A Profile of the Leasing Sector and Potential Criteria for a Definition of a Lessor under the CSBFA Capital Leasing Pilot Project

A Research Project by

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The Conference Board of Canada
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1. Background and Data Issues

The Financial Research Group of The Conference Board of Canada ("the Conference Board") is pleased to present this report as part of the efforts to design a pilot program whose objective would be to make incremental lease financing available to SMEs. The study builds on the work undertaken by the Conference Board and by other analyses of the CSBFA and the Canadian leasing industry. In particular, the report is based on the findings of the Conference Board *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). This report* suggested it would be possible to design a program for leasing that would include many of the features of the now-defunct SBLA. The feedback received for this report forms the basis of the work.

Some words of caution are in order. A complete review of potential modalities and their application to all types of leases are beyond the scope of this report. The six weeks elapsed were not sufficient to do justice to the task. Similarly, the Conference Board expresses no opinion as to the legal ramification or application of any of the suggestions contained herein. A thorough review of the pilot programs by lawyers familiar with the industry and the Canada Small Business Financing Act (CSBFA) will be necessary before any of the suggestions contained in the report are implemented. Similarly, since there was no time for the industry to critique the suggestion, the Conference Board suggests that the pilot program, in draft form, be reviewed closely by a focus group consisting of selected representatives of the industry familiar with the leasing areas that are to be covered by the pilot program.

The analysis was conducted in two parts. Initially, the Conference Board obtained data from Statistics Canada and Dunn and Bradstreet on firms offering leasing in Canada. It then compared this data to that available from the Canadian Finance and Leasing Association to determine the representativeness of the association membership. It then drew on its experience studying the leasing industry and previous reports commissioned by Industry Canada to draft modalities for the pilot project.

All of these data sources, as used in the report are incomplete in some way and should be used with caution.

- The various data bases used are not always consistent in their definition of what is a lessor. Some sources include subsidiaries of other corporations (such as banks). Other data sources do not. Please see chart 1 for a recent estimate of the total leasing market in Canada.
- Statistics Canada data is based on data on financial leasing companies (table 12-050D), and other consumer and business financing intermediaries (table 12-049-D), and as such exclude leasing activities of other intermediaries, notably chartered banks who conduct such activities as part of their banking activities. In addition, all of the data obtained on leasing companies with assets under $10 million have been estimated by Statistics Canada. This means that some of this data, on the number of firms, for example, was unreliable and had to be estimated. Only data on companies with assets over $10 million are surveyed directly by Statistics Canada and are therefore believed to be completely accurate for the purposes of the study.
- The conclusions on CFLA data are based on a closer examination of 29% of CFLA's membership, exclusively those members that are directly involved in leasing. In addition to lessors, CFLA membership includes a number of manufacturers, lawyers and other service providers who may or may not be involved in leasing directly. They are also primarily Ontario-based and large by industry standards.

- The Dunn and Bradstreet data is derived from periodic interviews and surveys. As a result, it may or may not be out of date due to the fact that it is only updated occasionally, not consistently. It also captures multiple leasing offices of single companies. In order to approximate the number of firms, only the head office location of the companies were selected and included in the study. This has ramifications on the reliability of this data for purposes other than to identify the basic profile and location of lessors.

As a result of these difficulties and to mitigate the risk of major errors, only tendencies that are suggested by more than one source are outlined in the report. Other conclusions may be possible and useful to Industry Canada in understanding the context of the leasing industry for the purposes of its pilot project. However, the data needs to be used with caution or checked with other sources.

2. Introduction

The Canada Small Business Financing Act (CSBFA) was promulgated in the spring of 1999 to replace the Small Business Loans Act (SBLA), which had been in existence since 1961. The purpose of the CSBFA is to provide incremental financing to small business that would otherwise find it difficult to obtain financing. The program is a joint initiative between the government of Canada and the private sector. Under the CSBFA, the federal government partially offsets any losses on CSBFA loans. The program is targeted at small firms with sales of less than $5 million and CSBLA loans totaling less than $250,000. The use of the proceeds is restricted to the purchase of lands and structures thereon, the construction and purchase of premises (including renovations) and the purchase of new and used equipment. There are cost-recovery fees collected by government associated with CSBLA financing, as well as limits on the interest rate charged.

Up until now, the availability of a guarantee on financing provided to small business has been limited to that on lending. Indeed, SMEs 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 government guarantee program depend on banks as their first line of financing. However, in recent years, trust companies and specialised financial institutions became much more prominent financial supporters of SMEs.

Studies by The Conference Board of Canada looking at the size of the leasing activity relating to small business include: *Alternative Sources of Debt Financing for Small and Medium-Sized Enterprises* in 1995 *What's New in Debt Financing for Small and Medium-Sized Enterprises* in 1997 and a soon to be released update of this work. These studies have shown that the Canadian market for small business financing is broader and much more vibrant than was originally thought. Indeed, the studies 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 specialised financing companies, with lease financing, in particular, almost doubling from 1994 to 1996. The growth trends continued in leasing in 1997 and 1998 (see tables 1 and 2, and chart 1).

Table 1: Total Lease Contract Financing in Canada

($millions)

	1,994	*1,996*	*1,997*	*1,998*
Outstanding at year end				
Domestic Banks	1,418	1,794	2,441	2,781
Foreign Banks	668	449	333	482
Life Insurers	309	233	192	206
Trust & Mortgage Loan	946	517	360	353
Credit Unions/Caisses Populaires	0	0	0	0
Specialized Finance Cos.	6,599	10,272	9,425	11,154
Crown Corporations	0	0	0	*0*
Credit Cards				
Total	9,940	13,265	12,751	14,976

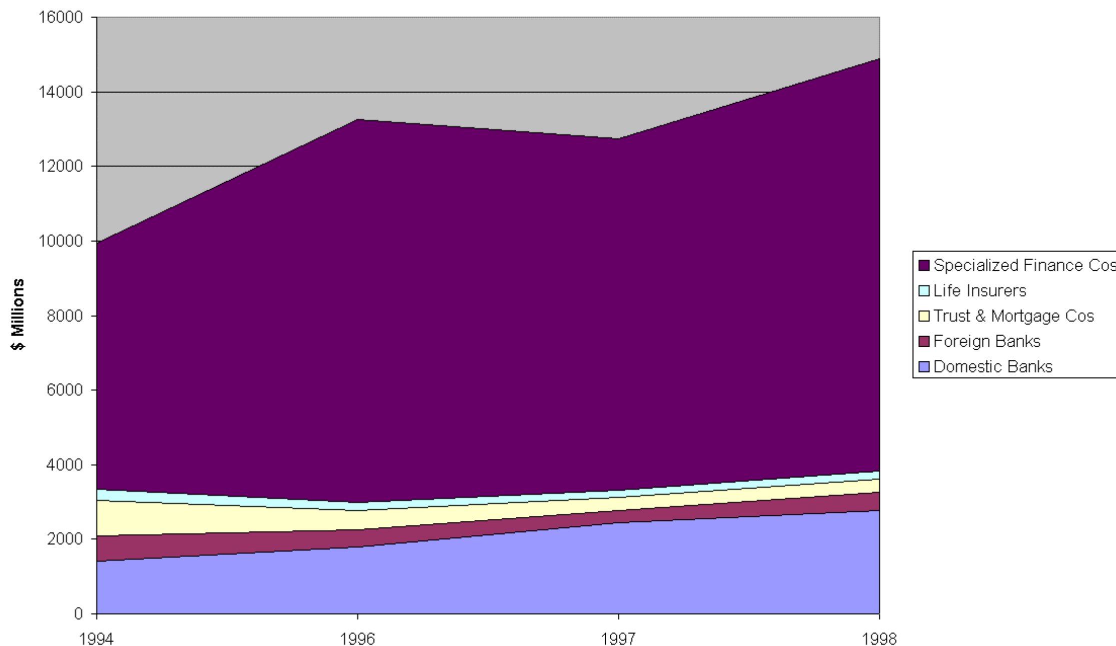
Source: The Conference Board of Canada

Table 2: Total Lease Contract Financing with SMEs in Canada

($millions)

Outstanding at year end				
Domestic Banks	468	628	842	884
Foreign Banks	111	72	53	77
Life Insurers	33	25	21	22
Trust & Mortgage Loan	189	165	228	113
Credit Unions/Caisses Populaires	0	0	0	0
Specialized Finance Cos.	2,310	5,650	5,184	6,135
Crown Corporations	0	0	0	0
Credit Cards	0		0	0
Total	3,111	6,540	6,327	7,230

Source: The Conference Board of Canada



Clearly, providing an SBLA-type guarantee for leasing would be one way to increase the financing available to SMEs.

- Large proportions of the industry's clients, particularly in the case of the smaller leases, are known to be SMEs.
- Asset-based finance companies are specialised institutions that provide financing in the form of a loan, lease or conditional sales contract to a variety of customers, including many SMEs.
- For several years, many leasing industry participants currently using government–guaranteed lending to SMES wondered why the guarantee was not available to leasing.
- It is clearly a complimentary form of financing.
- Over the 1990s, as lease financing gained in importance, pressure began to mount to include capital leases under the umbrella of the existing government guarantee.

For such a guarantee program to work effectively, it must be designed to deal with a number of operational issues related to capital leasing which 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.

