate for comprehensive global style lending commitments where banks were taking on significant credit risk. They also agreed that “general market disruption” was a way to describe pure liquidity lines, and that only these pure liquidity lines should carry a zero capital charge. These words were adopted in the Basel II Accord, drafts of which were released for comment many years ago, with implementation scheduled in many countries beginning in 2007.

OSFI Guideline B-5

Guideline B-5 is the name of the Canadian capital guideline that set out the above-noted capital charges for loans by Canadian banks to ABCP conduits. As with all our guidelines, B-5 was

² Capital charges generally vary by asset class, with riskier loan classes having higher capital charges.

finalized in Canada via a public consultation process. B-5 was first issued in the early 1990s and permitted a zero percent capital charge for all short term liquidity lines, in line with international agreements. The Canadian bank market grew quickly. The conduits offered by Canadian banks had and continue to have mostly conventional loans. In 2004, OSFI increased the risk weight factor for global lines for these conduits to 10 percent, resulting in a 0.8 percent capital requirement. This recognized the different risks inherent in the two types of liquidity lines that had developed in the industry.

Guideline B-5 was prudent and necessary in order to set appropriate capital requirements for Canadian banks. It also set out other important requirements, such as the need for banks to identify their role vis-à-vis conduits (which was to the benefit of all players involved in the securitization market) and indicated that banks should not absorb any losses suffered by ABCP vehicles or by investors (which underscored the point that risk was to be transferred away from banks, thereby supporting no need for a capital charge).

Ratings agencies wrote public reports on their views regarding the “limited general market disruption liquidity lines” backing ABCP conduits. OSFI also attended conferences where the differences in liquidity lines were openly discussed. Through all this, OSFI made it clear that it was not dictating what type of lines should be used for conduits -- that was a decision for the conduit creators and investors and ratings agencies to make. OSFI's role was limited to ensuring that, 1) whatever types of loan commitment banks entered into, appropriate capital would be charged; 2) the roles and responsibilities of Canadian banks were clear.

Growth of the ABCP Market

Banks around the world were active participants in the ABCP market and set up conduits that held loans that the banks originated themselves (therefore, they knew the quality of those loans). They also set up conduits that held loans generated by others (while banks would not have originated the loans in the latter case, they would have had processes to verify the quality of the assets). Most Canadian banks typically only had in place general market disruption lines for their ABCP conduits in Canada. At least one large Canadian bank changed that practice some time ago and established only global style lines to its Canadian conduits. All the major Canadian banks had in place only global style lines for their conduits in the United States, since U.S. investors insisted on global style lines as well as two ratings.

One ratings agency gave top ratings to ABCP conduits with general market disruption lines,

presumably because Canadian ABCP conduits had more "credit enhancement" than seen in international structures (an example of credit enhancement would be the well established practice of having the face value of the assets in the conduits exceed the face value of commercial paper sold to investors so that if some assets went bad, investors would not lose money, assuming the excess value of the assets in the conduit was high enough). Other ratings agencies believed the risks were not balanced, and would not rate the Canadian ABCP.

Meanwhile, some new Canadian (non-bank) firms entered the market and specialized in creating ABCP conduits. These firms found that their product was easily accepted in the Canadian market because they could obtain high ratings for ABCP issued by their conduits, even with general market disruption lines. As well, a number of large sophisticated investors assessed the risks and bought the product in significant amounts, further enhancing its acceptance in the marketplace.

The new firms entering the market chose to opt for general market disruption lines exclusively. This may be because, compared to the cost of global style lines, general market disruption lines were inexpensive. This allowed the firms to put together a package viewed as being attractive -- the inexpensive liquidity lines and high ratings meant that providers of assets (like a car dealership) received a good price for the loans they supplied to the conduits; in return, investors received a higher yield; and the firms themselves made money.

The new Canadian firms that entered the market (which are not overseen by OSFI, but are subject to securities laws) initially copied what the Canadian banks had done. For example, they bought car loans and leases from businesses, as well as mortgage loans, and credit card receivables; and sold ABCP based on those assets. But evidence suggests that some of the new firms began to develop ABCP products that were far more complex than what had previously and typically been found in bank ABCP conduits.

In January 2007, the Dominion Bond Rating Service (DBRS) announced that it was changing its ratings methodology and would no longer give high ratings to the new structures they were seeing, which combined much greater complexity backed by general market disruption liquidity lines.

Given that (1) pure liquidity lines existed in Canada prior to the 2004 revision to Guideline B-5; (2) Guideline B-5 did not apply to the vast majority of participants in the non-bank ABCP market; (3) Canadian banks subject to B-5 had in place a mixture of both global style and general market disruption lines; and (4) European banks had no capital charges for any type of liquidity line they provided to the non-banks, it is clear that Guideline B-5 or any regulatory capital charge did not drive the uniqueness of the Canadian market.

