



Government of Yukon's Investment in Asset-backed Commercial Paper

Department of Finance

February 2008



Office of the Auditor General of Canada
Bureau du vérificateur général du Canada

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Auditor General of Canada
Vérificatrice générale du Canada

To the Honourable Speaker of the Yukon Legislative Assembly:

I have the honour to transmit herewith my report on the Government of Yukon's Investment in Asset-backed Commercial Paper to the Yukon Legislative Assembly in accordance with the provisions of section 35 of the *Yukon Act*.

Sheila Fraser, FCA
Auditor General of Canada

OTTAWA, 7 February 2008

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Government of Yukon's Investment in Asset-backed Commercial Paper

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Main Points

What we examined

In summer 2007, the Government of Yukon invested a total of \$36.5 million in asset-backed commercial paper issued by two trusts (asset-backed commercial paper is a short-term investment in securities backed by a variety of assets such as mortgages, car loans, and credit card balances). The securities were to mature on 31 August 2007 and 4 September 2007.

Along with many other investors in asset-backed commercial paper, the Government was unable to recoup its investment at the maturity dates. On 9 November 2007, the Office of the Auditor General of Canada became aware of questions regarding whether the Government had complied with Yukon's *Financial Administration Act* when it made the investment. Given that we assess compliance with authorities as part of our annual audit of the Government's financial statements, we decided to review this matter and report our findings to the Legislative Assembly.

Why it's important

On 31 August 2007, the Government of Yukon had about \$215 million in investments. Yukon's *Financial Administration Act*, which governs all government spending, clearly limits the kinds of investments that the Government may make with public money. It is important that the Government be certain its investments meet the conditions set out in the Act.

What we found

- The asset-backed commercial paper in which the Government invested was not one of the three types of investment permitted by Yukon's *Financial Administration Act*—it was not guaranteed by the Government of Canada or any provincial government, was not issued or guaranteed by a bank, and was not issued by a company incorporated federally or provincially and given the highest rating by at least two recognized security rating institutions, although one rating agency had provided the highest rating of the trusts' commercial paper. Prior to making these investments, the Government did not obtain a legal opinion on whether the investments would comply with the Act.

- The trusts had liquidity agreements (agreements with banks that are intended to protect the trusts when there is a general market disruption), which Yukon's Department of Finance viewed as a guarantee that the principal would be repaid when the commercial paper matured. Although there is no reference to liquidity agreements, we noted that the information memorandum for each trust included a clause stipulating that there was no guarantee of payment from the trustee or other parties specified in the memorandum.
- In addition to the investments in question, we also found that the Government has made prior investments in asset-backed commercial paper issued by trusts set up by both banks and non-banks, which also did not meet the conditions set out in the Act.
- At this writing, a group of financial institutions has proposed a restructuring to replace about \$33 billion in short-term, asset-backed commercial paper with notes that mature over longer terms. The restructuring process is expected to be completed in March 2008. The Government has yet to quantify the financial impact on its investment, as the financial terms of the restructuring have not yet been made available.

Introduction

1. The Government of Yukon (the Government) is in a healthy financial position. Indeed, it has reported an annual surplus for five consecutive years. On 31 March 2007, the Government reported an accumulated surplus of \$714 million. Also on 31 March 2007, the Government had about \$183 million—approximately 39 percent of its financial assets—in investments.

Investing in asset-backed commercial paper

2. Commercial paper is a short-term investment, usually maturing in less than a year, but often in as little as a month. Asset-backed commercial paper is backed by a variety of assets, such as mortgage loans, car loans, credit card balances, and other interest-bearing assets. The investor buys the paper for less than face value (or “par”) and holds the paper until it matures, at which point the investor receives the face or par value of the paper. The difference between the purchase price and the face value of the paper is interest income to the investor.

3. In Canada, asset-backed commercial paper is issued by **trusts** set up either by **domestic banks** or by other entities, which are referred to as “**non-banks**.” About one third of asset-backed commercial paper that is issued in Canada is managed or administered by these non-banks. Banks and non-banks set up trusts to issue the asset-backed commercial paper, which is then distributed to investors by banks and other financial institutions.

4. In July and August 2007, the Government invested a total of \$36.5 million in two asset-backed commercial paper trusts that were set up by non-banks. The commercial paper, which the Government acquired through a bank, was due to mature on 31 August 2007 and 4 September 2007 (Exhibit 1).

Trust—A legal entity created to hold assets for the benefit of beneficiaries.