Conference Board work with the leasing industry suggests it is highly competitive in the SME marketplace, not only on lease terms but also on the quality of service, ease of access and quick turn around on leasing decisions. Leasing industry customers take advantage of this situation and, looking for the best deal possible, routinely apply for leases simultaneously with several companies. This differs significantly from the banking industry practice where customers tend to have established relationships with fewer providers.

2. a) 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 distinction is not always clear within the contracts themselves, there are generally two kinds of leases, capital and operational leases, both of which are well defined in practice, notably under Revenue Canada and the Canadian Institute of Chartered Accountants (CICA) guidelines.

It is strongly suggested that the pilot project deal exclusively with capital leasing contracts. Under such contracts, the capital lease is used to finance assets over a major part of its 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 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.

Previous work by the Conference Board suggested that including leasing within the purview of the CSBFA would be a both valuable to the industry and widen the choice of financing available to their business customers. Large proportions of these leasing customers are already small businesses, as defined generally under the CSBFA. More importantly, it has been suggested that a proportionally larger number of the lease applications that are not approved usually are rejected on the basis of the lack of a financial track record which usually plague particularly small SMEs, start up situations and/or knowledge based industries. This was confirmed on the basis of interviews with 20 small leasing companies conducted for the purposes of this study. It is therefore likely that the pilot projection capital leasing would significantly improve the leasing situation of these SMEs.

Industry executives have also suggested 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 the current guarantee. The similarity of capital leases to term loans means that the structure of the pilot project could be adapted from existing guidelines to deal with capital leases.

3. The Unique Nature of Leasing

From a customer's perspective, the unique nature of leasing is that it is able to offer 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. It is a high volume, low touch, and quick turnaround business.

Flexibility also differentiates leasing from traditional bank lending. This is particularly true in the small ticket leasing market, the market comprised primarily of SMEs. For example, a ski lift operator using the equipment 6 months a year and 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. On the asset disposal side, leasing companies are usually experts in the re-marketing of assets and the optimisation of asset values – they actually own the asset. There are also different levels of service depending on the type of equipment being leased, ranging from simply providing the equipment, right through to maintaining the equipment and agreeing to exchange the equipment for more up to date versions periodically.

Leases are significantly different than loans, however. These differences, based on earlier Conference Board reports, relate to:

- Cost of financing
- Industry Financing
- Definition of the lessor
- Verification requirements
- When is a default a default

4. The Market for Lease Contracts

As outlined in Chart 1, the value of lease receivables held by Canadian financial institutions totaled almost $15 billion in 1998, an increase of more than 50 per cent since 1994. For 1998, other work by the Conference Board has estimated the total market to be $14.976 billion, up from 112.7 billion in 1997. The portion of the total that can be allocated to SMEs is estimated at 7.2 billion (see tables 3 and 4). These numbers are somewhat of an underestimation because of the industry practice of securitization, which take lease financing off balance sheet. Only lease contracts outstanding are captured by the Conference Board study.

Table 3
Total Business Debt Financing in Canada
($ billions)

Total Market Size	1998 Lease Contract:
Domestic Banks	$2.781
Foreign Banks	$0.482
Life Insurers	$0.206
Trust & Mortgage Loan	$0.353
Credit Unions/Caisses Populaires	$0.000
Specialized Finance Cos.	$11.154
Crown Corporations	$0.000
Credit Cards	$0.000
Total	$14.976

At year-end 1998
Source: Statistics Canada, The Conference Boa

Table 4
SME Debt Financing in Canada
($ billions)

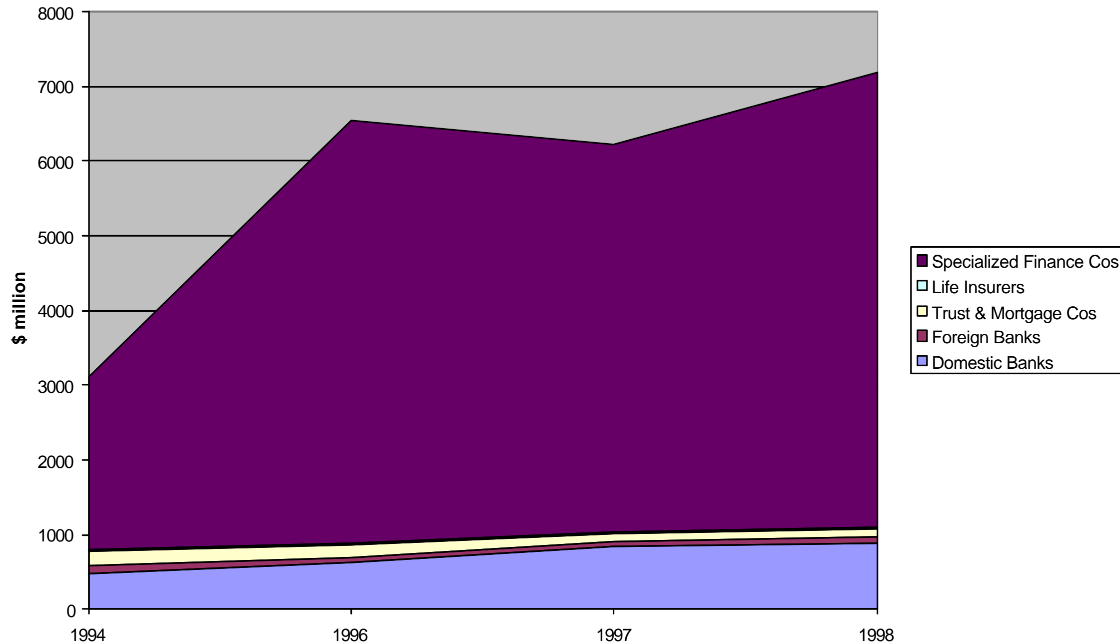
	1998 Lease Contracts
Domestic Banks	**$0.884**
Foreign Banks	**$0.077**
Life Insurers	**$0.022**
Trust & Mortgage Loan	**$0.113**
Credit Unions/Caisses Populaires	**$0.000**
Specialized Finance Cos.	**$6.135**
Crown Corporations	
Credit Card Companies	
Total	**$7.230**

At year-end 1998
Source: The Conference Board of Canada

The majority of the growth in lease contracts took place between 1994 and 1996 when lease receivables increased from $9.9 billion to $13.3 billion. In contrast, the value of lease receivables held by the financial sector actually declined 3.8% during 1997. As mentioned earlier, fluctuations in leasing from year to year appear to be the result of both securitization and the increasing attention of specialized finance companies to commercial lending as an alternative to leasing. Indeed, a look at the long-term trend in lease receivables demonstrates how frequently large chunks of lease receivables are taken off balance sheets – i.e., securitization. As shown in table 5, the data on leases outstanding often decreased by 10 or 20 per cent within a single year. This would be consistent with a large number of contracts being securitized and taken off the balance sheet of the leasing companies. More significantly, this variability represents a change from the early 1990's when the opportunities to securitize were not as common and peak amounts of lease receivables usually occurred in the fourth quarter.

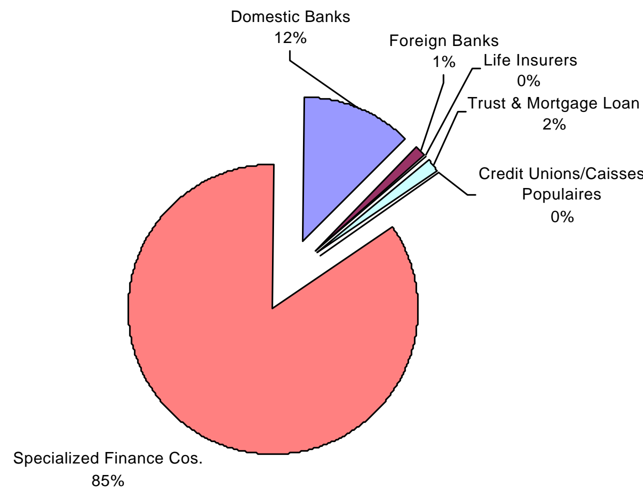
Table 5 **Impact of securitization on lease contracts outstanding**	Leasing Company holdings, Amounts for selected calendar quarters	Lease holdings of Other Companies, Amounts for selected calendar quarters
1988	1701/q4	1452/q4
1989	1910/q4 1925/q3	1307/q4
1990	2274/q2 2205/q1	1549/q2
1991	2157/q2 1953/q4	1855/q4
1992	1964/q4 2533/q1	2122/q4
1993	2484/q3 2305/q4	2897/q4
1994	2068/q4 2294/q2	4395/q4
1996	1787/q4 2000/q2	8363/q4
1997	2883/q4	6425/q4
1998	2922/q4 1981/q2	

A substantial amount of lease contracts can be attributed to the small business sector. The Conference Board estimates suggest that this market has also grown rapidly since 1994, as demonstrated by Chart 2.



There are many providers of lease contracts in Canada. However, the industry is primarily concentrated around the activities of specialized leasing companies. The banking sector is an important provider of leases, however, under the Bank Act , banks are restricted from leasing consumer goods, passenger vehicles, light trucks and real estate. The largest share of the overall business lease market in 1998 was held by specialized finance companies (74.5 per cent), followed by domestic chartered banks (18.6 per cent). However, in the SME leasing market, it is estimated that the specialized leasing companies hold about 85 per cent of leases with SMEs (see chart 3).

