

ABCP Update

DECEMBER 18, 2007

It has been over four months since the disruption in the Canadian Asset Backed Commercial Paper (ABCP) market. Last Friday, December 14, was the expiry of the 120 day standstill period during which the Crawford Committee was to develop a proposal to restructure the illiquid securities into long term floating rate notes. Instead of a major announcement on Friday, we learned that the Committee has not yet completed its work and will not be able to propose a resolution to investors until January 31, 2008 with final restructuring not expected until March 14, 2008. However, there has been some progress:

- *Skeena Capital Trust, the first of the 22 impacted conduits to be restructured, has presented a definitive resolution to ABCP investors that, if passed, will redeem their ABCP with cash equal to approximately 98% of par value. This restructuring is expected to close this week without incident.*
- *A framework for restructuring the remaining 21 ABCP conduits has been developed and parts of that framework have been disclosed to investors – including a suggestion that the Canadian banks may provide a syndicated credit facility that the conduits could draw upon to meet the margin requirements of their leveraged assets.*

In this newsletter, we provide our insight on these developments as well as some background on the overall situation.

The ABCP Meltdown

On August 13, investors witnessed the first ever disruption in the Canadian ABCP market. A significant portion of the ABCP that was to be issued on that day failed to find buyers. Since conduits (issuers of ABCP) normally use the proceeds of newly issued ABCP to repay ABCP maturing the same day, the impacted conduits were unable to cover their maturities.

The conduits all have standby credit facilities for such an eventuality. If they are unable to issue ABCP in the market, they can draw upon the credit line to pay off the maturing ABCP. Unfortunately, on August 13 a previously poorly understood feature of these facilities came to light – that a “Market Disruption Event” must be declared in order for the conduits to draw funds. According to the legal drafting in most of the conduits’ liquidity agreements, no “Market Disruption Event” had occurred and therefore the conduits were not allowed to draw.

By August 14, DBRS, the rating agency of record on all impacted conduits, had positively affirmed the credit quality of the assets underpinning the ABCP. Unfortunately investors now had a much larger problem – the liquidity agreements backing their ABCP investment were insufficient to guarantee the liquidity expected from these instruments. As one might expect, this caused the market to freeze irreparably.

On August 16, several major investors, impacted conduit sponsors and the liquidity banks banded together and created the Montreal Accord. Key elements of this agreement are that:

- *All impacted ABCP (some \$34 billion) would be converted to long term floating rate notes*
- *Margin requirements on roughly \$20 billion of leveraged assets would be relaxed*
- *All parties would ‘stand still’ for 60 days until the restructuring was completed (October 15)*

This standstill agreement has been extended twice, first to December 14 and most recently to January 31, allowing the Crawford Committee overseeing the restructuring more time to continue its work.

Skeena Capital Trust Restructuring

Last week, the Committee distributed a proposed resolution to restructure the first of the 22 impacted conduits, Skeena Capital Trust (Skeena). The proposal, which is likely to be approved by the required 2/3 of ABCP holders, will see most Skeena investors paid out 98% of the par value of their ABCP in cash. Other investors, primarily financial institutions that were asset and liquidity providers to Skeena, will receive long term floating rate notes that are AAA-rated and pay interest of 150 basis points above Bankers’ Acceptances.

While this is positive news for investors, a lingering question remains. Skeena was launched in the summer of 2006 - after DBRS had amended its criteria for liquidity facilities and thus benefited from liquidity agreements where the threshold for “Market Disruption Event” was almost certainly met. This leaves investors asking why Skeena was not able to draw fully on its liquidity agreements to redeem its liquidity-backed Class A notes at par when they matured back in August.

As advisor to the Investor Committee, JPMorgan noted these liquidity agreements and the potential for a par payout in its report, but despite this observation it excluded the liquidity agreements from its restructuring analysis. The reason for their omission is not clear.

Framework for Remaining 21 Conduits

The latest standstill agreement expired on Friday, December 14th. Shortly after midnight, a press release from the Investor Committee announced that a framework for restructuring had been developed. By extending the standstill period until January 31, 2008, the Committee now expects to be able to develop a definitive proposal to holders of all 21 impacted ABCP conduits and that investors could expect the restructuring to be complete by March 14, 2008. After the targeted closing in March, the Committee expects that a secondary market will develop for the resulting securities, allowing investors seeking liquidity to sell their new securities at that time.

The framework announced last weekend was consistent with that described four months earlier when the Committee was formed, but there was a bit more information for investors:

- *There will be three different proposals depending on the type of underlying assets – traditional assets (e.g.: mortgages, leases, etc); structured assets (eg: levered and unlevered CDOs); and US sub-prime*
- *There is intent to establish a credit facility that can be drawn in the event that the restructured conduits are required to post additional margin in support of their leveraged transactions.*

It is expected that holders of ABCP backed by traditional assets will receive a floating rate note backed by those same underlying assets. The same is true for investors who hold ABCP backed by US sub-prime assets.

For ABCP backed by structured assets, investors are expected to receive two notes – one senior and one junior – in exchange for their ABCP. Each conduit's allotment of senior versus junior notes will likely be determined based on the relative market value of each conduit's assets. Conduits with higher market valuations will likely receive more senior notes while those with lower valuations will receive more junior notes.

Leveraged transactions comprise about 58% of the impacted assets. The Committee is hoping to deal with them by negotiating relaxed margin triggers with the conduits' swap counterparties, reducing the probability of a margin call. At the same time, the Committee is hoping to secure stand-by funding facilities from a syndicate including the Canadian banks, allowing the conduits to draw funds as required to meet potential margin calls.

The Road Ahead

With this latest announcement, the Investor Committee has given itself six more weeks to develop a concrete proposal to investors. This is no small feat as there is currently no commitment from the potential lending syndicate. If the Committee is unable to secure this commitment or alternately devise a way to avoid margin calls entirely, it will be very difficult to move forward with the restructuring as currently contemplated. If the Committee is able to address the margin issue successfully, there is a much greater probability of success, but there remains a significant amount of detail to be fleshed out, drafted, and confirmed prior to January 31, 2008.

For further information, please contact: Connor, Clark & Lunn Financial Group

COLIN KILGOUR

• President, Connor, Clark & Lunn Wholesale Finance

• 416 216-7076

• ckilgour@cclgroup.com