Domestic banks—Banks listed in Schedule I to the *Bank Act*.

Non-banks—Financial institutions that are not banks listed in Schedule I to the *Bank Act*.

Exhibit 1 Government of Yukon's investment in two asset-backed commercial paper trusts

Trust	Purchase date	Maturity date	Face value	Purchase price	Rate of return (%)
Symphony Trust	30 July 2007	31 August 2007	\$10,000,000	\$9,959,400	4.65
Symphony Trust	1 August 2007	31 August 2007	\$13,500,000	\$13,447,755	4.73
Opus Trust	31 July 2007	4 September 2007	\$13,000,000	\$12,941,890	4.68
Total			\$36,500,000	\$36,349,045	

Source: Yukon Department of Finance

5. Investing, by its very nature, involves risk. Different types of investments carry different levels of risk. The following are the key risks relating to asset-backed commercial paper:

- Cash flows of trust assets may not be available when the repayment of the commercial paper is due.
- If there is a market disruption, the trust may not be able to issue new commercial paper to replace the maturing paper.
- The trust may not be able to sustain itself if its assets deteriorate.

6. As the underlying assets have a longer maturity than the asset-backed commercial paper instruments that finance them, most trusts that issue asset-backed commercial paper are required to have liquidity agreements in place in order to receive a credit rating. A liquidity agreement is intended to protect the trust when there is a general market disruption and the trust is unable to **roll over** the asset-backed commercial paper.

Roll over—Issuing new debt to replace maturing debt.

7. In August 2007, there was extreme volatility in the global credit markets. Many issuers of asset-backed commercial paper were unable to roll over the paper when it matured. Certain banks and liquidity providers refused to provide **liquidity support** under the liquidity agreements on the basis that the situation did not meet the “market disruption” definition in the agreements. As a result, the Government and many others who had invested in asset-backed commercial paper, issued by trusts that were set up by non-banks, could not recoup their investments at the maturity dates. However, investors in asset-backed commercial paper, issued by trusts that were set up by domestic banks, were able to redeem their investments on maturity.

Liquidity support—A commitment to lend to those that issue commercial paper in order to ensure that investors receive timely payment of principal and interest.

8. As of 31 August 2007, the Government’s investment portfolio had a total value of approximately \$215 million. Of this, \$36.5 million had been invested in two asset-backed commercial paper trusts set up by non-banks.

Focus of the audit

9. On 9 November 2007, we became aware of questions regarding whether the Government of Yukon’s investment in two asset-backed commercial paper trusts was made in accordance with Yukon’s *Financial Administration Act*. Given that we assess compliance with authorities as part of our annual audit of the Government’s financial statements, we decided to review this matter and report our findings to the Yukon Legislative Assembly.

10. The focus of our audit was to determine whether the Government's investment in two asset-backed commercial paper trusts—totalling \$36.5 million—was made in compliance with the Act.

11. More details on the audit objective, scope, approach, and criteria are in **About the Audit** at the end of this report.

Observations

Managing investments

Investments did not meet the conditions set out in Yukon's *Financial Administration Act*

12. Yukon's Department of Finance is responsible for managing the investment of public money. We expected that the Department would comply with Yukon's *Financial Administration Act* when it made investments. Under subsection 39(1) of the Act,

If money in the consolidated revenue fund, other than money in a trust fund, is not immediately required for payments, it may be invested in any of the following:

- (a) securities that are obligations of or guaranteed by Canada or a province;
- (b) fixed deposits, notes, certificates, and other short term paper of or guaranteed by a bank including swapped deposit transactions in currency of the United States of America;
- (c) commercial paper issued by a company incorporated under the laws of Canada or a province, the securities of which are rated in the highest rating category by at least two recognized security rating institutions.

13. We found that the investments in the two trusts were not obligations of, nor were they guaranteed by, the Government of Canada or by any provincial government.

14. We also found that the investments in the two trusts were not issued or guaranteed by a bank. The Department was aware that the trusts that issued the asset-backed commercial paper had liquidity agreements, and it viewed these agreements as a guarantee that the principal would be repaid when the commercial paper matured. While the Department acknowledged that the liquidity agreement is not an unconditional guarantee, it believed that it is in compliance with subsection 39(1)(b) of the Act, because it viewed the liquidity agreements as a guarantee.