Chart 3 - Relative Market Shares, SME Lending Lease Contracts



This estimate is based on a soon to be published Conference Board update of the data on the financing market for SMEs. These estimates suggest that financing provided to SMEs in the form of lease contracts totaled $7.2 billion in 1998, up from $6.2 billion in 1997. The largest share of the SME lease market in Canada in 1998 was attributed to specialized finance companies, which held a total value of $6.1 billion (84.8 per cent) of total lease contracts outstanding with SMEs . Domestic banks accounted for the second largest share at 12.2 per cent, with $883.6 million in SME lease receivables. Leasing provided to SMEs by other sectors was minimal, as demonstrated by Chart 3.

This Conference Board study also suggests that traditional lending has not grown as quickly as lease financing in Canada since 1994. This unusually high rate of growth is explained in an analysis by the CFLA, which states that, *Canada has seen a consistent and steady upward trend in this ratio for the last 20 years. As it has not yet reached full potential, high rates of growth in terms of both new business financing and total assets are likely to continue.*[1]

Looking at trends and to the future, we draw on the analysis provided by the president of the CFLA in his annual report, which states:

> *Key sectors driving the demand for financing in 1998 included manufacturing, construction, transportation and oil drilling. Some of these sectors reported excess equipment capacity going into 1999. Asset-based financing companies have achieved this growth within an increasingly competitive market. The Canadian market offers a number of opportunities. As a result, there are many new entrants, both domestic and off-shore. The expectation from within the industry is for continued strong growth, at least through to 2000.*

The level of growth illustrated under chart 2 supports this finding.

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[1] Quoted from the annual report by David Powell, President, Canadian Finance and Leasing Association.

For this report the Conference Board conducted an additional overview of the leasing industry as a whole using available data from Statistics Canada and Dunn and Bradstreet, supplemented by 20 interviews of small leasing companies that are not members of the CFLA. As a result of this review, the Conference Board was able to profile both the CFLA membership as well as the industry as a whole in terms of the following classifications:

- Characteristics of the various types of leasing companies
- Types of financing and leasing activity (e.g. technology equipment, vehicles, etc.);
- Age of the company;

In addition, on the basis of the interviews, the Conference Board was able to provide the following data on small lessors who are not members of the CFLA:

- Average amounts of lease contract;
- Range of sizes for small versus large leases;
- Average default and loss rates;
- Average interest rates charged;
- Targeted groups and clients;
- Relationship with manufacturers;
- Differences between small and large players in terms of sources of funds;
- A description of income statements and balance sheets, by size of firm.

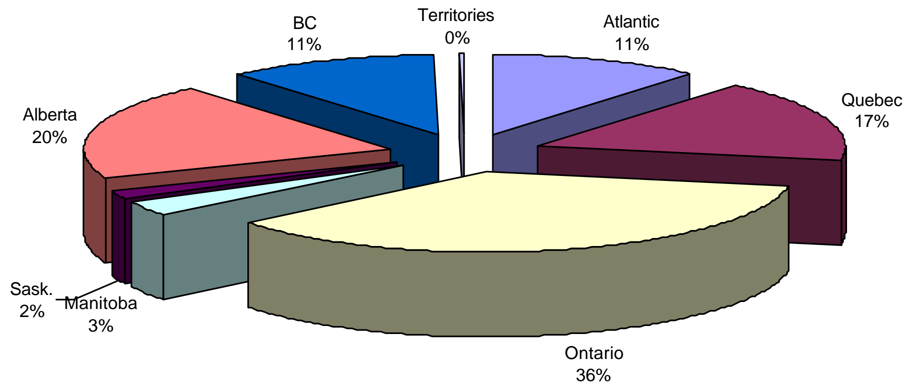
4. a) Overview of CFLA membership and the Industry as a Whole

In his 1999 report, David Powell, president of the CFLA states that "*the market penetration ratio of companies (*that are members of the CFLA*) rose to 18.9%* (of total financing in 1999)*, up from 17.0% in the previous year*". He describes the 175 members of the CFLA as including "most of the larger lessors" and confirms that "there are many more companies who are not members that remain uncounted particularly among the small and medium-sized lessors". This is consistent with our analysis of the industry statistics that suggest that there are more than 568 leasing companies in Canada. As will be demonstrated later, many of these firms are very small or are a part of corporate groups.

Approximately 75% of the CFLA members are based in Ontario, followed by 10% in British Columbia, 7% in Quebec, 6% in Alberta and even smaller representation from Manitoba and Saskatchewan. This is significantly different from the data obtained on the industry as a whole which are concentrated in Ontario and Quebec, but significantly present throughout Canada (see chart 4).

This profile of the industry is also significantly different from that of CFLA members. CFLA membership is geographically over represented in Ontario, and under represented in the Atlantic Provinces and western provinces.

Chart 4 - Location of Leasing industry in Canada



4. b) Which Leasing Market

The CFLA membership is split roughly between auto leasing and equipment leasing. The definition of equipment encompasses but is not limited to, heavy industrial and construction equipment, restaurant supply, light manufacturing, retail furnishings, and office supply including telecommunications and computer equipment.

This broad range of leasing activities is mirrored in the data for the industry as a whole. Indeed, the Dunn and Bradstreet database reports a large number of SIC codes along with those of leasing companies. And it is not uncommon to find individual companies active in 4 or 5 different types of leasing. Table 6 lists the number of industry participants according to their primary SIC code only.

Table 6 - Percent of Leasing Industry by Primary Type of Leasing

Audio Visual	1.8%
Auto leasing	10.8%
Auto rentals	5.2%
Business finance	5.6%
Computers	1.3%
Constr supply & eqp	14.3%
Crane & erl eqp	2.5%
Electrn eqp	5.9%
Equipment leasing	15.6%
Household rental	3.2%
Industrial supply	1.3%
Manufacturing	2.0%
Office supply	2.2%
Oil & gas	4.7%
Party supplies	1.1%
Real estate	1.6%
Rent-All (&machinery&	3.9%
Sign rental	1.4%
Steamship	0.7%
Telecomm eqp	3.2%
Truck leasing	7.9%
Other	3.9%

The largest sectors in the leasing industry are equipment leasing (manufacturing and construction) and vehicle (automotive and truck) leasing. There are several factors common to both of these types of leasing:

- they cater principally to corporate clients;
- the bulk of the transactions are conducted with repeat clients; and
- the leasing company is sometimes a subsidiary or sister company of a larger organisation and
- is created to act almost exclusively as its sole supplier.

In this last instance, the risk of loss through default by the lessee is reported to be virtually non-existent because the company, usually a large company is in effect leasing to itself.

Leasing companies that specialize in one type of product (i.e. photocopiers or broadcast equipment) and utilize a sole supplier enjoy several advantages; competitive pricing, vendor buy-back at the end of a lease or in the case of early termination; and continuously upgraded revolving stock. Again, such relationships may well reduce the risk of loss.

Not all CFLA members write leases. Of the 175 CFLA members listed on the association's web site, some provide legal and other services to the leasing industry and do not get involved directly in leasing. Yet others write very short-term leases that are clearly not capital leases and would likely not qualify for the leasing pilot. This finding is consistent with lessors identified through the Dunn and Bradstreet database and contacted as part of the interview process. Some of those "lessors" are actually manufacturers who use leasing as part of the sales process and not as a main business.

Therefore, it is likely a number of Canadian companies offering leasing are not, in fact *primarily* leasing companies. An example of this would be local car dealerships who have the option of

making leasing sales through the manufacturer–sponsored leasing company (GMAC, FORD Credit, etc.), or lease directly through an affiliate or a subsidiary for their own account (perhaps to local fleet managers). Another example would be a sign manufacturer who offers capital leases on the custom signs he sells. It is likely that a number of such lessors would qualify for the program because:

1. they are in the leasing business for the long term,
2. they have a track record in leasing,
3. they utilize standard industry practices, including credit checks

but…

4. leasing is just a part, *and not* their primary line of business.

This suggests that the leasing pilot would do well to target particular types of leases, not only particular types of specialized leasing companies to ensure the leasing pilot is properly targeted and not creating winners and losers in a particular line of business.

There are also many otherwise qualified lessors that should probably not be included in a leasing pilot project. For example, car rental companies would likely not qualify for a whole category of short-term leases (i.e. weekend rentals, or by the week). Similarly, heavy construction-type equipment lessors, that lease equipment like loaders, pavers, and diggers, which are often rented out by the hour or the day clearly would not qualify as providers of capital leases. This type of equipment is sometimes leased with an employee to operate the equipment. At the margin, some of these leasing companies are in reality acting subcontractors on construction projects. The terms are loosely defined, and the leasing company is hired for the job instead of a specified length of time – some would say such companies are not leasing companies at all.

