BAs or BDNs  

What is the difference?  

BY JAMES HYMAS  

Here’s a skull-testing question for advisors: In the event that a major Canadian bank gets wiped out overnight, which of their money market products is safer, a banker’s acceptance (BA) or a bearer deposit note (BDN)?  

BAs have a relatively short history in Canada, which has been admirably tracked by George Nor- lain, and before that by Daryl Mar- rett in the Bank of Canada Review of October 1981.  

The EVOLVING MARKET  

Canadian money markets were under- development of the 1980s. Short-term bonds were heavily traded, but Canadian dollar Treasury Bills (introduced in 1934) were typically a buy-and-hold investment for banks. As the federal government’s fiscal agent and conductor of monetary policy, the Bank of Canada (BoC) tweaked its own rules in the 1950s and 1960s while encouraging changes in federal law to increase the trading in T-Bills and the issue of commercial paper. This followed similar efforts by the Federal Reserve in the U.S., from the moment of its founding in 1913.  

The first step in the creation of a commercial paper market is the establishment of a vi- brant market in BAs – a BA being simply short-term paper issued by a corporation, but having a timely repayment of the principal and interest or the face value ("accepted") by a bank in exchange for a fee (the "stamping fee"). It should be noted that a holder of a BA has no claim on the underlying loan, the BAs are not a "credit-enhanced" product like covered bonds.  

BAs were launched in Canada on June 11, 1962, and were limited to self-liquidating transactions as defined in the Bank Act of the time. The emphasis on self-liquidation was taken as an emphasis on safety of principal, since the borrower will not have to refin- ance the loan – it will be repaid with the proceeds of the business’ daily operations and interest paid.  

The history of finance is re-plete with examples of short-term loans defaulting because they could neither be refinanced nor collaterized by the asset it was used to purchase. Readers will doubtless be able to supply examples from the headlines of the past year.  

Another justification for an in- 

sistence on self-liquidating trans- actions is the "Real Bills Doctrine." Thomas Humphrey summarizes that it holds that "money can never be excessive when issued against short-term commercial bills arising from real transactions in goods and services." Central bank theorists now consider this assertion to have been convinc- ingly refuted by Henry Thornton in 1802 but it remained influen- tial with many central banks, in- cluding the Federal Reserve and Deutsche Bundesbank.  

BA MARKET FLOURISHES  

In 1978, this restriction broke down. As the major banks announced guarantees would be available to qualified borrowers regardless of the particular pur- pose of the specific financing, the banks were taking on a certain amount of liquidity risk with this move, since the BoC would not acquire such BAs, but the policy also determined other inducements for borrowers to select this financing method – a tripling of the size of the BA market. In 1980, the BoC announced that it would no longer accept BAs of any nature and placed a limit on dollar loans and repurchase agreements; this prohibition was not rescinded until 2001.  

It is difficult to overstate the im- portance of BAs to the Canadian money market. Canadian chartered banks had over $6.5-billion of BAs outstanding as of the end of the first quarter of 2008, whereas Canadian Treasuries held by the public general totalled about $106-billion. Canadian Dollar BAs comprise about one-third of total corporate short-term paper. Perhaps even more tellingly, af- ter removing securitization paper from consideration, BAs account for well over half of the commercial paper outstanding that is backed by a mere promise – and in terms of trading, BAs dominate treasury bills and are reviled only as asset- backed paper in dollar volume.  

This importance is reflected in many ways; interest rates on BAs are highlighted by the BoC in its reports of financial conditions, they are heavily weighted by money market funds and – perhaps most maddeningly – they are the first choice of many advisors placing client funds in a non-man- aged money market investment.  

The BA spread over T-Bills is now much larger than has been experienced in the past (nearly 90bp on July 7, according to the BoC), but it is far from the market. For 3-month BA/T-Bill spread has historically been 10-20bp. Why not place money in a 3-month BA? After all, the reasoning goes, they’re both safe and liquid, so the spread simply represents free money!  

TIMELY REPAYMENT, BUT NO GUARANTEE  

BAs are regarded as being essen- tially certain to repay the loan at a timely manner, despite the fact that they are not insured by the Canadian Deposit Insurance Cor- poration (CDIC). But when things go wrong, they can go wrong in a hurry! While the chances of one of the major banks defaulting on what is essentially a small, it behooves a prudent in- vestor to know exactly where he stands in the pecking order once the bank is wound up and the creditors are squabbling over the corpse. The priority assigned to various bank securities was ex- amined in "A Vale of Tears," Ad- visor’s Edge Report, March 2008, but at that time I did not examine the seniority of BAs.  