It is clear that general market disruption lines were popular in Canada, in both the bank and non-bank ABCP markets.

While Canadian banks were subject to B-5 in their US operations, they did not use general market disruption lines there. Presumably the frequent (but not exclusive) use of general market disruption lines by bank-sponsored ABCP conduits in Canada reflected the fact that high ratings were possible in Canada even when backed by general market disruption liquidity lines. Historically, these high ratings may have reflected the quality and stability of cash flows associated with the assets in the bank conduits, as well as the credit enhancement in the structures. Although conduits were supposed to be stand-alone vehicles, ratings may have indirectly taken into account the fact that large Canadian banks are regulated by OSFI and are considered to be very strong; indeed, Canadian banks had the financial strength to issue statements in the summer of 2007 indicating that they would back their ABCP conduits.

In comparison, non-banks used general market disruption lines exclusively, presumably reflecting their acceptance by sophisticated investors and, until January 2007, their acceptance by ratings agencies even for very complex ABCP structures. Non-banks may have also have chosen general market disruption lines for cost reasons.

The Role of Foreign Banks

The new firms that entered the market appear to have chosen mainly offshore banks when setting up liquidity lines and when choosing counterparties for complex transactions, such as credit default swap arrangements.

Firms in Canada are free to borrow from any bank in the world, and free to seek out other business dealings with them. Thus, they have access to credit globally, which enhances their choice and ability to compete³. On the other hand, if an offshore bank wants to come to Canada to solicit deposits from Canadians then the *Bank Act* would apply and such offshore banks would be regulated by OSFI. This is because Canadians could be making deposits with such banks and need protection.

³ More recently, it has been reported that Canadian firms have increased their borrowing from Canadian banks relative to offshore banks, given that some offshore banks have experienced significant losses in the global credit market turmoil.

Canadian investors also have protection; it lies with the provincial securities commissions. The securities commissions have rules to protect investors buying securities. ABCP was a security, but because it was structured as a short-term, highly rated debt instrument, it was exempt from Securities Act disclosure requirements⁴.

OSFI Actions to Address the ABCP Issue

When the turmoil in the ABCP markets began in August 2007, OSFI moved to assess the impact on all federally regulated institutions and pension plans. Very few institutions it oversees had material exposure to non-bank ABCP. Private pension plans that OSFI oversees had virtually no exposure (private pension plans are set up by private companies for their employees). Some public pension plans did have material exposure to non-bank ABCP, but these plans are not subject to OSFI oversight.

OSFI and its international counterparts, via the Basel Committee, announced on April 16, 2008, steps being taken to make the banking system even more resilient to financial shocks, including increasing capital requirements for securitization products that are based on complex structured products (called Collateralized Debt Obligations of Asset-Backed Securities), which have produced the majority of losses globally. The Committee also announced it will be enhancing the capital treatment for liquidity facilities to support ABCP. OSFI has recommended, as part of that process, that the zero capital charges for market disruption liquidity lines be removed.

The OSFI recommendation is based on the fact that, since August 2007, Canadian banks have issued statements saying that they will back their ABCP conduits. Hugely beneficial to bank ABCP investors, this action demonstrated that Canadian banks will support their own conduits, even when not legally required to do so. Thus, the risk has not been transferred to investors, therefore challenging the theory that banks could transfer risk to another party, which was an underlying rationale for zero capital charges on liquidity lines to ABCP conduits.

In light of the foregoing, OSFI has recommended that, in the future, there be a capital charge for any liquidity support provided to ABCP conduits and that more work be undertaken by Basel

⁴ Securities Commissions can provide more information on their system of regulation.

Committee members, including Canada, to determine the appropriate capital charges. In the meantime, the 10 percent risk weight OSFI established for global lines in 2004 was increased to 20 percent, as of November 1, 2007, as part of the new Basel 2 framework. Since all liquidity lines offered by Canadian banks are now global style lines, they all carry a capital charge.

OSFI has been very involved in the work of the Financial Stability Forum (FSF) to assess the causes of the turmoil and to formulate recommendations to enhance system resilience. The Superintendent worked with international colleagues to draft the *FSF Report on Enhancing Market and Institutional Resilience*. The report includes over 60 recommendations, which have been accepted by the G-7 Finance ministers, and covers key issues such as capital and liquidity for banks, as well as the need for more transparency in ABCP conduits, and various changes that should be made by ratings agencies.

Moving Forward

OSFI will continue to fulfill its mandate and maintain its strong international reputation, as was confirmed by a recent IMF Financial Sector Assessment Program (FSAP) Report released in February 2008. It said Canada's "financial stability is underpinned by sound macroeconomic policies and strong prudential regulation and supervision".

The freezing of the non-bank ABCP market has rightfully led to a lot of questions and it is important to identify and understand what happened. OSFI fully supports the efforts being made by all parties in this regard and will continue to provide input into these deliberations.

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