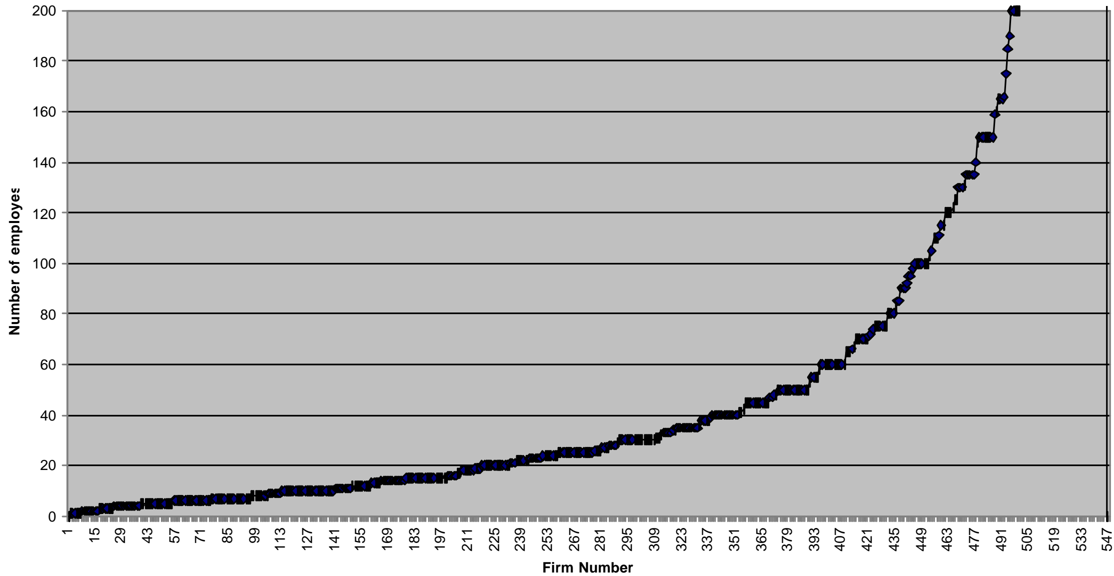
In Alberta, much of the oil and gas industry equipment is rented out on an hourly or daily basis. The equipment comes back when the job is done - and that can be quickly when things go well or take longer when things don't go well. Operators for such leases can come from a variety of sources, from the equipment company, from the oil company client, or from a "rigging outfit". Naturally when the equipment company supplies the staff, it affects the price. The leasing pilot will likely need to be able to differentiate and stay clear of such hybrid leasing. Again, this can likely be accomplished by limiting the target to plain vanilla capital leases.

There is another type of leasing which may be of interest. The oil and gas equipment companies particularly appear to have established a pattern of repeat clientele as do the other types of heavy equipment suppliers. They lease the equipment for much of its useful life, except that they do so in bits and spurts, one short-term lease contract at a time, but repeatedly over a period of years. Again, this finding suggests that the definition of the eligible type of lease will, more than everything else, dictate the type of lessors that will become eligible (because they write those types of leases).

4. c Profile of Employment

Most leasing companies have less than 25 employees. Indeed, as demonstrated by chart 5, almost all firms report less than 200 employees in total (490 out of 558 firms). Thus, the industry is very fragmented with many small firms. In fact, more than 200 firms report less than 20 employees.

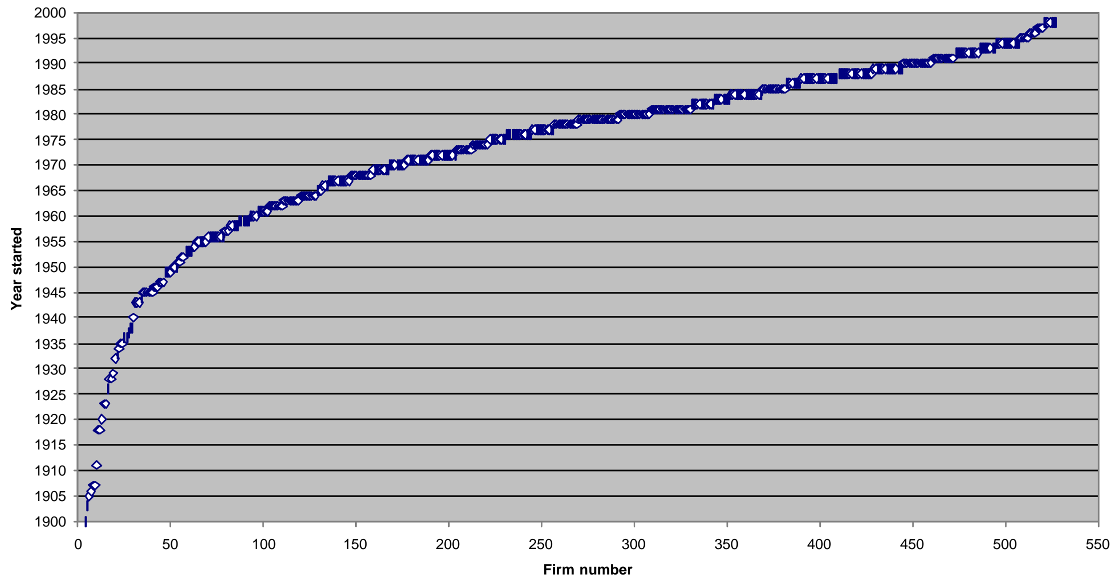
Chart 5 - Number of Leasing Firms with less than 200 employees
Source: Dunn & Bradstreet



This presents unique challenges for the leasing pilot as this group is quite different from the current crop of CSBFA lenders. Indeed, one might argue that the economies of scale as well as the more important requirement for capital in the lending sector usually result in much larger firms with a larger complement of employees. This suggests that a basic decision has to be made as to whether to target small businesses lessors who themselves provide leasing to small businesses. A different approach may be required to address the needs of such small lessors *at the same time as* the needs of the much larger sophisticated lessors.

4. d) Age Profile of Lessors.

The industry is primarily made up of firms that have been in business for a long time. As many as 300 lessors report being in business for more than 20 years, and a full 508 firms, more than 95 % of the industry according to Dunn & Bradstreet report being in business more than 5 years.



This suggests that almost all leasing firms will meet the eligibility criteria for the leasing pilot if it is similar to that for the CSBFA. Many of these seasoned lessors are still relatively small, indicating that they have found a niche that they are able to fulfil, that they likely know well, and that they service well. Again, it is likely that such firms will self select whether they want to participate in the leasing pilot depending on the usefulness they attach to the guarantee program, its ease of administration and the reporting requirements that are associated with it. The leasing pilot will likely have to use different requirements than the CSBFA to account for the types of participants that are quite different.

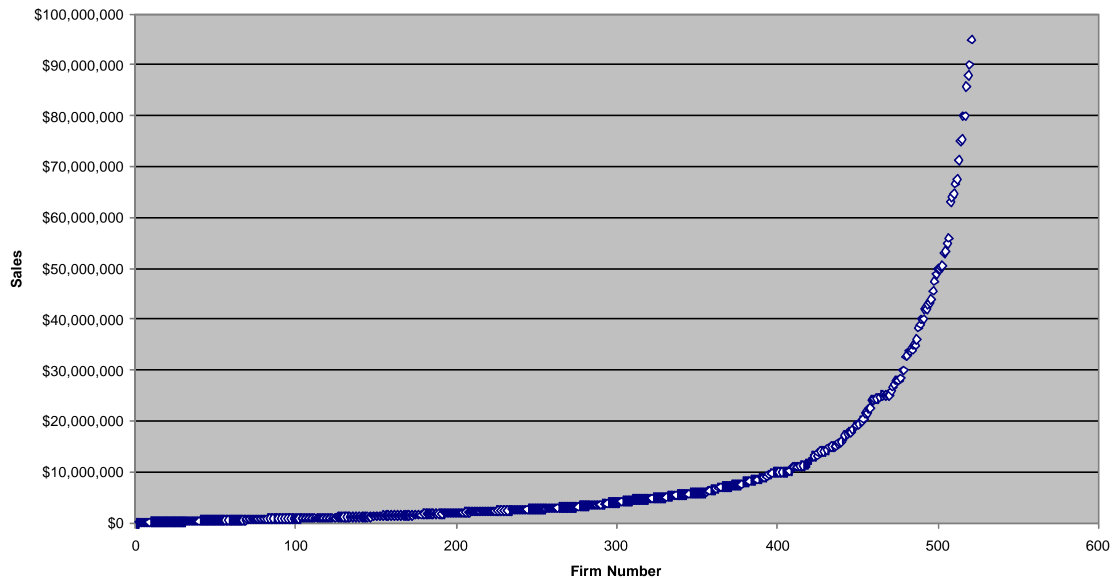
4. e) Profile of Incomes

CFLA members included in the study tend to be very large, as demonstrated by the attached profile of incomes. In the interest of time, only 75 CFLA members chosen at random were profiled using the Dunn and Bradstreet database (for consistency).

On this basis, we found that 16% had sales of more than $100 million in sales, 9% have sales between $25 and $100 million, about 10.5% have sales between $10 and $25 million, and about 64.5% have sales under $10 million. This is comparable to the industry as a whole where only 5.3 % had sales of more than $100 million, 9.5% had sales between $25 and $100 million, 11.5% had sales between $10 and $25 million, and more than 73% had sales under $10 million. This supports the contention that CFLA members are usually larger than the industry as a whole, but do represent a pretty good cross section of the leasing industry in Canada (based on this random sample).