When you purchase a BA you can’t even get a good description of what you have bought.  

We know that insured depos- its are the safest way to lend money to a bank. Despite my qualms about the adequacy of the CDIC, which has just been shown in the event that something goes seriously wrong, their war- chest of over $1.5-billion and their promises of drastic action if warranted are a lot bet- ter than nothing! All possibilities must be considered, however, in a world where multi-billion-dollar write-offs have become routine.  

The CDIC’s reserves do not even cover their gross obligation; the 14 largest in- stitutions it ensures go bankrupt – there won’t be much room to make new commitments and backdate a guarantee on outstanding BAs.  

When Northern Rock expe- rienced its difficulties last fall, a couple from Cheltenham with over one million pounds on de- posit barricaded a hapless bank manager in her office, angry that their funds were not immediately available. Would this couple have considered themselves safer or less safe had they held BAs? In the event of such difficulty in Canada, who will get paid first – uninsured depositors or BA holders? Should a rational investor choose BAs or Bear Stearns Notes (BDNs)? If all else is equal?  

PRIORITIES OF CLAIM  

Fortunately, priorities of claims are addressed by the Bank Act s 369(1). In the case of the insolvency of a bank, (c) the payment of the deposit liabilities of the bank and all other liabilities of the bank, except the liabilities referred to in paragraphs (4) and (5), shall be a third charge on the assets of the bank: … (4) the payment of the deposit liabilities of the bank and all other liabilities of the bank, except the liabilities referred to in paragraphs (2) and (d), shall be a third charge on the assets of the bank: … (5) The Bank Act section 369(3) Priorities within each of paragraphs (1)(a) and (b) shall be determined in accordance with the laws governing priori- ties and, where applicable, by the terms of the indebtedness and li- abilities referred to therein.  

THE BANK ACT SAYS…  

The Bank Act section 369(3) clear- ly allows the banks to determine the relative seniority of BAs and uninsured deposits. While both this issue will rank behind, for example, debts owed to the federal government and ahead of, for in- stance, preferred shares, the bank is specifically authorized to nego- tiate the relative priority of these two liabilities with its customers.  

The representative who had claimed they were pari passu by law later admitted the existence of section 369(3), but insisted that his bank had not taken advantage of this discretion in a recent bankruptcy. I must stress that I consider the chances of a major bank burning through its capital with sufficient speed that the “third charge” is im- paired in the lifetime of a specific BA – or before the uninsured de- positors have safely exited – to be fairly remote. But in such an event, it will be of major importance to determine who suffers first! Who will receive all their money, and who will be short-changed? Will pari- passu creditors be barricading bank managers in their offices? A responsible investor should examine this possibility – and, in the wake of theropdowns directed at those who invested client mon- ey in Portus or non-bank ABCP, having this knowledge can only be considered prudent from a regu- latory perspective.  

BANKS’ GOOD CREDIT  

Unfortunately, not a single one of the largest six banks in Canada has so much as a term sheet available for its BAs. When one plucks down one’s money to purchase a BA, this act is being performed on simple faith that somehow ev- erything will be all right. A BDN might be safer; it might be riskier; they might be equivalent – you have no way of knowing for sure.  

Of the six IR departments I contacted in a quest for informa- tion, three sent me an emailed re- sponse claiming that their BAs are pari passu with their uninsured de- posits. But no guarantee the Bank and a creditor can agree that a BA constitutes sub- ordinated indebtedness, in which case such subordinated indebted- ness would be a fourth charge on the assets of the Bank as provided under section 369. While it is im- possible to say for certain whether this type of agreement has been made between the Bank and some of our clients for every BA guar- anteed by the Bank, I can con- firm that based on our experience it would be unlikely.  

So there you have it. Forty-six years after the introduction of BAs, with the BoC having taken a deep interest in the matter, under constant federal regulatory scruti- nity … when you purchase a BA you can’t even get a good descrip- tion of what you’ve bought: you are simply hoping that somehow everything will be all right. BAs are probably pari passu with BDNs, but an investor has no way of veri- fying this at the time of purchase.  

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