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**Report on the Focus Group Session to Develop
Industry-Supported Requirements and Modalities related to the Provision of an
SBLA-Type Guarantee for Capital Leasing (SBCL)**

**Prepared by
The Conference Board of Canada
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Introduction

The Financial and Business Research Group of The Conference Board of Canada (“the Conference Board”) was asked by Industry Canada to conduct a focus group session involving Canadian providers of lease financing to scope out the modalities and requirements that would be associated with extending a Small Business Loan Act (SBLA)-type guarantee to capital leasing. For such a guarantee program to work effectively, it must be designed to deal with a number of operational issues related to capital leasing that are different from those that apply to traditional bank lending. This is necessary in order to ensure that the leasing industry can make effective use of such a guarantee program and can contribute to the related policy objectives.

This paper reports on the focus group session that was conducted on February 11, 1998, in Toronto. The session was designed to provide background and achieve consensus on detailed suggestions for guidelines that would mirror those in place within the SBLA, but be applicable to capital leasing contracts written with small and medium-sized enterprise (SME) clients. The report builds on earlier work by the Conference Board, confirms the merits of an SBLA-type arrangement for capital leasing and outlines specific guidelines that would have the support of the industry under such a program.¹ For the purposes of this report, such an industry-supported model for an SBLA-type arrangement for capital leasing has been dubbed the Small Business Capital Leasing (SBCL) program.

The focus group session was very successful and served to confirm interest in such a program. In the process, industry representatives were able to achieve consensus around arrangements and guidelines that would help ensure that the program would be workable from the outset. The focus group participants would like to express their thanks to Industry Canada for asking them to suggest workable modalities toward finally including capital leasing for SMEs within the umbrella of the SBLA, and look forward to working with Industry Canada to finalize any eventual capital leasing guarantee program.

1. Project Description and Methodology

¹ See Operational Issues Related to the Provision of a Small Business Loan Act-type Guarantee for Leasing, The Conference Board of Canada, 1996.

As part of a review of the SBLA, Industry Canada asked The Conference Board of Canada to conduct a focus group session in order to provide a brief report that would identify a range of working requirements that might be implemented under a program whereby an SBLA-type guarantee would be extended to capital leasing contracts (or an “SBCL” for our purposes). The report was also to serve as a reference document by providing a leasing industry perspective on such a program, and identifying and proposing key operational arrangements to be considered in setting up such a program. The scope of this project is strictly limited to documenting any industry consensus on the working requirements of an eventual SBCL, and does not extend to developing or analysing various options that Industry Canada might consider in light of the industry perspective.

The Conference Board of Canada conducted a one-day focus group of executives in the asset-based financing industry. In total, 12 industry executives attended the meeting and 2 more were involved in reviewing the output of the meeting (for the focus group agenda, see Appendix A, and for the participants list, see Appendix B). Participants were provided with a pre-meeting briefing document that introduced and described the SBLA requirements, and provided an initial description of potential guidelines and requirements that might apply to an SBCL (a program whereby the SBLA would be extended to capital leasing).

The suggestions themselves were borrowed from previous Conference Board reports and industry submissions on the topic. During the focus group session, participants worked toward a consensus position on capital leasing principles. The Conference Board then prepared an annotated version of draft guidelines that are attached as Appendix C. In view of this process, and the timing constraints associated with its preparation, Appendix C should be viewed merely as the start of a more detailed technical review process, particularly by lawyers familiar with the SBLA.

In fact, these preliminary suggestions have not been reviewed by the industry and should be seen as illustrations and as a series of initial thoughts as to possible types of guidelines that might work for an SBCL. The suggestions found in the Appendix are not meant as authoritative or even definitive suggestions resulting from the focus group. The industry will be pleased to discuss with Industry Canada more detailed suggestions for capital leasing guidelines in due course.

2. Overview of Considerations Relative to the Leasing Industry

Traditionally, SMEs² have primarily looked to commercial banks for most of their initial debt financing needs. As a result, a number of the SME customers targeted by the SBLA program depend on banks as their first line of financing. However, in recent years, trust companies and specialized financial institutions have become much more prominent financial supporters of SMEs.

A recent study by The Conference Board of Canada entitled *What's New in Debt Financing for Small and Medium-Sized Enterprises* found that the total business debt financing market for SMEs had grown more rapidly than the market as a whole. The report confirmed that the bulk of this growth had come from financial instruments provided by specialized financing companies, with lease financing, in particular, almost doubling from 1994 to 1996.

Clearly, providing an SBLA-type guarantee for leasing would be one way to increase the financing available to SMEs. Focus group participants confirmed that a large proportion of their clients, particularly in the case of the smaller leases, were SMEs. In fact, asset-based finance companies are specialized institutions that provide financing in the form of a loan, lease or conditional sales contract to a variety of customers.

Focus group participants described asset financing as an industry that is highly competitive in the SME marketplace, not only in lease terms but also in quality of service, ease of access and quick turnaround on leasing decisions. Leasing industry customers take advantage of this situation and, looking for the best deal possible, routinely apply for leases with several companies simultaneously. This differs significantly from the banking industry practice where customers tend to have established relationships with fewer providers.

Rationale for Extending the Guarantee to Capital Leases

A *lease* contract is an agreement under which the owner of the equipment (the “lessor”) conveys to the user (the “lessee”) the right to use the equipment in return for a number of specified payments over an agreed period of time. Although the structure of individual lease contracts can blur the distinction, there are generally two kinds of leases—capital and operational—both of which are well defined in practice, notably under Revenue Canada and Canadian Institute of Chartered Accountants guidelines.

This report deals exclusively with capital leasing contracts. Under such contracts, the *capital lease* is used to finance assets over a major part of their useful life, and there is a reasonable assurance that the lessee will obtain ownership of the asset by the end of the lease term. While there are variations, a capital lease is

² There is no single definition of a SME. It is usually a business entity with less than 100 employees, a loan authorization of less than \$500,000, or an annual revenue of less than \$5 million

generally viewed as equivalent to a term loan or conditional sales contract, and the lessee is committed to a stream of payments that will amortize the cost of the asset over the life of the lease.

The focus group consensus was that the creation of an SBCL would be valuable to the industry as well as widen the choice of financing available to their business customers. A large proportion of these leasing customers are already small businesses, as defined generally under the SBLA. More importantly, however, the focus group suggested that a larger proportion of the lease applications that *are not approved* are generally rejected because of the lack of a financial track record, which usually plagues particularly small SMEs, start-up situations and/or knowledge-based industries. Within this context, a guarantee program that would apply to capital leasing would significantly improve the situation of these SMEs.

Industry executives also generally agree that, from a government risk perspective, a capital lease is virtually identical to a term loan or a conditional sales contract, both of which are eligible for guarantee under the current SBLA program. The similarity of capital leases to term loans means that the structure of the current SBLA program could be adapted relatively easily to deal with capital leases. In fact, the focus group confirmed that the current fee structure whereby an initial fee of 2 per cent plus a yearly fee of 1.5 per cent is levied on all approved SBLA financing to cover any disbursements under the program guarantee would be adequate, particularly since Industry Canada research shows the loss experience of the leasing industry to be “less than those that the big six banks lenders typically experience on commercial loans to SMEs.”³ The consensus of industry participants was that, with clarification and relatively minor adjustment to the SBLA to reflect the different structure of the industry and/or the nature of lease contracts themselves, it would be possible to extend the SBLA guarantee to capital leasing.

The Unique Nature of Leasing

Commercial lending and leasing are different products, each with an important role to play in the capital structure of SMEs. From a customer’s perspective, there are a number of features that make leasing more attractive as a business financing decision. Leasing typically offers long-term financing at a *fixed rate* over the financing term. This means that the customer is insulated from spikes in interest rates that occur within the Canadian economy from time to time.

Flexibility is another key differentiator of leasing as compared with traditional bank lending. This is particularly true in the small ticket leasing market, the market composed primarily of SMEs. This flexibility

³ Please see: Extension of the SBLA to Capital Leases: Analysis of Lessee Attributes and Defaults, Alan Riding, Equinox Management Consultants Ltd., December 9, 1996

is a significant operational advantage in a number of situations where the lease payments can be tailored to a customer's revenue streams, and it offers a level of flexibility in timing and payment schedules unmatched in the traditional lending sector. (For example, a ski lift operator using the equipment six months a year can make seasonal payments on its equipment. Similarly, other seasonal businesses such as school bus operators can take advantage of the unique flexibility that leases offer.)

Another unique element is the knowledge and expertise of the specific equipment. As an asset management-based business, the lessors are frequently responsible for the asset leased from the time the equipment is purchased to its resale or disposal. The leasing industry often provides its clients with considerable expertise relative to the type and size of equipment that is required for a job. Leasing thus frequently offers an upgrade path to accommodate technological obsolescence.

Similarly, on the asset disposal side (and unlike traditional lenders), leasing companies are experts in the re-marketing of assets and the optimization of asset values. This leads to a valuable and growing after-market in second tier equipment, a by-product of this asset management expertise.