The industry is very much dominated by a large number of very small firms, as indicated on the attached chart that profiles the Dunn &Bradstreet data in terms of sales. However, there is a

significant upward tail on this distribution that is not shown. In fact, this top 10% of the leasing firms by assets write 90% of the leasing business in Canada.



According to Statistics Canada data, the average leasing firm would have about $21 million in sales. Yet, firms with less than $10 million in assets (most of the industry) average just under $2 million in annual operating revenue. By contrast, the largest firms with more than $100 million in assets average more than $175 million in sales. These are very different types of firms, suggesting again that leasing does not have the types of economies of scale that are apparent in lending industries such as banking, nor the capital requirements necessary before such firms are allowed to operate.

Indeed, the leasing industry appears to be a classic case where the top 10% of the firms write 90% of the total business (see chart 7). Again, this suggests that the leasing pilot will either have to target one or another type of firm, or be flexible enough to address both types. Clearly, such vastly different firms will have different expectations that will have to be addressed if the leasing pilot is to be successful with all firms. It may be simpler to merely limit the applicability of the pilot project to certain types of firm (or as suggested before, by type of lease).

There are interesting variations in the analysis by asset size. For example, most of the industry write-offs occur in firms with assets between $10 and $25 million, who, according to Statistics Canada do not appear to provide for bad debts. Unless this is the result of a data error, it would suggest that firms of different size are managed differently!

Most leasing contracts are written by firms with more than $100 million in assets. Because of this, it may be possible to limit the pilot project only to the largest firms and still access most of the leasing business, depending on type of lease.

More than two thirds of firms, or close to 350 firms have sales of less than $10 million. The industry's focus group suggestion in 1998 to limit lessor eligibility to companies writing more than $10 million in leases each year would therefore prevent a large number of firms from participating in the leasing pilot project. On the other hand, if such a limit were not placed, the

pilot project would potentially have to register a large number of low volume lessors, whereas a large number of capital leasing pilot project lease contracts will come from a very few providers. As such, the leasing pilot may consider two sets of registration requirements, one for volume participants, and another for low volume participants.

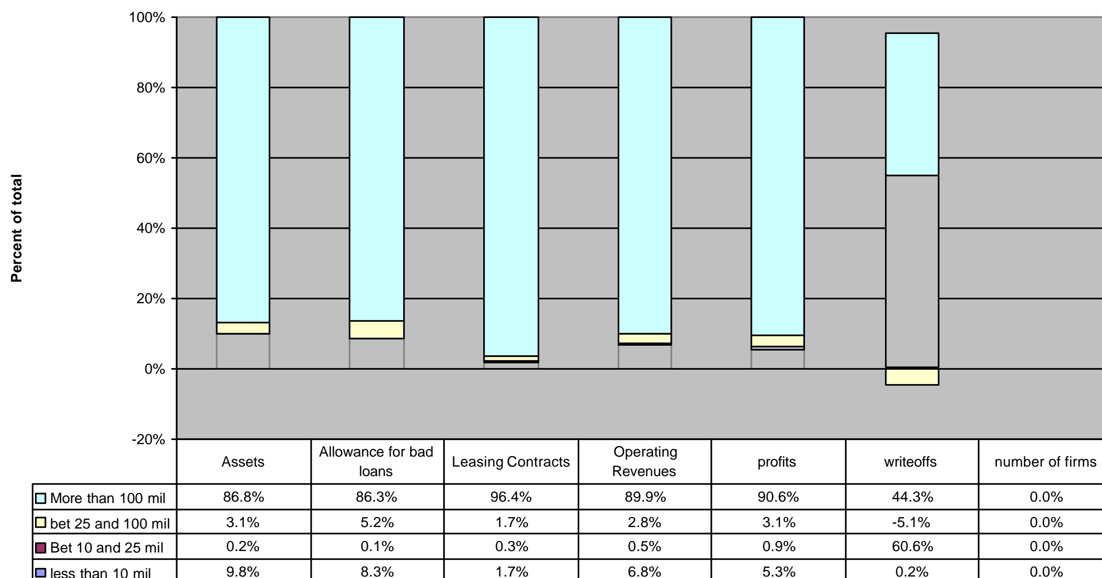
4. f) Profile of Balance Sheets

This section reviews how the various types of firms are financed, and the types of balance sheets they have. The data is based primarily on Statistics Canada data. Where possible, this has been substantiated by the findings of the interviews to ensure a sampling error does not cause the results.

Statistics Canada data needs to be interpreted with caution because only leasing firms with assets of $10 million or more are surveyed directly. Estimates are made for all of the figures for firms with less than $10 million in assets.

Firms with less than $10 million represent about 10% of the industry assets. Firms between $10 million and $100 million in assets are few in numbers and represent less than 3% of industry assets. Firms with more that $100 million in assets represent 88.2% of total industry assets, even though they represent less than 10.5% of leasing firms.

Chart 8 - Selected leasing industry indicators, Percent of total industry, by size

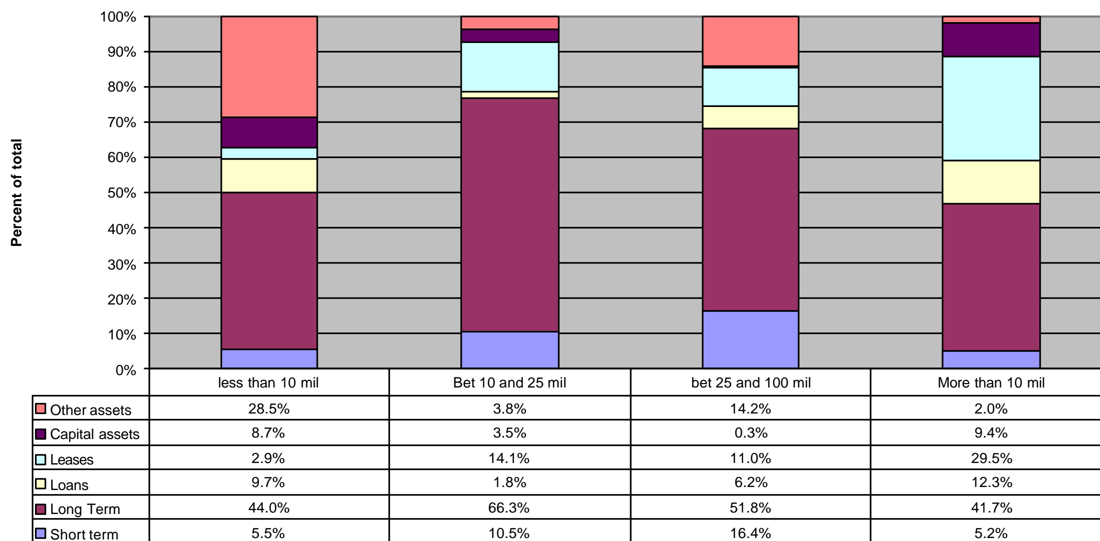


	Assets	Allowance for bad loans	Leasing Contracts	Operating Revenues	profits	writeoffs	number of firms
More than 100 mil	86.8%	86.3%	96.4%	89.9%	90.6%	44.3%	0.0%
bet 25 and 100 mil	3.1%	5.2%	1.7%	2.8%	3.1%	-5.1%	0.0%
Bet 10 and 25 mil	0.2%	0.1%	0.3%	0.5%	0.9%	60.6%	0.0%
less than 10 mil	9.8%	8.3%	1.7%	6.8%	5.3%	0.2%	0.0%

Source: Statistics Canada, The Conference Board of Canada

Small firms are funded differently and on a much more long-term basis than large firms are. Small firm balance sheets are made up primarily of investments and accounts with affiliates, loans and leases and other assets. The make up of their asset base appears to be more long term in nature, well diversified and investment focused. Funding comes primarily from borrowings and is again long term focused. Such borrowing comes not primarily from chartered banks, but from other lenders, presumably the wealthy individuals and affiliates that fund the firm's leasing business. This type of funding appears to be more typical of a small business than financing for a financial intermediary.

