Yukon government investments not risk free

Friday, November 9, 2007
By Chris Oke *Special to the News*

Premier Dennis Fentie answers the opposition during question period at the Yukon legislature on Thursday.

The Yukon government failed to adequately research its $36.5-million investment in two high-risk asset-backed commercial paper funds [ABCPs].

The funds were frozen on August 17.

It’s not clear when investors can expect to get their money back, or how much they stand to lose.

The Yukon is not expected to lose any money in the collapse of the asset-backed commercial paper market, said government officials.

However, write-downs stemming from those funds are already occurring in publicly traded companies.

A write-down signals the companies are expecting to lose money in the deal and have adjusted their books to show that.

“Those that own the paper and are obliged to make public disclosures are writing down as much as 15 per cent,” said Diane Urquhart an independent Financial Analyst.

“The write-downs made by investment banks that were involved in the packaging and have more information, are between 20 and 35 per cent.

“If they were sold on the market, my thinking is that there would be a 25 to 35 per cent loss.”

Not only will the investors lose the interest they were expecting to receive but also as much as one third of the original investment.

That’s more than $12 million for the Yukon government.

A company called Parameter Financial in Toronto is in the process of setting up an electronic market to sell the papers at the appropriate loss.

This is much to the chagrin of a consortium of banks, asset providers and investors that are currently attempting to reach a settlement agreement.

The group is attempting to extend the payback period to between five and 10 years and has promised to deliver the terms by December 14.

Two asset-backed commercial paper funds were bought by the Yukon government in July and August of 2007. They were supposed to mature 30 days later.

The asset-backed paper schemes can be confusing.

They hinge on asset-backed loans — that is, loans issued to buy cars, corporate mortgages and other things.

These loans are collected in trusts, which then look for investors. Those investors buy into the trust and profit from the interest paid on the loans.

In theory, the diverse loan holdings are supposed to lessen the risk.

Investors generally buy the papers for 30- to 90-day periods. When that deadline is reached, the investor can choose to sell the paper or continue to hold it, “rolling them over,” and collecting interest for another period.

The Yukon government has been investing in similar funds for 10 years.

In August, investors looking to sell could not find buyers for their asset-backed papers.

That caused a panic, which cascaded through the 22 such trusts.

Investors expected the investment banks to buy them out. But they didn't.

"For investors to suggest that they do not own a piece of paper that has significant exposure to market-to-market losses is incorrect," said Urquhart.

"Thankfully, none of the trusts we invested in were exposed to the subprime market," said Clarke LaPrairie, director of financial systems.

However, 77.8 per cent of ABCP is backed by something known as collateral debt obligations.

Basically this is a package of securities or derivatives sold on the international markets, said Urquhart.

"It's a blind pool — people don't know what's in those," said Urquhart.

"And those collateral debt obligations are, in fact, more serious than the US subprime mortgage (market) itself."

The money enters what is known as the credit-default swap market, where investors bet on the risk of default on loans.

Because the money is leveraged, even a small percentage default is magnified 20 times in your loss, said Urquhart.

The Yukon's Financial Administration Act is written to protect public money from losses in risky investments.

It states investments must adhere to specific guidelines.

They must be guaranteed by Canada or a province, guaranteed by a bank, or receive the highest rating from at least two recognized security-rating institutions.

The two funds bought by the Yukon government, Newshore's Symphony and Opus funds, were not guaranteed by any government.

And they were not rated by two institutions.

Dominion Bond Rating Service was the only agency that rated the investments.

"They were the only credit-rating agency willing to do so," said Urquhart.

“Standard & Poor’s refused to rate it and wrote a report in 2002 called Leap of Faith in which (it) expressed extreme concern about the high risk.

“They refused to rate it at all, they wouldn’t even give it a low rating.”

Why did DBRS hold a different opinion?

Because it was receiving a percentage of all the papers sold on the market as a provision for the research it did on the rating, said Urquhart.

Normally rating agencies get paid a flat fee for their services; this was one of the first times that percentage payments were used.

“It was extremely lucrative, and it also led (it) to be more optimistic than (it) otherwise would be,” said Urquhart.

“It’s a conflict of interest.”

Without two high ratings, the government’s Finance department depended on a guarantee from the bank.

“We viewed it as guaranteed,” said LaPrairie.

“In case they can’t sell the commercial paper, which is what happened, the banks were supposed to step in.

“The banks backed off the guarantee.”

But there was no internationally recognized guarantee.

“They had liquidity agreements, but they were weak liquidity agreements, not guarantees,” said Urquhart.

“With a full-fledged guarantee, if there is more than one commercial paper that cannot be sold, then the bank is forced to buy it.”

In this case, all of the commercial paper in the country could not find a buyer and the banks refused to pay because they didn’t have to.

The banks announced that if the paper was manufactured by anyone other than themselves then they would not honour the liquidity agreements, said Urquhart.

The funds the Yukon bought were compiled by third parties — entrepreneurial companies that weren’t in the position to offer any kind of moral guarantee.

And Newshore explicitly refused to give any guarantees in the information memorandum they issued for the funds.

“The banks were paid premiums so that the sponsors and vendors who sold this paper could say that there was a liquidity agreement,” said Urquhart.

“But they knew that the chances of them ever needing to provide the cash to purchase back the paper would virtually never happen.

“The investment bank that sold this paper to the Yukon government should not have done so, it was too high a risk.

Generally top quality commercial paper is 0.5 per cent higher than a government-issued treasury bill, which is considered to be the safest investment possible.

However, the asset-backed commercial paper is 0.55 per cent higher.

There is a slightly higher risk, and subsequent higher yield from investment, because the securities are created by private, third-party firms and only sold through the banks.

“In first year economics you learn that higher risk means higher reward,” said Canadian Taxpayers Federation spokesperson Scott Hennig.

“By virtue of the payout, these things have to be a higher risk.”

Hennig also believes that investing $36.5 million, 15 per cent of the government’s investment portfolio, into these papers is not a safe investment.

“Why is the government doing savings anyway?” he added.

“If individuals want to invest, that’s their choice. Why not give the money back to the taxpayers and let them decide?”