Leasing also offers different levels of service, depending on the type of equipment being leased. This level of service can range from simply providing the equipment, right through to maintaining the equipment and agreeing to exchange the equipment for more up-to-date versions periodically. Unlike the banking industry, the leasing company continues to have a stake in the actual product purchased throughout the lease, and continues to own the asset until the end of the lease term.

Finally, speed is another innovative hallmark of asset-based financing and leasing. Credit decisions, among others, can now be made in a matter of minutes. This is particularly true in the small ticket leasing market, the market comprised primarily of SMEs. This rapid decision-making capacity is essential to cost-efficiency. It is a high volume, low touch, quick turnaround business.

Specific Areas of Differentiation

As a result of the focus group session, the industry highlighted several broad issues that would have to be clarified for an SBCL program to work effectively:

Cost of financing: A key point of differentiation from traditional lending is the cost of financing as calculated under a lease versus a loan. While SME loans are often tied to the prime rate, most leases are written as fixed rate transactions.

The “prime rate” is thus an irrelevant measurement in leasing. Generally, the “prime rate” is a short-term floating rate index that is adjusted from time to time as market conditions dictate. At best, “prime” is a short-term variable corporate rate.

For greater certainty for both lessor and lessee, particularly SMEs, however, the advantage of fixed-rate transactions is that they are not subject to any fluctuations in rate during the term. If leases typically have service terms of 24, 36 or 48 months, it is *essential* to match these terms with fixed rates. Funds are not borrowed for such periods at prime. For benchmarking purposes, government bond rates for similar periods should be used (i.e., a two-year Government of Canada bond rate is more relevant to set a fixed cost for financing a 24-month lease). Government bond rates are generally recognized as a more accurate benchmarking of longer term borrowing costs.

This industry reality tends to explain the wide variations found by the Alan Riding study in terms of both absolute and relative interest rates for leases, and the range of interest rates observed.⁴

Ease of use: For an SBCL-type program to be effective, it would have to be easy to use and conducive to a high volume, small ticket item process. Due to the high volume of agreements, reporting, tracking and payment schedules have to be clear and easy to use. In particular, it was hoped that electronic filing and the batching of transactions would be allowed by the administrators of the program. The system should also provide simplicity and be flexible relative to the way small and large providers register individual leases under the program.

Industry funding: Another key differentiating feature of the leasing industry is the way the industry funds its operations. In fact, many of the leases administered by the industry are securitized through a third party. Indeed, it is the securitization of leases that has enabled the industry to finance rapid growth and keep pace with the popularity of flexible leasing arrangements. Furthermore, it is the nature of the industry’s funding that allows leasing companies to offer a fixed term over a range of economic conditions. The participants felt it would be possible to address the current practices within the context of an SBCL through the definition of the lessor.

Definition of the lessor: Because it is common practice for a number of lessors to fund their portfolios through the sale of asset-backed securities, for any SBCL-type program to be effective, the definition of the lessor would have to be expanded to include third-party purchasers of leasing contracts who may own

⁴ See Extension of the SBLA to Capital Leases: Analysis of Lessee Attributes and Defaults, Alan Riding, December 1996.

or administer lease contracts on a pooled basis. In particular, guidelines similar to a Canada Housing and Mortgage Corporation (CMHC) mortgage-backed security program would have to be developed on how the guarantee would be transferred to such purchasers of leasing asset-backed securities.

Verification requirements: The industry is seeking clarification on the due diligence required relative to the information provided by lessees on their applications, especially in terms of financial information. The industry practice of due diligence normally includes credit checks on the individual application, as is the case with banks. It also includes an assessment of the cash flow and ability to pay aspects of the potential lease client. A key remaining question, however, is how best to verify a \$250,000 ceiling limit for individual clients. This question is not unique to leasing and needs to involve SBLA loan providers.

When is a default a default?: Under leasing agreements, ownership of the asset stays with the lessor. Because of this ownership, the lessee could default on the lease on non-monetary grounds: for example, failure to maintain insurance on a piece of equipment, or taking the equipment to an unauthorized jurisdiction. These non-monetary defaults are established to protect the value of the asset. Therefore, it would be important for any SBCL-type program to clearly account for such situations that flow from the lessee not carrying out the stipulations of the lease.

3. Creating an SBCL Program

The focus group consensus was that all of the above areas of differentiation could be addressed by changes or modifications to the current SBLA program. Focus group participants made a number of suggestions that should satisfy both Industry Canada and the industry, and assist in ensuring that an SBCL-type program would be successful from the outset. Preliminary suggestions compiled by the Conference Board are presented in Appendix C.⁵ Further explanations for changes are organized in the following five sections:

- Provider Registration Issues and Processes
- Eligibility Criteria and Operational Modalities
- Policy Aspects of Extending SBLA Guarantees to Capital Leases
- Security in a Capital Leasing Context
- Remedies upon Default, Termination and Disposal

⁵ In view of the drafting process, and the timing constraints associated with its preparation, Appendix C should be viewed merely as the start of a more detailed technical review process, particularly by lawyers familiar with the SBLA .

The industry consensus is that with such changes, the industry would be able to expand its product offering targeted at the small end of the market, ensuring that it can effectively offer guaranteed capital leases to SMEs currently underserved by the industry because of other factors such as track record or size.

Provider Registration Issues and Processes

This section explains the suggested registration processes to be adopted under an SBCL for both approved lessors and approved loans.

Suggested SBCL Approach for Capital Lease Eligibility

While several asset financing institutions are registered under the SBLA, none are members of The Canadian Payments Association, and membership in this organization should not be a pre-requisite in the case of the SBCL. On the other hand, potential lessees would have to obtain an approved lease contract from an approved lessor and there needs to be a set of criteria that help the SBCL administrator decide on lessor registration issues. The industry came to consensus that in order for their leases to be eligible for the SBCL, the leasing company would have to meet the following eligibility criteria:

- It should write a minimum of \$10 million of new arm's-length financing with eligible SMEs every year.
- It should have a track record of providing asset financing in Canada in at least one province or territory for at least three years.

This SBCL guideline for provider registration provides a balance to ensure that the lessor has an established leasing presence in Canada of sufficient size to effectively address requirements similar to those that exist under the SBLA.

Suggested SBCL Process for Lessor Registration

A designated administration office within Industry Canada should be given the power to approve lessors based upon a duly verified application with sufficient proof of eligibility as per the above-mentioned criteria. The approval of the minister would continue to be available as another route toward registration. Similarly, should SBLA de-listing guidelines be implemented on the basis of lack of activity over a three- or five-year period, excessive claims over a similar time period, or some other criteria, it would be possible to adapt those guidelines to the leasing industry, subject to remedies that are already available under the SBLA.

Focus group participants suggested that a statement or a legal undertaking by a company officer be used to verify the adherence to the lessor eligibility condition. To prove a track record of asset financing in at least one province or territory for at least three years, GST or PST account numbers could be used as backup. The industry is open to other suggestions from Industry Canada, providing that they would not be onerous for the industry to provide.

Focus group participants suggested that, if the asset-based financing company can show that it meets the criteria, the SBCL administration office would automatically approve (without discretion) the company as an SBCL lender. Securitized lenders would be approved in the same way, once they demonstrate a similar volume and track record. New entrants into the leasing business (from the U.S., for example) that fail to meet the minimum criteria would have the option of applying directly to the minister, as is currently the practice.

Suggested SBCL Reporting Process for Leases

Due to the high volume, low touch nature of the industry, it is important that the program administrator create an easy-to-use system. Focus group participants agreed that this could be best achieved through an electronic-based registration, payment and balance tracking schedule that would be prepared when the lease contract is written, and updated on an as-needed basis when the payment schedule changes. The electronic files of the lessor would be used as background to the yearly fee remittance schedule. Forms could be filed in paper form, but in the case of high volume, low amount leases would be best filed electronically and in batch form, on a prescribed schedule, such as once a month. As there is no standard leasing agreement form, the program administrator should either list the information required or provide a standardized electronic form to transmit the information required for tracking purposes (see SBCL Guideline 10).

Based on discussions with Industry Canada, it is likely that any such electronic filing procedures could be developed at reasonable cost since this issue has already been examined within the context of SBLA procedures. (In fact, an electronic registration software package was developed, although it has not been fully implemented as yet.) Since existing plans at Industry Canada call for improvements in the area of electronic commerce, it is likely that by feeding into existing processes using existing data formats and electronic registration software, an SBCL procedure could be implemented with a minimum of cost and effort on both sides.

Suggested SBCL Lease Registration Process

As outlined in SBCL Guidelines 10, a process for lease registration similar to that being used by the SBLA would be used for the SBCL. Lessors would remit to the administrator a payment equivalent to the 2 per cent fee on SBCL leases being registered. Leases would be registered on a batch basis (such as monthly) and the information on individual leases would be transmitted, along with the prescribed fee to the SBCL administration office. To eliminate the need to send paper files, it was suggested that the signature of both the lessor and lessee could be remitted electronically or held on file by the lessor. The normal lease verification techniques and processes would be followed and the lease application would be used to verify with the client his/her SBLA/SBCL status (assuming a single loan limit applies to both leases and loans).

Eligibility Criteria and Operational Modalities

This section summarizes some of the focus group discussion surrounding key operational requirements of an SBCL.