Chart 9 - Leasing Industry Assets, By firm size

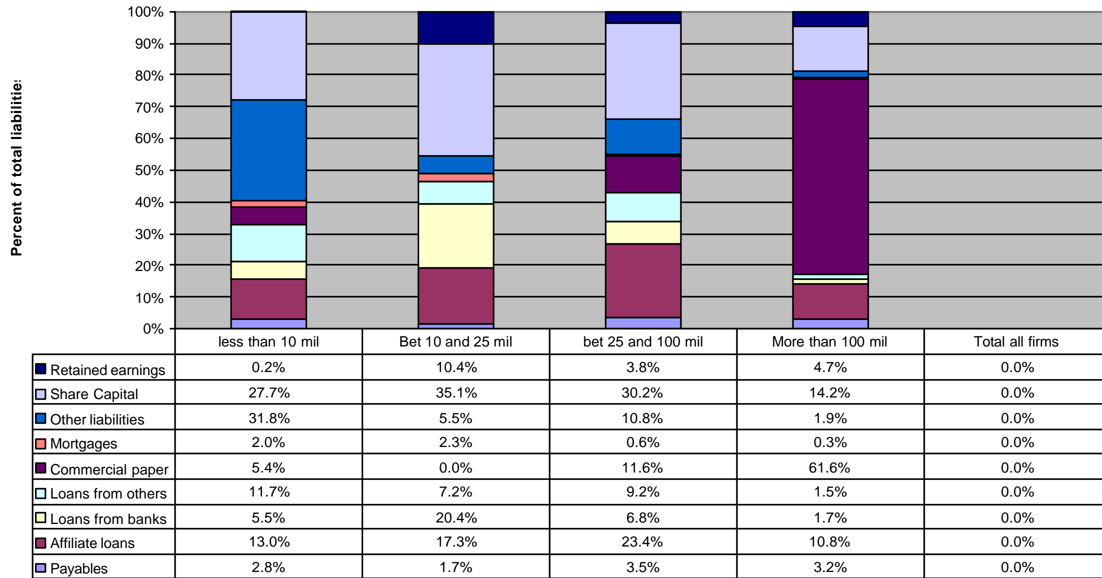


	less than 10 mil	Bet 10 and 25 mil	bet 25 and 100 mil	More than 10 mil
Other assets	28.5%	3.8%	14.2%	2.0%
Capital assets	8.7%	3.5%	0.3%	9.4%
Leases	2.9%	14.1%	11.0%	29.5%
Loans	9.7%	1.8%	6.2%	12.3%
Long Term	44.0%	66.3%	51.8%	41.7%
Short term	5.5%	10.5%	16.4%	5.2%

Source: Statistics Canada, The Conference Board of Canada

The larger the company, the more likely it is to be specialized around loans and leasing, and the more likely it is to be funded primarily through bank lending and other commercial paper. Indeed, large firms (more than $100 million) hold 95% of the industry’s borrowings, 99% of the bankers’ acceptance and 98% of the industry’s bonds and debentures. Such financing is practically non-existent for firms smaller than $100 million in assets. On the other hand, the smallest firms hold a bigger share of the equity financing, which might explain why so many of them have been around for so long; they are very conservatively financed compared to the larger firms.

Chart 10 - Industry Liabilities, Percent by size



	less than 10 mil	Bet 10 and 25 mil	bet 25 and 100 mil	More than 100 mil	Total all firms
Retained earnings	0.2%	10.4%	3.8%	4.7%	0.0%
Share Capital	27.7%	35.1%	30.2%	14.2%	0.0%
Other liabilities	31.8%	5.5%	10.8%	1.9%	0.0%
Mortgages	2.0%	2.3%	0.6%	0.3%	0.0%
Commercial paper	5.4%	0.0%	11.6%	61.6%	0.0%
Loans from others	11.7%	7.2%	9.2%	1.5%	0.0%
Loans from banks	5.5%	20.4%	6.8%	1.7%	0.0%
Affiliate loans	13.0%	17.3%	23.4%	10.8%	0.0%
Payables	2.8%	1.7%	3.5%	3.2%	0.0%

Source: Statistics Canada, The Conference Board of Canada

5. Profile of Participants in the Leasing Industry (based on interview findings)

The analysis in this section summarizes the results of the random sample of firms that were interviewed for the study. The interviews were used to provide an independent check for the findings.

5. a) Lease Size and Length of Lease

The average lease size for leasing companies that offer a wide array of products is in the $10,000 to $25,000 range and the average length of lease is 3 to 4 years throughout the industry. This was a common response of almost all interviewees.

There is considerable variability depending on the type of lease being offered. The average large lease varies between $100,000 to $250,000 and is more often associated with specialized construction or manufacturing equipment, fleet transport, and telecommunications equipment. Small leases average between $3,000 and $10,000 and are usually for office and small business type products, as well as for restaurant and light manufacturing equipment. The average length for these types of lease is also 3 to 4 years.

This suggests that the leasing pilot will need to identify particular types of leases and assign criteria to such types of lease. Indeed, there is so much variability in leasing depending on the type of asset being leased that it will be difficult to have a single set of criteria for all types. In a large lease, it will be easy to justify the additional requirements relating to the guarantee. Indeed, a large lease is likely to be quite similar to a typical CSBFA loan. However, for small ticket items with high volumes, such as computers, requirements may need to be streamlined to simplify the administration. For example, the administration may want to allow the batching of lease contracts for larger volume providers with group reporting for similar classes of leases (for example, photocopiers). This would allow for simplified tracking and reporting on an exception basis, or in cases of unusual activity. Otherwise, the administrative load on a large number of small leases may exceed the value of the 1.25 per cent administrative fee for small leases.

5. b) Due Diligence Procedures

The leasing companies interviewed confirm that they use normal industry credit check procedures and leasing criteria before they write leases. This includes credit checks, an assessment of the viability of the lessee, and personal credit history.

The majority of leasing companies report that they deny leases to approximately 20 to 25 per cent of applicants. This suggests that they follow a stringent screening process, including credit searches; require a minimum of two to three years in business to qualify. In the case of large leases, proof of personal solvency by the business owners to ensure that the risk of default is minimal to the leasing company.

Interviewees reported that 0.5 to 3.0% of leases have to be terminated and the asset repossessed. It was reported that about 1 per cent of leases result in an unrecoverable loss for the leasing company.

There does not appear to be any correlation as to the type of lease that may become delinquent. Rather, it is the type of lessee that tends to determine the riskiness of the lease. For example, defunct partnerships was cited as one frequent cause of failure, followed by the usual business failure of business without a track record, i.e., newly created firms. The interviewees do report, however, a tendency for smaller leases to become delinquent more often, and for the smaller leases to be normally associated with small business. New businesses and partnerships are generally more risky irrespective of the type of equipment being leased. This is consistent with previous studies of the loss experience of loan guarantees under the SBLA.

These due diligence procedures and delinquency rates also appear consistent with those of previous studies of the leasing industry. It also suggests that there is considerable scope for the guarantee to benefit new businesses or firms that would otherwise be denied lease financing. This would be completely consistent with the mandate of the CSBFA.

Having said that, the leasing pilot will need to carefully define the types of lease that are eligible in light of the registration requirements, the failure rates and the loss rates. It is likely that the more marginal leases targeted by the leasing pilot will result in slightly higher loss rates. Indeed, interviewees confirmed that they are generally often wary of leasing equipment to new, unproven small business clients because:

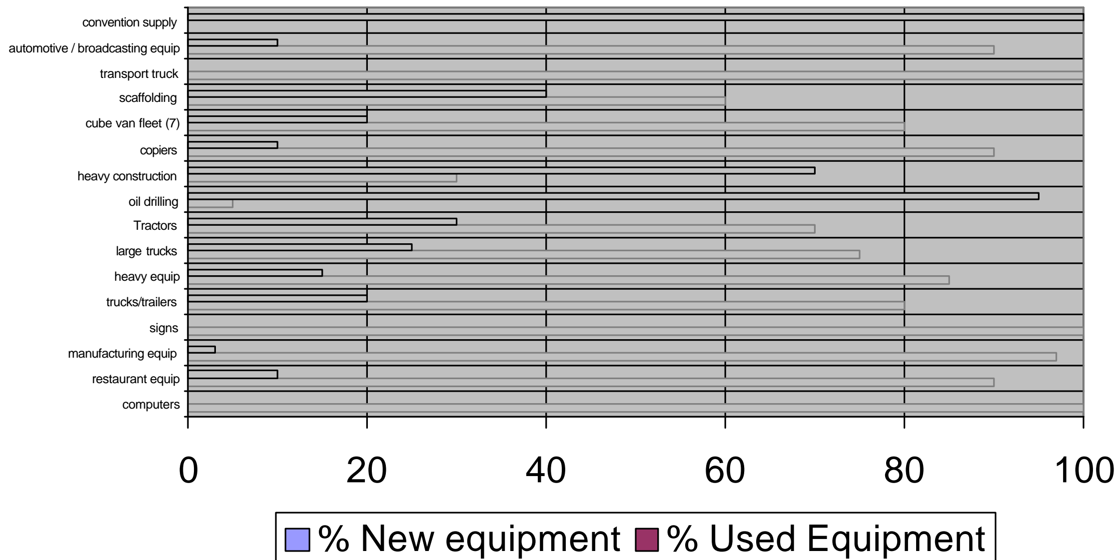
- loss rates are generally higher on new small business clients or partnerships;
- such leases are more likely to default on payments or go out of business;
- the equipment is sometimes retrieved in a less than ideal condition;
- the equipment is more likely to be unretrievable than in the instance of a larger business failure;
- a higher rate of interest has to be charged to compensate for the risk, and because the profit margin on small leases is lower, which makes such leases harder to sell.

5. c) Non-qualifying Activities

In many cases, interviewees related situations that are not likely to qualify for the leasing pilot. Heavy equipment and machinery (i.e., oil and gas) leasing companies sometimes bid for the privilege to act as the supplier to large oil or mining companies. These large-scale operations do not normally assign leases, but rather charge an hourly rate for machinery. They may also supply the manpower to operate the machinery. In these instances, the leasing company could be considered as a sub-contractor.

Another sector that charges an hourly or daily rate is the "Rent-all" type stores aimed largely at the consumer market. The rentals are for all types of tools and small equipment and these operations require a deposit and valid identification or approved credit card to secure the rental. These types of operations are often franchises or family owned enterprises.