15. When we reviewed the information memorandum for each of the two trusts, we noted that, while there is no reference to liquidity agreements, each included the following clause that stipulated there is no guarantee of payments from the parties noted:

Neither the administrative agent, the trustee, the note [commercial paper] trustee, any beneficiary of the trust, any originator, nor any of their respective affiliates or related parties will guarantee or otherwise assure payment of notes issued by the trust, nor will any such persons compensate the trust or holders of notes if the trust realizes any losses on its portfolios of asset interests.

16. Finally, the Act also states that an investment can be made if the commercial paper is issued by a company that is incorporated under Canadian or provincial laws and if it is given the highest rating by at least two recognized security rating institutions. However, trusts are not incorporated, and when the investment was made, only one security rating institution had given the highest rating to the asset-backed commercial paper that was issued by these two trusts.

17. The Department was aware that the asset-backed commercial paper had only one rating and, therefore, did not rely on this rating when it made the investment. However, even if the commercial paper had been rated by two institutions, the investment would still not have complied with subsection 39(1)(c) of the Act, since investment in a trust is not permitted.

18. The Government did not obtain a legal opinion before these investments were made to ensure that they met requirements of the Act.

The timing of repayment of the Government's investment is unknown

19. The Government's investments in the two trusts that issued the asset-backed commercial paper matured in late August and early September 2007. However, the Government could not recoup its investment when the commercial paper matured. Many other investors in the commercial paper faced the same situation. The Government has not received any payment of principal and interest from the two trusts.

20. The market for asset-backed commercial paper issued by trusts set up by non-banks effectively froze in August 2007. A group of financial institutions met in an attempt to resolve the liquidity problem that was affecting the market. They agreed to take steps to restructure about \$33 billion in asset-backed commercial paper that was stranded

in 21 trusts. The restructuring aims to replace the short-term, asset-backed commercial paper with notes that mature over longer terms. The restructuring process is expected to be completed in March 2008. As the financial terms of the restructuring have not yet been made available, the Government has not yet quantified what the financial impact will be. We will be reviewing the Government's analysis of this financial impact when we audit its financial statements for the year ending 31 March 2008.

The Government made similar investments in previous years

21. We found that the Government made investments in asset-backed commercial paper that was issued by trusts set up by non-banks in the past, dating back several years. At the end of the 2004–05 and 2005–06 fiscal years, the Government had about \$9.4 million and \$6.4 million respectively in this kind of investment in its accounts. The Government redeemed all of this paper on maturity. For the reasons described in paragraphs 12 to 18, these investments also did not meet the conditions set out in Yukon's *Financial Administration Act*. On 31 March 2007, it did not hold any investment in asset-backed commercial paper that was issued by trusts set up by non-banks.

22. The Government also made investments in asset-backed commercial paper that was issued by trusts set up by domestic banks. At the end of the 2005–06 and 2006–07 fiscal years, it had about \$5 million and \$7 million respectively in this kind of investment in its accounts. On 31 August 2007, it had about \$22.5 million invested in two asset-backed commercial paper trusts that were set up by domestic banks. The Government redeemed all of this commercial paper when it matured. For the same reasons as those given for asset-backed commercial paper issued by trusts that were set up by non-banks, these investments did not meet the conditions set out in the *Financial Administration Act*.

23. The Government stated that it has not made any investments in asset-backed commercial paper since 10 August 2007.

Conclusion

24. Yukon's *Financial Administration Act* prescribes the investments that the Government of Yukon can make. We found that the Government's investment in summer 2007 in two asset-backed commercial paper trusts that were set up by non-banks (total value: \$36.5 million) did not meet the requirements of the Act. When this

report was written, the Government had not yet received any payment of principal and interest from these two trusts, and it has not determined the financial impact this may have. We also found that the Government has made prior investments in asset-backed commercial paper issued by trusts set up by both banks and non-banks. These investments also did not meet the conditions set out in the Act. It is important that the Department of Finance manage the investment of public money prudently and in accordance with legislation.

About the Audit

Objective

Our objective was to determine whether the Government of Yukon's investment in two asset-backed commercial paper trusts was made in compliance with Yukon's *Financial Administration Act*.

Scope, approach, and criteria

Our audit focused on the Government of Yukon's investment in two asset-backed commercial paper trusts with a total value of \$36.5 million. Once we concluded that the investments in these two trusts were not in compliance with the Act, we looked for other investments made by the Government that were not in compliance with the Act.

We interviewed officials from the Yukon Department of Finance and reviewed internal and external documents. We based our audit on the following criterion: Investments should be made in compliance with Yukon's *Financial Administration Act*.

Audit work completed

Audit work for this report was substantially completed on 4 January 2008.

Audit team

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