Suggested SBCL Maximum Guarantee Amount

The maximum guarantee amount for all SBLA loans and SBCL leases with an eligible SME would remain at \$250,000, including the 2 per cent registration fee. This requirement would be applicable “as is” under an SBCL (see SBCL Guideline 1).

Suggested SBCL Payment Terms

Technically, a capital lease is not a loan with a promissory note, but a contract. Therefore, this section should refer to payment terms as opposed to repayment terms. However, the focus group agreed that the same modalities could apply and that, in order for the capital lease contract to be eligible:

- the lease payments should begin within 12 months
- irregular payment patterns should be allowed
- at the time the contract is signed, the lessee should sign off on the schedule of payments associated with the contract (in lieu of a promissory note) (see SBCL Guideline 2).

Suggested SBCL Maximum Interest Rate

Participants in the focus group agreed that, from a business perspective, market rates rather than a fixed rate ceiling should be applicable to guaranteed capital leases. Under prior incarnations of the SBLA, interest rates were tied to a blended average of certain reference rates of interest, providing what was effectively a market-based maximum rate of interest.

In discussing the concept of “maximum interest rates,” for reasons mentioned above (see “Specific areas of differentiation: Cost of funds”), the focus group indicated that neither a bank “prime plus” nor “residential mortgage rate plus” are relevant yardsticks in leasing. Thus, lending and leasing rates cannot be harmonized. The focus group suggested that examining leasing companies in terms that are appropriate to banks and other regulated institutions would only result in confusion and misunderstanding. There are different dynamics at play here.

The focus group described a situation whereby the calculation of the cost of financing rates essentially includes the actual cost of funds to the lender/lessor, plus administrative costs, plus profit. While a bank’s true cost of funds is generally not publicly known, clearly, a bank’s prime rate reflects considerably more than simply its true cost of funds. Other costs are blended in. A bank may be able to use “prime plus” as a relevant means of expressing the customer cost of borrowing. Also, deposit-taking institutions generally have access to cheaper funding that a non-bank does not have. Furthermore, bank profitability in terms of spread over the cost of funds is enhanced by the fact that they are deposit-taking institutions and enjoy a leverage between 20:1 and 50:1, depending on the nature of the institution and the asset involved. Leasing companies, on the other hand, do not enjoy the same advantages and may consider themselves fortunate if leverage is between 6:1 and 10:1.

The focus group confirmed that the cost of doing business is the predominant factor in leasing, particularly for small-ticket transactions. A maximum lease financing rate formula is suggested in Appendix C, based on a fixed spread over an equivalent term Government of Canada bond rate. It is essential to understand that the “fixed spread” will inevitably have to exceed the 3 per cent figure the SBLA currently uses. The real transaction cost to a leasing company is normally greater than that.⁶

As specialists in the area of asset financing and management, lessors bring to the table other skills and services needed by SMEs. The key differences between lenders and lessors cannot be measured by the same yardstick. While interest rates or rate of return are critical concepts, they must be differentially applied so that leasing companies are compared with other leasing companies and lending institutions with

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other lending institutions, because the products are so different. Focus group participants concluded that using language and terms that attempt to homogenize these products would be a mistake.

Suggested SBCL Conversion / Cancellation Penalties

As in the case of residential mortgages, leasing contracts generally do not allow for prepayment. This is already well understood by officers within the Office of Consumer Affairs of Industry Canada, who are working with the industry under the aegis of the Federal Provincial Cost of Credit Disclosure Working Group. If a lease is paid before the final date, the full amount of the lease becomes due and payable. Generally though, as in most business situations, but in contrast to residential mortgages, lessors are open for negotiation. If the lessee decides to purchase the asset, the lease is terminated (see Guideline 3).

Policy Aspects of Extending SBLA Guarantees to Capital Leases

As noted above, a number of leasing executives interviewed by the Conference Board noted that a guarantee could be useful in providing lease financing to a start-up business that meets all other leasing criteria except for the needed credit history. Because of the variation of approaches among leasing companies, attempts to specify particular leasing criteria would be difficult to implement. The SBLA program specifies that lenders must apply their usual credit criteria, and a similar approach could be taken for leasing.

Suggested SBCL Guidelines for Loan Eligibility (from Guidelines, Section 4)

Participants in the focus group session reviewed the guidelines for loan eligibility and agreed that it would be possible to completely mirror those of the SBLA under the SBCL.

The only point of clarification required relates to whether equipment leases directed at the farming sector would still need to be excluded from the SBCL. Since it was not possible to fully examine the rationale for this exclusion, the focus group suggested that this issue be tabled for consideration at a later date (see SBCL Guideline 4).

Suggested SBCL Definition of “Business Improvement” for Leasing

In this area, the focus group agreed that the equipment definition applied to the SBLA aligned quite well with those opportunities that exist within the leasing industry provided that it is clear that equipment includes vehicles (see Guidelines, Section 5).

There are, however, real questions about the appropriateness of retaining premises, land and fee “leases” with an SBCL. The focus group understood the purpose of the exercise to be to extend the SBLA to equipment leasing. Concerns were expressed that simply to substitute the word “leases” for the word “loans” wherever the latter appears in the relevant sections of the SBLA would not work. If nothing else, such an approach risks confusing the real differences between lending and leasing.

Security in a Capital Leasing Context

The security issues related to capital leases are simpler than those related to loans because the lessor does not give up legal title to the asset. However, some industry executives raised the issue of transferability of a guarantee.

The issue of transferability was raised in connection with securitizing assets. A number of lessors fund their portfolios through the securitization of asset-backed securities (similar to CMHC mortgage-backed securities). The ability to attach a government guarantee to leases that would then be securitized is essential in these circumstances.

Suggested SBCL Security for Leases

Generally, because the title does not transfer over to the lessee, the focus group found they could significantly simplify this area of the guidelines and still provide the same or better security than the SBLA (see Guidelines, Section 8).

The group was told that a capital lease is itself a security agreement within the meaning of provincial personal property security legislation (PPSA) now adopted in seven, soon to be eight, provincial and territorial jurisdictions. As a security agreement within the context of the PPSA, a capital lease provides the lessor with a security interest in the leased asset, which if properly registered, would have a higher priority than any other interest in such asset.

In cases where there is existing security on the assets to be encumbered, however, such as in the case of a sale leaseback for example, Section 16(3) of the SBLA Act requires that the security shall be a fixed charge of the highest available rank. Final wording on security will have to be addressed by lawyers and goes beyond the scope of this report.

Suggested SBCL Change of Lessor Provisions

The focus group suggested that because the lessor owns the asset being financed, transfers at the request of the lessee are rare. Because of this, the focus group thought it appropriate merely to add the stipulation: “in the event that the lease provides for transfers,” and to keep the current transfer guideline intact for the SBCL (see Guidelines, Section 13).

Similarly, for Guidelines 14 and 15, the focus group decided simply to maintain the same requirements for the SBCL. The question of securitization is a highly technical one and remains to be addressed by experts. Many familiar with this funding technique argue that securitization of a portfolio of lease assets does not constitute a change of lessor. This issue is, however, beyond the scope of this report.

Suggested SBCL Maintenance/Substitution Arrangements for Leases

Because the title does not transfer over to the lessee, the focus group suggested that it would be relatively simple to define such arrangements for leases, because a change in the asset covered by a lease almost always results in a new lease being written. Therefore, if the asset is changed, sold or otherwise modified, a completely new lease is written to replace the existing lease. As such, the entire Guideline 16 does not appear to apply to the SBCL (see Guidelines, Section 16).

Remedies upon Default, Termination and Disposal

Industry Canada research suggests that the leasing industry is usually better at collecting its bad debts upon default than its counterparts in the deposit-taking sector. In its recent study, actual lease loss rates ranging from 0.07 per cent to 0.96 per cent (depending on the asset category) were somewhat better than bank loss rates on conventional loans. It is therefore likely that, in this respect, leases under an eventual SBCL would compare favorably with loans under the SBLA. Similarly, many of the remedies used for the SBLA would have direct applicability in the case of leases.

In fact, all of the applicable guidelines under Section 17 (Suggested SBCL Guidelines for Amendments to Payments) and Section 18 (Suggested SBCL Non-compliance Remedies) were found by the focus group to be directly applicable to leasing.

Suggested SBCL Moment of Default Provisions

The focus group reviewed the definition of the moment of default and, as described earlier, stressed that certain requirements under leasing contracts (such as preventive maintenance of the asset or insurance) would have to be in place to protect the value of the asset. This is essential in leasing because the asset is usually the only or primary security for the transaction. As such, a lease technically in default might not

necessarily be in financial default, as described in the guideline. The consensus was to augment the definition of default to encompass having to put the lease in default in order to preserve the value of the asset (see Guidelines 19 and 20). An overarching consideration in this case would be for the lessor to apply the same policies and procedures used in their normal assessment of a lease default.

Suggested SBCL Provisions for Collection, Realizing on Assets and Guarantees

Because title does not actually transfer over to the lessee, the focus group agreed that the same procedures, *subject to provincial regulation in the provinces that have them*, could apply in the case of collection, realizing on assets and guarantees. In fact, participants confirmed that the same procedures are generally used in leasing and that SBCL Guideline 22 would be largely the same as the corresponding guideline under the SBLA.