Some of the leasing activities of the industry relate to used equipment (see chart 11). The decision to implement a *capital* leasing project almost certainly means limiting the program to new equipment. Among other factors already mentioned, it is likely that including used equipment would bring a host of valuation problems that are best avoided altogether. Limiting eligibility to new equipment also allows the administration to rely on new equipment prices as the main valuation tool, both to determine lease amounts for purposes of the guarantee, and to determine whether the lease is a capital lease.



5. d) Interest Rates Charged

Automobile leasing companies normally charge interest rates comparable to prime bank rates (0.5 to 1.0 % over prime). The interest rate fluctuates between the high and low end of that scale depending on the number of vehicles leased by any one customer.

In the case of equipment leasing, the interviewees suggest that interest rates are generally between 10 and 21 per cent and that a number of "non-interest" related variables come into play to determine the lease interest rate. Some of these variables include:

- the size and length of the lease,
- whether it is a new customer or repeat customer,
- and type of equipment being leased.

The profit margin is low on small leases even though they are usually associated with leasing at the high end of the interest rate scale. The risk tends to be greater when leasing to new small businesses and the higher rate help to offset the losses. The rationale to lease to these customers may be that if they are successful, they will remain as loyal customers for years to come.

Other non-interest related reason that equipment leasing companies report they are willing to lease to new small business is to satisfy their supplier, by building a stronger customer base for the future and strengthening brand identification. This is usually associated with equipment leasing companies that deal with one brand name and offer one or two types of product exclusively. The supplier also acts an underwriter, in that they offer volume discounts, buy back programs at the end of leases and revolving stock. The leasing company is thereby relieved of the burden of auctioning off old equipment or arranging to have damaged equipment repaired.

In the case of property leasing, the lease amount is based on a price per square foot. Many variables come into play such as: location and what the market will bear, type of space (retail,

warehouse, etc.), property taxes, utilities, common area costs, length of lease, and lessor financing. Usually property leasing companies can expect to lose two to three months rent in the event that the lessee goes out of business.

The leasing pilot will have to decide whether to apply a maximum lease rate to eligible leases. The existence of a maximum will make it uneconomic to offer certain types of leases that also offer a service component, or that involve small assets that depreciate quickly. In these cases, a higher rate is required to account for the higher risk. On the other hand, the existence of a guarantee may make some lessors willing to lower the rate they would normally charge because the risk is being shared by government. This is a difficult question that again may be best handled by selecting specific types of leases and identifying reasonable maximums for such types of leases.

5. e) About the Interviews

The Conference Board interviewed 20 leasing companies: 10 from Ontario, 5 from BC, 3 from Alberta and 2 from Quebec. The interviewees were selected to represent a cross section of locations. The selection was also made to provide a representative cross section of the industry by type of lease. The 20 companies interviewed represented the following types of leases:

- 9 companies leased equipment (construction, restaurant, retail, and office);
- 4 companies leased vehicles (cars, trucks and trailers);
- 4 companies leased telecommunications and computer equipment;
- 1 company leased signs;
- 1 company leased convention supplies (tables, linens, chairs, stages, etc.); and
- 1 company rents only oil and gas drilling equipment.

The equipment leasing companies were varied, leasing everything from store equipment, tools, heavy construction, office equipment and restaurant equipment. All equipment leasing companies report leasing both new and used equipment. The average was 77% new and 23% used equipment. Office and store equipment and manufacturing equipment is usually leased new while heavy construction and tool leasing companies primarily leased used equipment.

The computer leasing companies lease 94% of their equipment as new equipment. The maintenance service contracts are separate from the leases and are signed with the product manufacturer or a firm that services the brand leased. Only one of the companies interviewed also supplied on-going technical and maintenance support. All the companies interviewed write the lease contracts for a 3 or 4 year term.

We interviewed a sign manufacturer that also leases signs. Only 5% of their revenues are from leases and the term is always for a 5-year period. The rationale for leasing is to increase sales and to build good customer relations. That case is typical of companies that offer leasing as a sales inducement.

All vehicle leasing companies write leases for their clients averaging 3 or 4 years regardless of the number of vehicles being leased. Three of the four vehicle leasing companies write leases for both new and used vehicles (typically the trucks accounting for the used vehicles). The average was 80% new vehicles and 20% used vehicles. Only one of the vehicle leasing companies interviewed reported that all of its leases were written for new vehicles.

6. The Criteria for Eligibility of Lessor Under the CSBFA Capital Leasing Pilot Program.

Using the profile of the leasing industry previously described, this section of the report seeks to develop a clear set of criteria that could be used to develop a definition of a lessor under the CSBFA capital leasing pilot program. The suggestions are based on previous work, both by the Conference Board and by others as appropriate, looking at ways to include capital leasing within the guarantee provided by the Small Business Loans Act (SBLA). The timing and funding for this report did not include an opportunity to verify the suggestions with the representatives of the industry and should not be interpreted as such. The Conference Board suggests that draft modalities for the pilot project be circulated and vetted by the industry before they are finalized. The suggestions are organised in order to, as much as possible, make CSBFA leases equivalent to CSBFA loans.

Many challenges relating to the capital leasing pilot project are legal in nature. This is because there are many legal issues associated with leasing and lawyers will need to find a way to effectively describe the legal requirements of leasing in the text. It is important to realize that the legal requirements of leasing will be different than lending even if the intent and the effect of the provisions are similar to CSBFA lending. In Appendix A, we have included an excerpt of a document from the United States on securitization of automotive leasing contracts which sheds some light on the nature of leasing and the many legal issues involved. This document provides an example of the type of legal clarity needed both for securitization and leasing. As explained earlier, the legal requirements necessary to implement the capital leasing pilot project are beyond the scope of the report.

For this section, the starting point is the process for making a CSBFA loan as described in the publication *How to Use the Canada Small Business Financing Act: A Self-Learning Tool for Lenders.* Indeed, the Conference Board encourages the creation of a similar brochure to explain to lessors in Canada how to make an eligible CSBFA lease. This would involve appropriate descriptions that describe in simple language the requirements of the leasing pilot program and would allow lessors to determine:

- whether the customer is eligible;
- whether the leased asset will be used for a purpose that is eligible;
- whether the amount of the lease will be eligible;
- whether the leased asset is properly documented (including securitization issues);
- and whether the terms and documentation for the lease are acceptable for the CSBFA.

We review each of these questions below to assist in the determination of how the government might apply the modalities of the CSBFA to capital leasing.

6. a) *When is the Leasing Customer Eligible?*

Although leasing is seen to be quite different than lending from the point of view of the lender, there is no reason why it should be treated differently from the point of view of the customer. Leasing is but a new financing option for small business to choose. Borrowers who are otherwise not able to obtain loans from financial institutions have the option to pay a fee and obtain a CSBFA guaranteed loan from their eligible leasing company. As a result, it is suggested that the eligibility requirements for leasing be identical to those for lending, namely:

- The customer's business must be for profit;

- Must not be agricultural in nature;
- Must carry on business primarily in Canada;
- Must have annual gross revenues below $5 million.

There may be special considerations for leasing. Because much of leasing involves moveable equipment, there may be special considerations, particularly relating to defining what carrying on business in Canada means. For example:

- a small trucking business that leases a tractor/ trailer combination to carry merchandise across Canada might also routinely be called upon to go across the border to deliver and pick up merchandise.
- similarly, a Toronto contractor who leases earth moving equipment might obtain a contract under NAFTA and be asked to work in Buffalo NY for an extended period of time.
- finally, a small business consultant that leases his laptop might obtain short or long term consulting assignments in the US.
- Are these customers eligible?

Situations change over the life of the lease and the equipment being leased is often particularly mobile. How such changes are tracked and whether they constitute a reimbursable default under the capital leasing pilot program might be a complex issue. Similar issues probably arise currently under the lending provisions of the CSBFA. However, such issues may arise more frequently with capital leasing in light of the type of assets being financed. It will be important to clarify such issues as the government moves into this new area for the CSBFA.

6. b) When is the Leased Asset Used for a Purpose that is Eligible?

There are already well defined categories for lending under the CSBFA. Indeed, the requirements clearly state that the "*Act is intended to help small businesses to buy or improve capital assets to be used in Canada for a new or existing business*".
Leasing is not buying and the guide needs to somehow reflect this fact. Perhaps the words "improve capital assets" will cover leasing activities. Alternatively, other words such as acquire, access, etc can be used to effectively allow leasing. It will be up to the legal community to review the wording to develop appropriate terms.

The lending categories include:

- Real property
- Leasehold improvement
- Equipment

As suggested by the industry focus group in 1998, it is possible to lease assets in each one of these categories. However, a key question is whether such leases would be capital leases. As such, the industry suggested that capital leasing be made to include only equipment leasing, and that the definition of equipment include vehicles. The Conference Board analysis supports this suggestion. Indeed, the capital leasing pilot project does not include operating leases, which form much of the leasing activity involving real property. It has also been shown that under the SBLA, longer-term lending, as well as large loans were more likely to default over time.[2] Capital leases involving real property are likely to be very long-term. For these reasons, and also for simplification of the capital leasing pilot project, it would be more appropriate to disallow leases relating to real property.

