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BEST-LAID PLANS AND UNINTENDED CONSEQUENCES

On Wednesday, July 21, 2010, U.S. President Barack Obama signed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Act) into law, thus setting in motion the biggest regulatory shakeup of the U.S. financial sector since the Depression. The 2,300-page piece of legislation was drafted with the intention of avoiding another financial crisis and the associated taxpayer-funded bailouts of financial services firms. Sweeping legislative changes, no matter how well intentioned, often have unintended consequences. For example, although it is unlikely that the politicians and officials who drafted the Act are familiar with the Montréal Accord or Master Asset Vehicle I and Master Asset Vehicle II (collectively, the MAVs), the Act could have adverse consequence for the MAVs and could potentially lead to the termination of the MAV structures, with subsequent losses being suffered by MAV noteholders.

In the aftermath of the financial crisis, both derivative products and collateralized debt obligations (CDOs) were often cited among the usual suspects said to have contributed to the systemic risk that led to the crisis. One of the objectives of the Act is to bring more scrutiny, transparency and regulation to the trade of derivative products. Since approximately 70% of the asset interests held by each of the MAVs consist of derivative products, the MAVs could fall under the new regulatory requirements of the Act.

Despite the length of the Act, many of the details are left to the regulatory rule-making process. The U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) will be largely responsible for drafting the rules to implement the derivatives provisions of the Act. Many of these rules must be in place within 360 days of the enactment of the Act. Since so many of the key concepts in the Act are subject to forthcoming regulatory detail, and the definition of many key terms in the Act have yet to be fleshed out, it is impossible to state with any certainty if the MAVs will be affected by the legislation and, if so, what the consequences will be. What follows must therefore be considered somewhat speculative.

Despite the fact that the Act is U.S. legislation and the MAVs are trusts under Ontario law, the MAVs may nevertheless fall within the scope of the Act, as many of the MAV's swap counterparties are U.S. entities. It is also not clear if all of the provisions of the Act will apply to existing transactions. If not, or if an exception for existing transactions is available, it is possible that the MAVs might not fall within all of the provisions of the Act.

In the event that the MAVs fall under the Act, they could be defined as "major swap participants" or "major security-based swap participants." If this is the case, the MAVs could face capital requirements, collateral requirements and reporting and registration requirements. All would entail costs – significant costs in the case of capital and margin requirements. Since the MAVs have little or no ability to raise additional funds, they may not be able meet these obligations.

The consequences of a failure of the MAVs to meet an obligation imposed on them by the Act are not fully apparent. It could be that fines would be imposed, that failure to comply would mean that continuing to participate in swap transactions would be illegal, or that the appropriate regulation would impose some other sanction. Under International Swaps and Derivatives Association, Inc. (ISDA) documents, which govern the MAV credit default swaps, both scenarios could lead to termination of the swaps, either as a result of misrepresentations regarding authority to perform under the swaps, breach of a covenant to comply with applicable laws or an additional termination event upon the occurrence of an illegality. If the swaps were to be terminated, they would be valued at market¹. Given the extent of the notional amounts being terminated simultaneously and the fact that the Act would make these trades less valuable, market values would likely be depressed. Under such a scenario, the Class B Notes and Class C Notes issued by the MAVs (and not rated by DBRS) would likely suffer a complete loss. The Class A-2 Notes issued by the MAVs would likely suffer some realized losses. If mark-to-market values were to plummet precipitously, it is possible that the Class A-2 Notes could suffer a total loss and that the Class A-1 noteholders could experience some degree of realized loss, despite the subordination provided by the Class A-2 Notes, Class B Notes and Class C Notes.

Alternatively, where required, it could be difficult or impossible to get market quotations for valuing the swaps, making it much more likely that the parties will dispute (either informally or through litigation) the termination value of the swaps.

Much of the above remains uncertain, given the lack of clarity in the Act and the pivotal role of the yet-to-unfold rule-making process. It should be emphasized that the unwinding of the MAV structures should be considered a worst-case scenario. Nevertheless, in light of the potential risks, DBRS believes investors should be aware of these possibilities.

Finally, it would be something between ironic and sad if the best-laid plans of the Montréal Accord, a difficult but ultimately successful private-sector restructuring in response to the financial crisis, that was a year-and-a-half in the making, were to be undone by a foreign government's response to that same crisis. It is a small world after all.

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1. Each of the credit default swaps to which the MAVs are a party were novated from pre-Montréal Accord affected or frozen trusts. Therefore, covenants and additional termination events and valuation procedures for each swap differ slightly. However, the statements made in this article relate to the vast majority of the MAV swap asset interests.

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