Suggested SBCL Sharing of Costs and Moneys Collected

Here again, the focus group suggested that the same provisions apply in those cases where there is a need to share the expenses among two or more leases, or two or more institutions, in realizing on a lease in default.

Suggested SBCL Time Constraints for Leases

The focus group agreed that the SBLA time constraints would be adequate for an SBCL.

Suggested SBCL Amount of Claim Calculation for Leases

The focus group confirmed that this section was applicable to leases except for the accrued interest calculation that would consist of:

the amount by which

(i) the net present value of the remaining lease payments for the remainder of the term, calculated at the date of change or cancellation and discounted at the lesser of the Bank of Canada rate or the implicit lease rate as of the date of calculation,

exceeds

(ii) the net present value of the sale or re-lease of the asset for the remainder of the term of the lease.

It was also suggested that GST and PST be added as one of the elements of cost to be included in the calculation (see SBCL Section 27). GST, and generally PST, does not apply to loans but to lease payments.

Conclusion

The focus group session was very successful and served to confirm that providing an SBLA-type guarantee for leasing would be one way to increase the financing available to SMEs. Industry executives also generally agree that from a government risk perspective, a capital lease is virtually identical to a term loan or a conditional sales contract, both of which are eligible for guarantee under the current SBLA program. The industry applauds the objective of eliminating a current bias affecting the business decision because of differences in the treatment of loan and lease guarantees. The industry also welcomes the added benefit of an expansion of the financing choices available to customers.

As noted above, commercial loans and leases are different products, each with an important role to play in the capital structure of SMEs. From a customer's perspective, a lease is very different from a loan. The unique nature of leasing is that it is able to offer long-term financing *at a fixed rate* over the financing term. Leasing, particularly in the small ticket market, is a high volume, low touch, quick turnaround business characterized by a level of flexibility that differentiates it from traditional bank lending. This flexibility is a significant operational advantage in a number of situations, since the lease payments can be tailored to a customer's revenue stream. The lessor can also often contribute to the lessee's business by providing expertise relative to the type and size of equipment that is required for a given job. In short, an effective guarantee program for leasing would be a good way to increase the availability of lease financing to many small businesses looking for a real financing alternative to an SBLA loan.

For the industry, a key objective is to correct the biasing effect of the current SBLA program. Because SME loans are included and SME leases excluded, there is concern that the effect of the program is to distort normal business decision making in favor of SME loans. By including capital leases under the program, balance would be restored and SMEs would choose the financing product that best suits their business needs. The inclusion of capital leases in the program would expand SME customer choice.

Overall, the industry welcomes the establishment of an SBCL and is eager to work with Industry Canada to finalize the modalities to be associated with such a program.

Appendix A: Focus Group Meeting Agenda

**Focus Group Session to
Develop Industry-Supported Requirements and Modalities Related to the Provision of an
SBLA-Type Guarantee for Capital Leasing (SBCL)**

February 11, 1998

Hosted by:

The National Club
303 Bay Street
Toronto, Ontario M5H 2R1
(Tel) 416-364-3247

Chaired by:

Jeffery Graham
Borden & Elliott

PROPOSED AGENDA

Wednesday, February 11, 1998

8:30-9:00 a.m.	Continental Breakfast
9:00-9:30 a.m.	Welcome and Introduction to the SBLA Review Process
	Jeffery Graham Borden & Elliott
	Pierre Vanasse The Conference Board of Canada
9:30-10:30 a.m.	Facilitated Discussions of "SBCL" Program Requirements Provider Registration Issues and Processes

Eligibility Criteria (loan limits, repayment period and schedule, security/title considerations, allowable interest rates, conversion/prepayment penalties)

Facilitator:

Penny Brady

The Conference Board of Canada

10:30-10:45 a.m. Coffee and Networking Break

10:45-12:30 p.m. Facilitated Discussion of Requirements of an “SBCL” program:

Defining the “Business Improvement” Aspects of Leases

Defining Leasing Security (types, insurance, substitution/maintenance of security and re-lease)

Defining Default / Termination / Disposal Provisions

Defining the Moment and the Amount of Loss (realizing on the asset, ability to re-lease, evaluating the loss)

“SBCL” Claim Procedures and Timing (when is the loss quantified?, loss sharing)

Facilitator:

Pierre Vanasse

The Conference Board of Canada

12:30-1:30 p.m. Working Luncheon

1:30-2:30 p.m. Discussions of Consensus Proposals

Proposed Definition of Terms

Proposed “Security Deposit” and Prepayment Requirements

Proposed Fees and Allowable Interest Rate Calculations

Facilitator:

Penny Brady

The Conference Board of Canada

2:30-2:45 p.m.	Coffee and Networking Break
2:45-3:45 p.m.	Discussions of Consensus Proposals Proposed Standard Lease Contract Proposed NPV Calculation for the Guarantee: relative to re-lease of the equipment relative to disposal relative to transferability issues
	<u>Facilitator:</u> Pierre Vanasse The Conference Board of Canada
3:45-4:00 p.m.	Summary and Wrap-Up

Appendix B: List of Participants, Focus Group Meeting

Chair:

Mr. Jeffery Graham
President
Bordon & Elliott

Participants:

Mr. Alan Parkinson
Senior Vice-President, Operations & Risk Management
AT&T Capital/Newcourt

Mr. David Powell
President
Canadian Finance & Leasing Association

Mr. John De Luca
National Credit Manager
Dana Commercial Credit Canada, Inc.

Mr. Stan Prokop
Credit Manager
Hewlett Packard (Canada) Finance

Mr. Moe Danis
Associate Director, Lease Financing
Mutual Life Assurance Company

Ms. Hillary Lockhead
Manager, Documentation & Marketing
Copelco Capital

Mr. Joel Cohen
Vice-President, Operations
Foss National Leasing

Ms. Dorothy Ward
Marketing Manager
IBM Canada Finance

Mr. John Guido
Vice-President, Operations, Transportation & Construction
Newcourt Credit Group

Mr. Richard Weigand
Credit Manager
Textron Financial Corporation (Canada)

Mr. Tom Simmons
Newcourt Credit Group

Ms. Carolyn Connor
Director, Government Affairs
Newcourt Credit Group

Appendix C: Preliminary Suggestions for an SBCL-type Program

Principles Behind the Small Business Capital Leasing (SBCL) Guidelines

PLEASE NOTE:

During the focus group session, participants worked toward a consensus position on principles behind potential guidelines for an SBCL program. The Conference Board then drafted the PRELIMINARY SUGGESTIONS found in this Appendix.

These preliminary suggestions are merely the start of a more detailed technical review process, particularly by lawyers familiar with leasing and with the SBLA. The leasing industry will be pleased to discuss with Industry Canada more definitive suggestions for capital leasing guidelines in due course.

SBCL Guidelines: Introduction

The Small Business Capital Leases Program is a federal government program designed to increase the availability of leases to proprietors of business enterprises for the purpose of the establishment, expansion, modernization and improvement of small business enterprises. Under the Program, the minister is liable to pay to a lessor a specified percentage of a loss that may be sustained by a lessor as a result of a lease made, provided that the requirements of the Program and the Regulations have been met.

The Small Business Capital Leases Regulations, 19XX, and subsequent amendments state the procedures to be followed and conditions to be met in the granting and administering of leases as well as submission and substantiation of claims for loss for leases made in lending period XX, i.e., April 1, 19XX, and after.

The Program and the Regulations collectively are generally referred to as the Small Business Capital Leases Program, or simply the Program. These Guidelines have been designed to assist lessors in the interpretation of the Program and the Regulations, and in the delivery of this Program. They have been divided into three sections: Section A outlines the eligibility requirements as well as the registration process for leases made in Lending Period XX; Section B refers to the administration of a lease; while Section C details the required action when a loss is incurred. Sections B and C describe the processes that may be followed by lessors with respect to leases made in lending periods prior to April 1, 19XX, and for lending period XX.

Lessors are expected to write business improvement leases with as much care as they exercise in the conduct of their ordinary business. The Program has been designed to enable lessors to incorporate its administration into their normal daily business, while providing government-guaranteed leases to small businesses that might not otherwise be able to acquire the lease financing they require.

Where lease officers are unsure whether the Program, Regulations, or Guidelines cover a given situation, they should seek clarification and direction from their head office, regional office or central office, as the case may be.

Assessing Eligibility and Registration of Business Improvement Leases (BILs)

(applicable to leases made after April 1, 19XX)

1. Maximum Lease Amount

The amount of the lease being made, plus any outstanding balance of principal owed by the lessee on leases or loans previously obtained under the SBCL Program and/or the Fisheries Improvement Leases Act and/or the Small Business Loans Act, including the up-front 2 per cent government fee, cannot exceed \$250,000.

2. Payment Terms

2.1 The lease is considered to be made on the date of the signing of the lease agreement.

2.2 The maximum repayment period of 10 years commences on the date of the first scheduled payment under the lease.

2.3 Payment of the lease must be scheduled at least annually. The first lease payment must be scheduled no later than 12 months from the date the lease was made.

a) Payments do not have to be equal, but the total amount of the lease agreement must be paid over the life of the contract.

