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Canadian funds endure U. S. meltdown exposure

CDS Investments

Karen Mazurkewich And Barbara Shecter, Financial Post

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Some of Canada's largest pension funds, which have taken more active investment strategies in recent years, are feeling the heat from the meltdown on Wall Street.

PSP Investments, Ontario Teachers' Pension Plan and the Caisse de depot et placement du Quebec all made significant investments in credit default swaps, which while highly profitable when times are good, were later dubbed "financial weapons of mass destruction." The down draft in financial markets is also causing pain in some pension funds' equities portfolios, where they own shares in companies facing their own Armageddon as a result of playing in the credit default swap (CDS)market.

A CDS, which resembles an insurance policy, is a contract between two counterparties. The buyer makes payments to the seller in exchange for the right to a payoff if a third party defaults on its debt.

It is often used as a hedge to offset the risk that an investment in a particular bond will sour, but it's also used as an active investment tool.

Possibly the most vulnerable pension fund is PSP Investments. According to its annual report ending March 31, 2008, the pension fund had marked-to-market losses of $510-million on $1.35-billion notional amount of credit default swaps they wrote. Because the fund did not purchase many swaps to offset those written, they had to write down $480-million. (PSP Investments' $2-billion exposure to non-bank asset-back commercial paper also forced it to take a $450-million writedown.)

Ontario Teachers' Pension Plan is also invested in credit default swaps. According to its annual report ending Dec. 31, 2007, it had marked-to-market losses of $427-million on $4.5-billion notional amount of CDSs it has written. Last year, OTTP offset those losses through the gains it made purchasing more than $17.5-billion notional CDS at a marked-to-value of $720-million.

But given the deteriorated market for these swaps, it's unclear whether the hedging strategy will continue to work for OTPP. On the written side, it will have to continue to have losses because the spreads have increased, says Paul Rivett, vice-president and chief legal officer of Fairfax Financial Holdings Ltd.

"No matter who they sold protection to, $4.5-billion is a huge number in this environment," he adds. The spreads have widened tenfold since May, 2007.

"On the purchase side, they could have problems if the counterparties are not credit worthy," says Diane Urquhart, a Toronto-based independent financial analyst. In other words, it might not be able to collect.

The Caisse, which invested $13-billion in ABCP, also has $20-billion notional exposure to the CDS market as of yearend 2007. It does not break down how much was purchased or how much was sold.

"The Caisse de depot has some exposure to some of [the flailing U. S. companies caught in the CDS scandal] but not all of them, and that exposure is not material," says Marc Boutet, vice-president of public affairs for Caisse.

While U. K. pension funds have more exposure to these swaps, fewer Canadian funds jumped into the fray.

"A lot of Canadian pension funds haven't gone down the road, they've had usual plain-vanilla fixed-income investments," says Janet Rabovsky, practice leader for central Canada, investment consulting, Watson Wyatt Worldwide. In fact, the Canada Pension Plan Investment Board, the British Columbia Investment Management Board and Ontario Municipal Employees Retirement System all say they are not involved in credit default swap instruments.

For analysts like Ms. Urquhart, pension funds should not have dabbled in the CDS market. "This was a new and exciting way to get premium yield but they didn't take sufficient care to examine the risk," she says.

Christopher Cox, chairman of the U. S. Securities and Exchange Commission, called on Congress on Friday "to take swift action" to plug "a massive hole" in the completely unregulated US$60-trillion credit default swap market.

"Neither the SEC nor any regulator has authority even to require minimum disclosure," Mr. Cox said.

Analysts here are calling for action by local regulators: "When are the Canadian regulators going to regulate this?" says Leo Kolivakis, former analyst with PSP Investments and an independent commentator. He's calling for more transparency from the pension funds.

While it's unclear what CDS liabilities these funds might have, what is coming into focus is the hits some of these funds are taking on their equity holdings.

The Caisse is holding some stock in Lehman Brothers Holdings Inc. OTPP is taking hits on a number of fronts. OTPP owned 5.1 million shares in Citigroup Inc. worth US$147-million. Today, those same shares are only worth US$93.6-million.

In addition, OTPP held two million of shares in American International Group Inc. worth US$113.7-million in value. Today those same shares are only worth US$6-million. OTPP also owned stock under US$50-million in Washington Mutual Inc. OTPP filed a motion in New York in June to be the co-lead plaintiff in a class-action suit against AIG. The fund was also named co-lead against Washington Mutual in July.