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Feature/Capital markets

The Canadian ABCP market

The fastest-growing sector of the country's capital markets, asset-backed commercial paper may replace the dwindling T-bill as the national benchmark.

By Robert Fisher, Charles Milne, Joanna Zapior, Peter Weldon

The Canadian asset-backed commercial paper (ABCP) market has grown exponentially in the last five years, and pricing suggests that demand continues to be firm. Some of the challenges the market has had to contend with include secondary market liquidity, potentially lumpy supply, and limitations of Canadian-style backstop liquidity.

As shown in Exhibit One, ABCP now accounts for 20 per cent of the Canadian money market, up from 2 per cent in November 1995. This expansion of market share by ABCP was at the expense of government paper, whose share had shrunk dramatically by October, 2000, to 38 per cent from 73 per cent in 1995, according to Dominion Bond Rating Service (DBRS). The overwhelming portion of ABCP is rated R-1 high, the highest short-term rating given by DBRS. In the future, R-1 high ABCP may become a proxy for T-bills, because of the shrinking supply of government paper and illiquidity associated with smaller and fewer T-bill issues.

At the other end of the credit spectrum, we may also see growth in the issuance of lower-rated ABCP as investors become more comfortable with asset-backed commercial paper structures.

Despite growth of the Canadian ABCP supply over the last three years, the market appears capable of absorbing new supply. While it is difficult to quantify how much additional capacity there is for growth, demand continues to exceed supply, as demonstrated by current spreads, which remain very tight, although not at their historically tightest levels. As little as 16 months ago, the spread between 90-day ABCP and bankers' acceptances was 10 basis points. Early in 2000, after Y2K fears dissipated, spreads narrowed to 7 basis points, and are now often less than 5 basis points. If the market were saturated, we would expect ABCP spreads to widen.

A further example of strong demand is that, as recently as 22 months ago, investors on the West Coast could easily buy C$40 million blocks of ABCP at 7 a.m. Pacific time. Currently, these same investors often have to buy large blocks before 6 a.m. Indeed, for some programs, they need to deal one or two days in advance. Admittedly, there have been times when huge volumes of ABCP have been brought to market quickly, and it has been difficult for the market to immediately absorb the volume. These instances have occurred primarily at bank year-ends, when the banks are motivated to manage capital structures for both capital tax and capital requirement purposes.

Oversupply may also occur temporarily when new programs come to market. Although new issues are pre-marketed to investors, there may be a lag between the time when a new program is launched and when it is placed on investors' approved lists.

We see no long-term imbalance between supply and demand for ABCP. The ABCP market is inter-alia about disintermediation. A major catalyst for ABCP demand has been the movement of cash away from deposits with financial institutions towards purchases of mutual funds. Financial institutions have, as a result, increased their use of securitization as a way to reduce funding needs. Mutual-fund purchases of ABCP complete the circle. In other words, this may be a zero sum game.

On the demand side, most major classes of investor are now comfortable investing in R-1 high ABCP, although there are still some large investors who do not participate in this market. We think that appetite for

R-1 mid and even R-1 low asset-backed paper will develop with time. (Exhibit Two shows a complete explanation of comparative ABCP rating systems.) Initially, however, lower-rated ABCP cannot be expected to sell at spreads of 1 to 5 basis points greater than R-1 high, as is the case with corporate commercial paper. As with R-1 high paper, investors will need to become comfortable with the structures and the liquidity of lower-rated securitized credits.

Market participants continue to be concerned about potential lack of liquidity in the secondary ABCP market. At this point, there are very few programs with syndicated distribution. As a result, there is little support for paper issued by one dealer from other dealers/competitors. On the positive side, most dealers provide two-way markets in their own proprietary programs. Bid/offer spreads for ABCP are generally reasonable, and usually similar to those on bankers' acceptances. However, if a dealer/underwriter has a large inventory, bid/offer spreads could widen notably, and investors would not be able to get competitive bids from other dealers.

In contrast, the corporate CP market usually involves a group of at least two dealers, which improves the likelihood of competitive bidding. This may be a major reason why investors limit the amount of ABCP they can hold in their portfolios.

Syndication of distribution may be one way to improve liquidity, although this development is not likely in the near future. Furthermore, argument that syndication would lead to better liquidity is weakened by the fact that spreads and liquidity for the few programs in Canada with syndicated distribution have not been markedly better than for non-syndicated programs.

The price of bank liquidity in Canada has increased as banks focus on profitable allocation of available liquidity and on risk-adjusted returns on capital. There is a concern that availability of bank liquidity may be constrained in the near to medium term, pending clarification of the proposed Basel Committee guidelines related to capital weighting for bank liquidity facilities.