2.4 At the time a lease is made, the lessee must sign off on the schedule of payments associated with the contract. The schedule of payments should set out the lease amount, rate of interest payable and the payment terms.

3. Maximum Interest Rate

In view of the range of services that are often covered within leasing contracts, there is no prescribed maximum interest rate for lease contracts. The rate of interest inherent in the payment schedule, including any services or options offered as part of the lease contract must be disclosed in the schedule of payment as described in Section 2.4. (A maximum interest rate formula can be based on a fixed spread over an equivalent-term Government of Canada bond rate.)

Prepayment/Conversion: As in the case of residential mortgages, leasing contracts generally do not allow for prepayment. If a lease is paid before the final date, the full amount of the payment streams associated with the lease becomes due and payable. If the lessee decides to purchase the asset, the lease is terminated.

4. Who Is Eligible for a Business Improvement Lease (BIL)

4.1 Proprietor: The proprietor is the person, partnership or incorporated body by whom the business enterprise is carried on or is about to be carried on. An unincorporated division of a company is not a proprietor. The lessor makes a lease to a proprietor, who is then called the lessee. The lessee is considered to be the sole proprietor, the partners of a partnership, or the incorporated body, as the case may be, that is carrying on or is about to carry on the business enterprise.

4.2 Business Enterprise: This is the business or professional activity carried on or that is about to be carried on by the proprietor. Virtually all business enterprises are eligible to receive a business improvement lease.

Exclusions: The business of farming and any business having as its principal object the furtherance of a charitable or religious purpose or not operating for gain or profit (e.g., a private club). For ease of implementation, the Administration will refer to the Standard Industrial Classification of Statistics Canada to define farming as the Major Group 01 - Agricultural Industries.

4.3 Requirements: The business enterprise must be carried on or about to be carried on in Canada for gain or profit:

- a) for an existing business, the estimated annual gross revenue must not exceed \$5,000,000 for the fiscal period during which the lease is approved;
- b) for a new business, the estimated annual gross revenue, must not be expected, at the time the lease is approved, to exceed \$5,000,000 during the first 52 weeks of operation.

Note:

Assets of a business enterprise financed with a BIL must be used, primarily, for the operation of the business enterprise that is carried on or about to be carried on in Canada.

5. Classes of BILs

- Equipment leases
- Premises leases
- Land leases

- Fees leases

5.1 Equipment Leases: Made to the proprietor of a business enterprise for the purpose of financing the purchase, installation, renovation, improvement or modernization of equipment necessary for the operation of the business enterprise, excluding the labour cost attributed to the proprietor.

Note:

Installation expenses are those that will be added to the cost of the asset(s) and capitalized.

5.2 Premises Leases: Made to the proprietor of a business enterprise who:

- a) is or is to become the owner of the premises through construction or purchase; or
- b) is or is to become the owner or the tenant of the premises and the lease is made for the purpose of financing the renovation, improvement or modernization of the premises necessary for the operation of the business enterprise, excluding the labour cost attributed to the proprietor.

Note:

A premises lease made to a tenant is generally referred to as a "leasehold improvement" lease. Premises leases are intended to permit the future financing of the improvement, renovation and modernization of assets.

Rules:

The assets to be financed with the lease are not intended for resale, lease or sublease by the lessee.

Note:

Businesses in the mini-storage, hospitality and health care industries are those found in the Standard Industrial Classification (Statistics Canada) under the headings: 479 - Other Storage and Warehousing Industries; Major Group 86 - Health and Social Services Industries; and Major Groups 91 and 92 - Accommodation, Food, and Beverage Service Industries. They must, however, meet other eligibility criteria (see Subsections 4.2 and 4.3 of these Guidelines).

The three-year rule: The three-year rule should be applied first and then, if part of the asset being financed is or will be in excess of the size necessary for the operation of the business enterprise, the 50/50 rule should be applied.

The 50/50 rule: Where premises are or will be in excess of the size necessary for the operation of the business enterprise, premises leases must meet at least one of the following criteria:

- a) the area occupied, or intended to be occupied by the business enterprise (within 90 days after the final advance under the lease), must be at least 50 per cent of the total area of the premises in respect of which the lease is made; or
- b) the annual gross revenue derived from the part of the premises that is in excess of that necessary for the operation of the business enterprise must not exceed 50 per cent of the total annual gross revenue (inclusive of the lease revenue) of the business enterprise.

5.3 Land Leases: Made to the proprietor of a business enterprise who:

- a) is to become the owner of land necessary for the operation of the business enterprise for the purpose of financing the purchase of land, including any building or structure on the land, or
- b) is to become the owner or tenant of land, including any building or structure on the land, necessary for the operation of the business enterprise, for the purposes of financing the acquisition of existing improvements to the land, including any building or structure on the land.

Rules:

The three-year rule: The three-year rule applies to all land leases (see Subsection 5.2 of these Guidelines).

The 50/50 rule: The 50/50 rule applies to any building or structure on the land in a land lease where the building or structure is necessary for the operation of the business enterprise.

Note:

Land leases are intended to permit the financing of the purchase/acquisition of existing (realty) assets, which would include the acquisition of existing improvements to buildings and structures on the land.

5.4 Fees Leases: Made to the proprietor of a business enterprise for the purpose of financing all or part of the 2 per cent registration fee required to be remitted to the Administration on equipment, premises and/or land leases.

5.5 Requirements: The following apply to equipment, premises and land leases:

- a) the amount of the lease must not exceed 90 per cent of the eligible cost of the asset(s) financed with the lease funds, as evidenced by an invoice, a deed of sale or a purchase contract, etc.
- b) the date of commitment to the transaction, as evidenced by an invoice, a deed of sale, or a purchase contract, etc., must not predate the date of the lessor's approval of the lease by more than 180 days.

Note:

Lessors are reminded that the 180-day backward count starts from the day the lease is approved and not from the date of the lease application or from the date of the initial disbursement of the lease funds. The 180-day predate period is a requirement in the Act that cannot be extended by the Administration.

c) the lessor must cause an independent appraisal to be performed where the lessee is purchasing the assets from a person not at arm's length, within the meaning of that term in the Income Tax Act. The amount of the lease must be based upon the lesser of the current market value as reflected in the independent appraisal and the cost of purchase of the asset(s).

Note:

Such appraisal costs are the responsibility of the applicant/lessee.

6. Examples of Items That Can Be Financed with a BIL

The following list of eligible lease purposes is not exhaustive. Some items are found in the Act or Regulations; others have been determined to be eligible. When in doubt, lease officers should contact their head office, regional office or central office, as the case may be, for advice.

- Computer software
- Ships, boats
- Water supplies and drainage systems
- Display cases
- Moulds used for production
- Dies and jigs
- Equipment for rental such as automobiles, power tools and videos provided that these items are capitalized on the books of the lessee and not classified as inventory
- Paving of parking areas
- Buildings with mini-storage units for lease

Note:

The cost of the items listed above is assumed to be the net cost to the lessee.

7. Examples of Items That Cannot Be Financed with a BIL

The following list of items that are not considered eligible under this Program is not exhaustive. When in doubt, lease officers should contact their head office, regional office or central office, as the case may be, for advice.

- Improvements to a family dwelling for non-commercial purposes
- Vehicles for personal use
- Land and premises for resale, leasing or subleasing within three years from the date of the lease other than the leasing and subleasing exclusions for businesses in the hospitality, health care and mini-storage industries

8 Security

8.1 At the time the lease is made, the lessor retains ownership of the assets financed by the lease, in accordance with normal leasing practice, supplemented, where applicable, by whichever security listed in Subsection 8.2 below is the most appropriate. Where the lessee is a tenant and the lease is a land lease or a premises lease, the lessor may take alternative security on any other assets of the business enterprise.

8.2 The security can be:

- A mortgage or hypothec on real property
- A chattel mortgage or hypothec on moveable property
- A debenture
- A general security agreement, which should include a detailed description of the collateral
- A conditional sales contract
- Other similar security consistent with normal leasing practice

Note:

For leases made to businesses located on Indian reserves, a lessor may take any type of security that is consistent with the provisions of the Act and the Regulations. Lessors should also ensure that they abide by the provisions of the Indian Act and any other relevant legislation.

8.3 The lessor must ensure he/she has unencumbered title to the asset or first priority security interest in the asset.

8.4 A lessor may, in addition to the security described above, take personal or corporate guarantees. However, personal guarantees obtained from individuals, whether or not the individuals have an interest in the business enterprise, cannot:

- a) be secured, and
- b) in aggregate exceed 25 per cent of the original amount of the lease.

Note:

A personal guarantee taken pursuant to the foregoing does not affect the liability of a sole proprietor or of the unlimited partners in a partnership.

8.5 If a lessor takes a secured personal guarantee or a personal guarantee that exceeds 25 per cent of the BIL, the lease will not be eligible under this Program.

8.6 For limits on the realization on personal guarantees, see Subsection 21.2 of these Guidelines.

8.7 A lessor may take secured or unsecured corporate guarantees for the full amount of the BIL.

8.8 The owner in a sole proprietorship and the partners of a partnership (jointly and severally) are liable for the full amount of the lease. Upon default, however, and after realization of their business enterprise assets, the lessor cannot realize on the personal assets beyond 25 per cent of the original amount of the lease of a sole proprietor or 25 per cent in aggregate of all the partners in a partnership. The Administration defines “the amount of the lease” to be the value of the contracted lease payment streams.

9. Checklist

Lessors may use their own lease-related documentation (i.e., application form, schedule of payments, etc.) with the exception of the registration and claim for loss forms. When assessing the eligibility of a lease, lessors' lease officers may find the following checklist useful:

- a) the lessee is eligible;
- b) the purpose of lease is eligible;
- c) the percentage of assets financed does not exceed 90 per cent;
- d) the gross annual revenue of business is not greater than \$5 million;
- e) the term of lease is not greater than 10 years;
- f) the first scheduled payment is within one year of the initial disbursement date;
- g) the leased land and premises cannot be sold. Leased land and premises are not intended to be re-leased or subleased within three years of the date of the lease except in the case of a business enterprise in the hospitality, health care and mini-storage industries;

- h) the area of the premises from which the lessee's business enterprise is/will be operating generates at least 50 per cent of the lessee's gross revenue or the business enterprise will occupy at least 50 per cent of the floor space for its business activity;
- i) the aggregate of the lessee's SBCL outstanding leases is not greater than \$250,000 (including outstanding leases and loans guaranteed under the SBLA or the Fisheries Improvement Leases Act);
- j) the required security has been/will be taken;
- k) insurance is held over assets pledged;
- l) unsecured personal guarantees, in aggregate, do not exceed 25 per cent of the original amount of the lease (this limit does not apply to corporate guarantees);
- m) the rate of interest is disclosed and reflects the services and payment options associated with the lease;
- n) evidence is on file to support the cost of assets financed (i.e., invoices, contracts, purchase and sale agreements, etc.);
- o) the date of purchase or commitment to purchase assets is not more than 180 days prior to the day the lease is approved;
- p) evidence is on file to support that the assets financed by the lease are owned by the lessor (i.e., cancelled cheques, vendor's receipted invoice, or vendor's declaration);
- q) independent appraisal is on file for non-arm's-length transactions;
- r) no fee, service charge, or charge of any kind is, by the terms of the lease, payable to the lessor by the lessee (as long as the lease is not in default) and no fee, service charge, or charge of any kind has been charged to the lessee for the lease (as long as the lease is not in default), other than the registration fee, except direct out-of-pocket expenses such as appraisal fees and costs (e.g., legal fees) to register the security; and
- s) the lease registration form is submitted with 2 per cent fee to the Administration.

10. Lease Registration and Repayment of Fee

10.1 Lease Registration and Repayment of Fee

Within three months from the date of the first disbursement of the lease, the lessor must send to the Administration, together with the 2 per cent fee, a lease registration notice properly completed and signed by a responsible officer of the lessor and by the lessee. Reporting may be on either an electronic form provided by the Administrator or a paper copy. In the case of electronic reporting, the signature can appear electronically or remain on file with the lessor. Repayment is made via the lessor's cheque or draft payable to the Receiver General for Canada. Once the lease has been registered by the Administration, a lease registration and fee receipt acknowledgement form will be sent to the lessor. Reporting and payment may be made electronically on a batch basis as arranged with the Administrator._

10.2 Lease registration notices sent to the Administration must be completed and signed according to the instructions attached to the registration form and accompanied by the lessor's cheque/draft for the correct amount. Reporting and payment can be made electronically, and/or on a batch basis, as arranged with the Administrator. Forms with missing information and/or incorrect cheque/draft will be returned to the lessor. Should this result in a delay in the submission of the request to register the lease, beyond the prescribed time period, any consequences of such a delay will be borne by the lessor. Documents lost in the mail will not be the responsibility of the Administration and will have to be replaced or duplicated by the lessor.

Note:

For (late) registration of leases, see Subsection 18(a) of these Guidelines.

10.3 The lessee is considered to be the sole proprietor in the case of a sole proprietorship, the partners in the case of a partnership, and the incorporated body in the case of an incorporated company. Therefore, leases will be registered in the name of the sole proprietor, the names of the partners of a partnership, or the name of the incorporated company, as the case may be.

10.4 Fees Lease

The 2 per cent fee can be added to the lease provided the total amount of the lease, including the 2 per cent fee and any outstanding SBLA BILs and Fisheries Improvement Leases, does not exceed \$250,000. The 2 per cent fee is calculated only on the underlying value of the equipment, premises and land leases. No specific security respecting a fees lease is required.

11. Environmental Consideration

Where there is an existing or potential environmental risk, lessors should apply the same policies and procedures used in their normal assessment of a lease application.

12. Lease Identification

Once the Administration acknowledges its registration of a lease by returning to the lessor the lease registration and fee receipt acknowledgement, the involvement of the Administration in respect of that lease is, by and large, completed.

While there are actually very few instances where correspondence is needed, the lessor may, however, encounter situations that should be reported to the Administration. Where this occurs, it is important that any letter or other contact concerning a lease identify the lease registration number indicated on the lease

registration and fee receipt acknowledgement, the eight-digit transit number of the lessor's branch that granted the lease, and the full name of the lessee as it appears on the lease registration and fee receipt acknowledgement form.

13. Change of Lessor (Lease Transfers)

In the event that the lease provides for transfers, an individual lease can be transferred from one lessor to another at the request of the lessee. The acquiring lessor must notify the Administration of the transfer within three months of its occurrence. The written notification will indicate the following:

- Lease registration number
- Name and address of the lessee
- Original amount of the lease as per the lease registration and fee acknowledgement form
- Outstanding balance being transferred
- Name and transit numbers of both the original lessor and the lessor acquiring the lease
- Date of the transfer
- Date lease was made by the original lessor

The Administration will record the lease in the name of the lessor acquiring the lease, issue a lease registration modification acknowledgement to the acquiring lessor, and make the necessary adjustments to the loss-sharing maximums of both lessors (see Subsection 27.4 of these Guidelines).

It will be the responsibility of the lessor acquiring the lease to satisfy itself that the original lessor met all of the terms and conditions of the Program. In the event that a claim for loss is eventually submitted, failure on the part of the original lessor to have complied with all the Program conditions that was not corrected within the stipulated time frame (see Section 18 of the these Guidelines) will constitute reason for the rejection or reduction of the claim for loss.

In accordance with the Regulations, any leases transferred to non-designated lessors will not be guaranteed by the Administration.

For more information on this matter and on the effects of lessor amalgamation and mergers, contact the Administration.

Note:

Any corrective measures by the new lessor, with respect to security, late registration, etc., are limited to those stated in Section 18 of these Guidelines, and the time frame for such corrections commences on the date the lease was made by the original lessor. In addition, the administration of the transferred lease must comply with the SBCL terms and conditions in effect when the transferred lease was originally made. For the purposes of the Regulations, a transferred lease is not a new lease.

14. Change of Name of the Lessee

When a lessee changes the name under which it operates but retains the same legal status, i.e., sole proprietorship, partnership of individuals or corporation, it is important that the lessor obtain from the lessee a formal notice and a copy of the pertinent legal documents such as registration, articles of amendment, letters patent, etc. In the event of a claim for loss, these documents will be required. It is not necessary for the lessor to inform the Administration of the lessee's change of name.

15. Sale of the Lessee's Business/Change of Proprietor

In this case there will be a change of proprietor of the business enterprise. One frequent instance is where the sole proprietor or a partnership of individuals decides to incorporate. Ideally, in the case where the assets of a business change hands, the lease should be repaid entirely. However, the lessor may choose to continue to carry the lease in its present form, that is, in the name of the original lessee and under the original terms of payment. In that case, the lessor must continue the original obligation of the lessee and ensure that the lessor's security is maintained. This does not preclude the lessor from, subsequently, applying any provisions of Section 16 of the Guidelines. The assumption of the lease by the new proprietor is an agreement between the new proprietor and the lessor. In the case of a corporate lessee whose shareholders sell their shares to other parties, the lease is not affected as there is no change in the lessee. The lessor need not inform the Administration of such transactions at the time they occur, but will be required to provide details upon the event of a claim for loss.

Note:

Where a sole proprietor incorporates or takes on a new partner, or where there is a change in the partners of a partnership, if the lease is not repaid entirely, the sole proprietor who incorporated or each partner of the original partnership remains liable. The lessor's security position must also be maintained.

A lessor cannot release a partner of a partnership unless the lease is repaid in full.

16. Security

16.1 Maintenance/Substitution

The substitution of an asset covered by a lease results in a new lease being written on the new asset. Consequently, this SBLA section does not apply to the SBCL.

17. Amending the Payment Terms

The lessor and the lessee may agree to revise the payment terms of a lease where there is an actual or impending default, without the necessity of seeking the prior written approval of the Administration. Lessors are reminded that any revision to the payment terms:

- a) must provide for the payment of at least one annual instalment; and
- b) should not result in extending the payment period beyond 10 years (see Subsection 2.2 of these Guidelines).

However, should the revision of the payment term have the effect of extending the total payment period beyond 10 years (see Subsection 2.2 of these Guidelines), authorization must be requested, in writing, from the Administration.