The Office of the Superintendent of Financial Institutions (OSFI) sets the parameters for liquidity. OSFI Guideline B-5 states that liquidity provided for ABCP programs must be for market disruption only. The goal is to ensure that the liquidity facility is not used as credit support for the program. The definition of market disruption is, however, very narrow. It has been interpreted to mean "total market disruption," a situation in which no issuer can raise money in the Canadian commercial paper market (not just the ABCP market, but also the entire market). Only then can a bank advance under the liquidity facility. This runs counter to the rules in other major securitization jurisdictions.

The differences between Canadian-style liquidity and liquidity facilities used in other major jurisdictions, which are often not so narrowly defined, gives rise to uncertainty related to how the banks will allocate capital to these two types of facilities. The most recent BIS proposal suggests that the U.S.-style liquidity would in the future continue to attract 20 per cent risk weighting for capital allocation purposes, while the Canadian style should continue to attract zero. However, until these guidelines are clarified, Canadian banks may be cautious about allocating incremental liquidity to the market. However, if the guidelines take the form suggested herein, Canadian-style liquidity will, in our opinion, continue to be the preferred structure in the market.

Alternatives to bank liquidity, such as extendible ABCP, would also help the Canadian ABCP market. Extendible commercial paper currently being issued has not been well received by investors, partly because of perceived illiquidity and partly from the perception the yield premium is not sufficient to compensate for the extension feature.

It would also be beneficial if new participants would enter the liquidity game, including insurance companies, mutual funds, and large retirement funds. However, there are currently no indications that these potential participants may enter this market.

To date, the buy side has accepted the Canadian-style liquidity, as evidenced by the growth of this market, albeit at a spread premium relative to U.S. market pricing levels. Canadian R-1 high spreads are now 4 to 5 basis points over bankers' acceptances, the Canadian equivalent of LIBOR. Meanwhile the equivalently rated ABCP in the U.S. ("A1+," "P1") trades at 6 to 8 basis points below LIBOR.

Canadian ABCP was until recently rated only by the two Canadian rating agencies, Canadian Bond Rating Service (CBRS) and DBRS, unlike corporate paper, for which Moody's or Standard & Poor's (S&P) ratings were also available in certain cases. This was partly because the OSFI-governed structure of the bank backstop made it difficult for U.S. rating agencies to compare Canadian issued ABCP with similar issues in the U.S., which were structured using U.S.-style liquidity facilities.

The recent acquisition of CBRS by S&P is an interesting development in the corporate market in general and, specifically, in the ABCP market. Based on public comments by S&P, we believe that S&P is now comfortable with most Canadian ABCP structures and is prepared to extend ratings to Canadian ABCP, although these ratings may be unique to Canada. Canadian-style liquidity will remain a challenge for S&P/CBRS and Moody's as they attempt to apply their global methodology frameworks to Canadian ABCP issues.

Anecdotal evidence suggests that there is a large group of investors who buy both corporate commercial paper and ABCP on rating alone. For a small shop with limited analytical re-sources, this outsourcing of the credit department is perhaps quite reasonable. Larger investors with dedicated credit analysts typically do additional analysis to familiarize themselves with the structure, the nature of the assets and the seller. Some investors avoid certain sellers, while other investors look at exposure to asset classes in aggregate and also at exposure to various industries. Investors that wish to supplement rating-agency information with their own research require access to both conduit and underlying asset performance data.

The traditional source of additional information is dealer reports on individual conduits and on trends in the market. Most of the dealers put out monthly summaries and status reports of their own programs. Both quality and quantity of these reports has improved substantially over the last year, but investors still lament the lack of one-stop shopping for portfolio information, which would be useful for comparative purposes and for providing timely information.

Those few investors that supplement ratings and dealer reports with their own in-depth analysis note that that they cannot thoroughly and quantitatively analyze the multi-seller and multi-asset programs because of a scarcity of information. Therefore, they may set smaller limits on these programs, and/or require a yield premium. However, from a seller perspective, a primary benefit of multiseller programs is that they provide anonymity to the underlying sellers of assets. Full disclosure is in the best interest of all market participants. When investors are informed about structure and asset performance, it is likely that issuers will enjoy better distribution and pricing. The logical source of such information would be the rating agencies, which receive trust performance information on a monthly basis. Therefore, they are well positioned to produce reports that are consistent in content and quality.

In the U.S., Web sites such as ABSNet post servicing reports and details of many programs from different dealers and financial institutions. This type of information dissemination is helpful, but it is limited by the fact that the independent Web sites do not house information on all outstanding programs. A similar effort in Canada would be a more reasonably-sized task given the lower number of outstanding programs.