18. Non-compliance Remedies

If, at the time a lease is made, a lessor inadvertently failed to comply with some requirements, the following remedies may be applied, within the following time frames, provided the lessee has not been or is not presently in default.

One-year time frame from initial disbursement of lease funds:

- a) Lease not registered: The lessor can register a lease up to one year after the initial lease date. An explanatory letter should accompany the lease registration request and fee repayment form.

Two-year time frame from initial lease date:

- b) Ten-year payment term exceeded: The lease documents and the security documents can be corrected within two years of the initial effective lease date.
- c) Non-conforming payment terms: The lease documents can be corrected within two years of the initial effective lease date.
- d) unauthorized charges to the lease account: Overcharges can be corrected within two years of the effective lease date. The overcharged sum must be credited to the lease account or to the lessee's current account if the lessee has already paid the lessor the overcharged amount. In the latter case, the lessor should keep a record of such credit.

e) Enforceable security not taken: This can be remedied by taking required security within two years from the effective lease date, provided the security priority ranking is in conformity with Section 8 of these Guidelines and the delay has not adversely affected the lessor's security position.

Note:

Where a lessor has failed to meet any of the above requirements within the prescribed period of time, the lease will not be a guaranteed lease.

19. Leases in Default

A lease is in financial default when any repayment of interest or principal in respect of the lease is not made on the date it is due. When this occurs, the lessor may consider a revision of repayment terms, which will have the effect of remedying the default. See Section 17 of these Guidelines. A lease may also be in technical default if the lessee fails to comply with or correct a specified requirement of the lease (such as insurance). When a lease is in technical default, the lessor may consider enforcing the security to preserve the asset. The lessor should apply the same policies and procedures used in its normal assessment of a lease default.

20. Calling the Lease

If the lessor decides that the default situation cannot be remedied (e.g., revision of payment terms is not appropriate), it must demand payment of the entire amount of the lease (principal and interest) and/or enforce its security on the asset. The lessor should use the same procedures and processes used for other leases or advances.

21. Collecting from Lessees and Realizing on Assets of the Business Enterprise and on Guarantees

Once the lease is in default, the lessor collects from the lessee by realizing on the security and guarantees subject to the applicable provincial regulations. Generally, lessors should apply the same policies and procedures used in their normal business practices to minimize the loss.

For leases made after March 31, 19XX, a lessor may not submit a claim for loss before taking all appropriate actions to collect from all possible sources and realize on security. This includes the following steps:

- a) if applicable, obtain other collateral security of the business enterprise;
- b) if applicable, realize upon any security of the business enterprise;
- c) if applicable, effect a compromise.

In respect of leases made after March 31, 19XX, only, compromise settlements with the lessee can be made prior to submission of a claim for loss, at the discretion of the lessor, based on the financial circumstances of the lessee.

Note:

The reason for and basis of any compromise settlement with a lessee should be well documented in writing.

To "realize on security" or "realization of security" means for a lessor:

- a) to seize, to take possession of, to sell, to arrange to sell or to engage a third party to sell secured assets;
- b) to fully settle or to negotiate a compromise settlement with guarantors;
- c) to have taken or be in the process of taking legal action without the lessor necessarily having received any or all of the respective proceeds; or
- d) to establish a market value of the security acceptable to the Administration at the lessor's full risk and responsibility for subsequent liquidation.

For the impact upon timing for submission of a claim for loss, see Section 26 of these Guidelines.

21.1 Realizing on Assets of the Business Enterprise

All assets of the business enterprise, including those not specifically acquired with lease proceeds, are subject to realization. Where the business enterprise has assets over and above those held as security for the lease, lessors are expected to follow normal practice in determining the cost effectiveness of realizing on those assets and, if appropriate, in realizing on those assets. Lessors are required to retain on file all documents pertaining to the realization of the security and, if appropriate, to provide the rationale for dealing with the other assets of the business enterprise.

21.2 Collecting from Guarantors/Sole Proprietors/Partners

The lessor must take reasonable steps to collect from the guarantor(s). Compromise settlements can be made at the discretion of the lessor, based on the financial circumstances of the guarantors.

The Administration defines "the amount of the lease" to be the total value of lease payments ultimately payable disbursed by the lessee to the lessor. If this differs from the original amount of the lease, the Administration would normally expect the lessor to have the original registered lease amount modified.

For leases made after March 31, 19XX, to a lessee operating as a sole proprietor or partnership and after realization of the security of the business enterprise assets, the lessor may not realize on the non-business enterprise (personal) assets beyond, in the aggregate, 25 per cent of the ultimate amount of the lease. This liability can be collected by a voluntary settlement or by legal procedures. The latter will usually result in the lessor realizing on non-business enterprise assets.

22. Sharing of Costs and Moneys Collected

Where moneys are collected and/or costs are incurred on behalf of both the lease and other leases from the same lessor, the costs incurred and the moneys collected are to be prorated between the respective leases as follows:

- a) based on the amounts of the unpaid principal, or
- b) where there is a judgment, based on the principal lease amounts claimed on the statement of claim, or
- c) where the realization proceeds are readily identifiable as belonging to the lease or to other advances from the same lessor, costs that were incurred on behalf of all leases are to be prorated on the basis of the amounts realized for the respective leases.

Note:

Where the lessor has a prior charge on security held for the lease and costs are incurred in the liquidation of the security, all such costs must be deducted from the proceeds received by the lessor. The net amount of the realization will then be applied to the leases according to security held.

23. Time Constraints

23.1 For leases made prior to April 1, 19XX, the lessor has a maximum of 19 months from the date of default (see Section 19 of these Guidelines) to submit a claim for loss. Upon the lessor's submission of a request for extension of claim submission date form prior to the passage of 19 months from the date of default, the Administration may extend the claim submission deadline one or more times.

23.2 For leases made after March 31, 19XX, the lessor must submit a valid claim for loss within 36 months from the date of default (see Section 19 of these Guidelines). The Administration may grant a lessor an extension, up to a maximum of 42 months, for the submission of a claim for loss provided the lessor submits such a request for an extension, in writing, to the Administration.

24. Environmental Risk

If it is suspected that an environmental problem does or may exist during the administration of a lease or the realization on security, lessors are advised to apply the same policies and procedures used in their normal course of business.

25. Reports and Annual Fees

Annually, by no later than May 31, every lessor shall:

- a) complete, and forward to the Administration, a Schedule XX "Report of Leases Outstanding for SBCL" as at March 31 (detailed instructions are found on each Schedule XX), and
- b) pay the Administration an "annual administration fee" of 1.25 per cent of the principal portion of the yearly average lease payments. The 1.25 per cent fee must be accompanied by a completed external auditor's report.

Lessors are requested to retain data and the respective working papers used to calculate the 1.25 per cent annual administration fee repayment, for 36 months after the March 31 of the year in which the remittance was forwarded. **Reporting and payment can be done on a batch basis, as arranged with the Administrator. Reporting may be either on an electronic form provided by the Administrator or a paper copy.**

Where the appropriate 1.25 per cent annual administration fee is not submitted to the Administration by the May 31 deadline, interest, at the average Bank of Canada bank rate plus 3 per cent, will be charged to the lessor on any unpaid portion, commencing June 1 of the year the repayment is due and ending on the day on which repayment is received by the Administration. Until a lessor's remittance and accrued interest, if applicable, have been received by the Administration, no claim for loss, concerning a lease made by that lessor in the period covered by the annual administration fee, will be processed.

26. Timing for Submission

Once the lessor has established a loss, a claim for loss may be submitted to the Administration. On leases made after March 31, 19XX, the Administration is prevented from accepting a claim for loss and recommending repayment, thereof, as long as:

- a) security in respect of the business enterprise remains unrealized, or
- b) the realization, if any, of non-business enterprise assets of a sole proprietor or an unincorporated partner remains incomplete.

Note:

If a claim for loss is submitted prior to a lessor having "realized on security" (see Section 21 of these Guidelines), the claim for loss is not a valid claim for loss. The lessor must submit a valid claim for loss or a request for an extension to the claim submission deadline within 42 months of the date of default (see Subsection 23.2 of these Guidelines).

If it is impractical or impossible to realize on all or part of the security and guarantees, or collect the balance outstanding from the lessee, a claim for loss may be submitted. Accompanying the claim for loss must be an explanation, as well as supporting documents, outlining why all security could not be realized upon and why no further recovery could be made from the lessee.

27. Establishing Amount of Claim for Loss

27.1 The amount of loss shall be determined by the Administration by aggregating the following:
the amount by which

(i) the net present value of the remaining lease payments for the remainder of the term, calculated at the date of change or cancellation and discounted at the lesser of the Bank of Canada rate or the implicit lease rate as of the date of calculation,

exceeds

(ii) the net present value of the sale or re-lease of the asset for the remainder of the term of the lease.

a) uncollected taxed legal costs;

b) all other taxes, legal fees and disbursements relating to the lease, i.e., out-of-pocket disbursements paid to parties other than the lessor's employees; and

c) other disbursements actually incurred by the lessor in endeavouring to collect the lease or in realizing on security, which were not paid by the lessee or for which sale proceeds were inadequate to cover repayment. Included are out-of-pocket expenses incurred by employees of the lessor in collecting or attempting to collect, such as travel, hotel accommodations and meals (for leases made after March 31, 19XX, only).

Also included are insurance premiums paid by the lessor after the lease has gone into default;

d) accrued interest on the unpaid principal amount of the lease;

e) for leases made after March 31, 19XX:

- for the period beginning on the day following the day on which the last instalment was made by the lessee, and ending on the day before the date the lease became due and payable at the rate of interest set out in the lease agreement, and
- for 36 months after the date the lease became due and payable or until the date of repayment by the Administration, whichever is earlier, interest will be paid, for the first 12 months of this period, at the rate (as per the lease agreement) that was in effect on the day the lease became due and payable, and thereafter (for a maximum of 24 months) at one-half that rate. As noted in Subsection 23.2 of these

Guidelines, an extension of the claim submission deadline may be granted for an additional six-month period; however, no interest will be paid by the Administration for that period.

27.2 Where a lessor has realized on security, collected under guarantees, or recovered funds from a lessee, the recovered proceeds will be applied to the principal outstanding on the date these proceeds were received by the lessor.

27.3 The government/lessor loss-sharing ratio is:

- a) 85 per cent/15 per cent for leases made during the period April 1, 19XX, to March 31, 19XX;
- b) 90 per cent/10 per cent for leases made during the period April 1, 19XX, to December 31, 19XX; and
- c) 85 per cent/15 per cent thereafter.

Note:

A lessor cannot avoid absorbing its 10 per cent or 15 per cent share of the loss by taking compensative security of any kind. Any recovery from such additional security is required to be applied to the lease and the loss established accordingly.

27.4 For each lending period, the Administration will reimburse the lessor in respect of losses sustained by it as a result of leases registered by the lessor for that lending period, up to a maximum amount calculated as follows:

Lending Period 12:

April 1, 19XX, to March 31, 19XX

the aggregate of:

- i) 90 per cent of the first \$250,000 of the total leases registered;
- ii) 50 per cent of an additional \$250,000 of the total leases registered; and
- iii) 10 per cent of the total amount of leases registered in excess of \$500,000 indicated in (i) and (ii) above

Individual claims for loss submitted by the lessor will be reimbursed as per Subsection 27.3 of these Guidelines. However, if the aggregate amount of claim for loss repayments to a lessor for any one lending period reaches the maximum liability as calculated above, subsequent claims for loss, submitted by the lessor in that lending period, cannot be reimbursed by the Administration.

27.5 Once a repayment of principal and/or interest has been applied to the lease, a reversal of such repayment after five (5) working days have elapsed will not be allowed for the purpose of establishing the loss.

28. Documenting Claim for Loss Submissions

When a lessor submits a claim for loss, the following documents must be submitted:

- a) a properly completed claim for loss form certified by both the responsible lease officer of the lessor and his/her supervisor;
- b) for leases made after March 31, 19XX, a copy of the lessor's application form or a copy of the lessor's documentation signifying approval for the lease;
- c) a copy of the lease registration and fee receipt acknowledgement form, and the lease registration modification acknowledgement form, if applicable;
- d) evidence showing the actual cost of the equipment, premises, and/or land, or in the case of "180 day" retroactive financing, see paragraph 5.5(b), that the cost of the asset(s) were paid by the lessee or by a third party on behalf of the lessee as the case may be;
- e) evidence showing that the lease proceeds were used to finance the cost of the asset(s);
- f) a copy of the lessee's statement of lease account (liability ledger card, computer printout, etc.) showing the date the lease proceeds were advanced, all repayments of principal, all repayments of interest, and all other entries to the lease account;
- g) a copy of the lessee's promissory note (see Subsection 2.4 of these Guidelines);
- h) evidence that the lessor has satisfied itself that the requirements outlined in Subsection 5.2 of these Guidelines were met;
and, if applicable:
 - i) a copy of the security documents relating to security and guarantees;
 - j) a copy of documents evidencing any revision in repayment terms;
 - k) a copy of documents evidencing the sale of security;
 - l) a statement of unrealized security, including guarantees;
 - m) a copy of documents supporting any settlement with the lessee or third parties, including guarantors;
 - n) a copy of invoices/receipts supporting costs claimed or costs deducted from asset sale proceeds;
 - o) a copy of the detailed solicitor's billing showing total time spent and rate per hour charged for the fee aspect of the billing;
 - p) a copy of the statement of claim, judgment and writ of execution;
 - q) evidence of bankruptcy/receivership, a copy of the lessor's proof of claim against the bankrupt estate of obligants (which is to include the total amount owing on the lease), and the trustee's/receiver's final report,

where one has been issued. Where the trustee's final report is not available, the lessor/trustee's comments as to the probability of receiving dividends from the estate should be provided;

- r) a copy of any approved request for extension of claim submission deadline;
- s) a copy of documents evidencing the landlord's distraint action against lease security, if available, otherwise, an explanation providing details of the distraint action;
- t) in the case of non-arm's-length transactions, a copy of the appraisal obtained on the assets being financed;
- u) other documents, if and when requested by the Administration to process the claim for loss.

Note:

Lessors are required to keep all documents on file until they are notified by the Administration that no further action will be taken.

29. Claim for Loss Form

Although, the four-page claim for loss form contains instructions for its completion, the following provides additional information for completing the narrative sections of the form.

29.1 Information on Business

History of the Business

The "history of the business" must include brief comments, as appropriate, on the following:

- a) description of the business;
- b) purpose of lease and description and function of assets being acquired; and
- c) problems leading to default and closure of the business.

29.2 Information on Lease

Description of security taken

- a) description of the security instrument and the rank of the security taken, as well as personal and corporate guarantees; and
- b) description and explanation of any subsequent amendments to securities and/or guarantees, as well as an explanation whenever a sole first or pari passu first fixed charge was not obtained.

Description of the realization process and the reasons that any security/assets/guarantee(s) were abandoned

- a) description of method used to dispose of the collateral security, success of action taken, and recommended action to dispose of unrealized security;

- b) an explanation of why the gross amount of proceeds realized from the disposal of collateral security and recoveries from the guarantors and the lessees was considered reasonable;
- c) in every case where security is sold and, to the knowledge of the lessor, the purchaser is a party to or has an interest in the lease (i.e., lessor, lessee, shareholder, guarantor, landlord, original vendor, etc.) or is related to the lessee by marriage or otherwise, an explanation as to why the sale and the amount realized were considered to be appropriate;
- d) where asset security has been abandoned, justification for abandonment should be provided (i.e., value of asset security versus estimated realization costs); and
- e) details of any suspected wrongdoing by the lessee (such as the conversion of assigned security) and details of the action taken by the lessor to remedy the situation.

29.3 Description of the potential for any additional recovery

- a) description and appraised value of any unsold assets taken as security for the lease; and
- b) if personal guarantees remain outstanding, financial and employment data on the guarantors supported by recent personal financial statements, the lessor's opinion as to the potential for future recoveries, its recommendation for further collection action, and the estimated costs involved. If a current personal financial statement cannot be obtained from the guarantor(s), the personal financial information should be obtained from other sources.

30. Post-Claim Follow-Up

30.1 After repayment of the claim for loss, the lessor may be requested to continue to actively follow up on an account in order to effect recovery and to provide reports on any developments.

30.2 Procedures:

- a) Specific action may be directed by the Administration from time to time. This could range from a request that an account be lodged with a collection agency/skip tracer or the judgment be executed, to a request for the gathering of more detailed information on a guarantor's circumstances.
- b) All reasonable out-of-pocket expenses in connection with any action undertaken on the lease may be claimed or deducted from recovered funds, as appropriate. Where expenses are incurred on the lease and other advances made by the lessor, the expenses are to be prorated between the leases. The lessor should first determine the amount of expenses applicable to the lease (see Section 22 of these Guidelines), then calculate for the 85 per cent/15 per cent or 90 per cent/10 per cent Administration/lessor sharing depending on the period involved.

c) Any engagement of a collection agency (other than for a "locate" action) is to be on a "contingency" fee basis. Legal action should not be undertaken through a collection agency without the prior written agreement of the Administration.

d) The Administration's share of any moneys collected after repayment of a claim for loss are to be forwarded to the Administration, with a cheque payable to the Receiver General for Canada. Included should be a statement showing the name of the lessee, the source of the funds, the date collection was made, the amount of any sums deducted from the gross proceeds, and a summary of the lessor's prorata calculations, where the funds are shared with other leases.

e) In the sharing of proceeds from the sale of security or collection on personal debts (direct or indirect), the lessor should first determine the amount of proceeds applicable to the lease (see Section 22 of these Guidelines), then calculate for the 85 per cent/15 per cent or 90 per cent/10 per cent Administration/lessor sharing.

30.3 The Administration must be provided with:

a) if the obligant is impecunious and improvement in his/her financial situation is unlikely in the future, current and detailed personal and financial data, preferably by way of a statutory declaration and an updated credit bureau report; and

b) if the obligant's whereabouts is unknown, a copy of a recent report from a skip tracing agency or collection agency indicating the obligant cannot be located.

30.4 When the Administration has decided to discontinue further action, the lessor will be so advised.