Similarly, it is possible to lease leasehold improvements. In such cases, the duration might be more in line with what is normal for leasing, namely 3-4 years. Indeed, the small businesses of

[2] Alan Riding: Estimation of Cost-Benefit Scenarios, March 1998

many industries would benefit from having a choice of lending or leasing in such cases. However, our review of the leasing industry only identified a few firms specialising in what could be called “leasehold improvement” leasing, and one was a sign manufacturer who provided leases only “from time to time”. The loss rates and modalities relating to signs were similar to that of other types of leasing. This would argue for allowing such a lease as part of the capital leasing pilot. However, this does not mean that we know that much about leasehold improvement leasing. Residual values, which directly affect loss rates for leasing, are largely unknown for many leasehold improvements. This is because many such improvements are highly customised to reflect the needs of the lessee. It may therefore not be possible to resell such improvements to realise on residual values. And we know from other analyses of leasing that residual values are highly correlated with the amount of loss. It may therefore be prudent to disallow such leases for the same reasons the capital leasing pilot project might want to disallow real property. This would be simpler, certainly at the beginning, as the pilot project learns about providing a guarantee on leasing. Another alternative to making such leases ineligible would be to more closely define what is eligible (such as signs, interior renovations, expansions, etc.) or merely follow the same rules as described under CSBFA lending.

The lending program includes equipment. Leasing is one of the primary sources of financing for equipment. These facts alone suggest that the capital leasing pilot program needs to be targeted primarily at equipment leasing. There are several reasons for this, -it is what the industry would like, equipment is by far the most typical lease and there are many providers. Data on the leasing market suggests that for many categories of equipment, such as automotive, leasing may in fact be one of the primary sources of financing.

The type of equipment being leased raises some questions. Some lessors lease both new and used equipment. There is an issue as to whether the guarantee should apply to both new and used equipment. The lending guidelines permit lending on used assets provided they have an appraised value. In the case of leasing, the value of new equipment is easily verifiable by using the manufacturer’s suggested retail price, or the purchase price of the asset. Not so for used equipment. To avoid all the complications of having to appraise a wide variety of used equipment, it is suggested that the capital leasing pilot project apply to new equipment only.

It might also be desirable to apply limits to the use of the new equipment. For example, personal automobiles should not be leased under a program targeting small businesses. This would also be the case under the lending component of the CSBFA and any tests applied to lending relating to eligible use should also be applied from the start. However, many small business owners might lease automobiles under the business but use them partly or significantly for personal uses. In the case of real property loans under CSBFA, there is a stipulation that 50% of the property must be used for the business purpose described in the application. Perhaps a similar or higher percentage test needs to be applied to automotive leasing, assuming such leases are included under the pilot project. The same can be said of light trucks that are increasingly popular as personal vehicles. The point is that it may be necessary to place specific requirements on certain types of leasing to ensure that their intended use is eligible. For example, the pilot project could guarantee automotive leasing only when the leased vehicle is clearly used for business purposes (i.e., has the business logo applied to it). Such stipulations may be necessary given that such a large proportion of leasing is in fact automotive leasing; cars and trucks of all shapes and sizes.

Other equipment may be more clearly related to eligible business purposes; tractor-trailers, panel vans, cube vans, dump trucks, loaders, backhoes, etc. The point is that more precise stipulations of eligibility may not be required for all types of equipment.

A requirement that has been well documented in the past is for the guarantee to apply only to capital leases and to avoid funding operating leases. The definitions used in the income tax act to define capital leases should be carefully applied to make sure no operating leases are included in the program. There are many reasons for this, which have been well documented in previous reports and will not be repeated here.

The lending requirement stipulates that the 2% registration fee may be financed as part of the CSBFA loan. Fees on leasing are typically charged as lump sum payments at the beginning of the lease, as are security deposits. It is not known whether the legal requirements of a lease will allow the fee to be financed as part of the lease. However, for the purposes of this report, this is assumed to be possible and the flexibility to finance the fee should be maintained for the pilot project.

Lenders under the CSBFA can include more than one class of assets under a single loan. Leasing, on the other hand, is typically related to specific assets specified by specific lease contracts. Although this may be possible, we have not come across examples of multiple types of assets being leased under a single lease contract. Typically, multiple leases are written when multiple types of assets are being leased. For this reason, and for simplification purposes, it is suggested that the multiple class stipulation not be available for the capital leasing project.

Another reason for this limitation to a single asset class would include increased clarity. By limiting leasing to one asset class per lease, it may be easier to obtain asset-specific data on lease rates, default rates and loss rates by type of asset. This may be useful in evaluating the success of the pilot project after a period of time.

6. c) When is the Amount of the Lease Eligible?

The lending requirements of the CSBFA are that loans to borrowers and related borrowers cannot exceed $250,000 and cannot exceed 90% of the eligible cost of the asset. In and of itself, this does not present many difficulties to leasing. From the interviews, we have seen that leases rarely exceed the $250,000 amount. Many leases, such as computer or office equipment leases are in fact much smaller and would range between $5,000 and $25,000. The 90% rule similarly does not present difficulties as most capital leases include a residual value payment at the end of the lease. This could be stipulated to be 10% for CSBFA purposes.

However, the addition of capital leasing does present some issues. Lending is traditionally done with few providers; that is, small businesses will have a limited number of loans, and deal with a limited number of lenders. Our interviews do suggest that leasing is similarly a relationship business. However, whereas a single small business loan might provide financing to purchase office equipment, computers <u>and</u> office space, the same business might obtain 3 leases with 3 separate leasing companies specialising in the respective equipment. The structure of leasing suggests that there will be cases of multiple leases with multiple companies, and that it will be important to verify that the total amounts of leases do not exceed the maximum amount for CSBFA leasing and lending simultaneously.

Similarly, both lenders and lessors will now need to verify that a small business using both CSBFA leasing and CSBFA loans does not exceed the overall limit of $250,000. Clarity is important relative to this question. Indeed, this question will greatly affect the complexity of the credit check and the application procedures for *all CSBFA lending and leasing,* and all forms

and procedures will have to be changed. In most cases, normal credit checks reveal the other loans or leases of the lessee or borrower, *but not whether such loans are guaranteed loans or leases*. In effect, both lenders and lessors are dependent on the honesty of the borrower or lessor in answering the question about their eligibility for additional CSBFA financing. While this is no different than the current situation where only lending is eligible, making leasing eligible does increase the complexity of the credit check for both lenders and borrowers by virtue of the nature of leasing (and the distinct possibility of multiple leases and multiple providers).

An alternative would be for the CSBFA to allow both a maximum guaranteed loan and a separate maximum guaranteed lease amount. This would simplify the process of determining eligibility by limiting it to one type of provider. It would also certainly increase the potential exposure of the program to individual defaults. As such, it may be unacceptable. A further alternative would be to provide a way for both lenders and lessors to check the names and addresses of borrowers and lessees against a list of existing CSBFA clients (both lease and loan) before any contracts are signed. Such procedures would have to be simple enough and quick enough to allow leasing companies in particular to approve leases *in minutes*, not days, as they currently do for a number of smaller leases. In a sense, this decision on overall limits by client may have some ramifications in terms of complexity, which would affect whether lessors actively participate in the pilot project.

The lending requirements that relate to the eligible cost of the asset, installation charges (when capitalised), freight and transportation charges, and non refundable custom duties and taxes all are likely to apply as currently described to the pilot project, as would the exclusions of discounts, rebates and allowances, and of labour costs. On the other hand, the requirements relating to obtaining an independent appraisal would not be necessary in the capital leasing pilot project as long as it is limited to new equipment where the purchase price or manufacturer's sales price can be used as the proof of value.

In the event of a claim for loss, the lessor would have to supply documentation that is similar to the existing requirements to indicate the value of an unrecoverable asset. Unlike lending, the leasing company retains title over the leased asset. Therefore, it is likely that any resale or release of the equipment would largely mitigate the losses associated with default. This reality might also explain the relatively low loss rates that were reported earlier as part of the interviews conducted for this report.

6. d) How is an Eligible Lease Properly Documented?

Much of the documentation relating to lending requirements refers to the need for proper security against a loan. The lending requirements refer to primary security and optional additional security.

Leasing should be simpler in this respect since the CSBFA guidelines on leasing are likely to stipulate that the leasing company must have ownership of the asset being leased. This may prevent some lessors from leasing equipment that they then re-lease to others. However, much of these activities relate to firms that lease assets by means of capital leases only to re-lease them under short term operating leases. Since operating leases are not eligible anyway, nothing is lost by requiring the lessor to directly own the asset being leased.

There is the question of additional security. While we did not come across cases where the leasing company obtained additional security to cover off their lease, some lessors may want to

have the flexibility to do so in some circumstances. As such, the analysis suggests that additional security of the type available to lenders be available to lessors.

In many cases, leasing companies gain access to low cost sources of financing by selling, through securitization, a portfolio of their lease contracts to investors, often banks, insurance companies, mutual funds or individual investors. Such activities present interesting dilemmas in as much as guaranteed lease contracts may become part of such securitization deals.

There are many benefits of securitization to the lessor. A key benefit is the ability to sell the financial asset of the lessor (i.e., the lease) in exchange for cash, which is then used to reduce the amount of debt required to finance the underlying asset (those that were leased and created the financial assets – or leases). This is very beneficial financially to the leasing company.

In financial terms, the securitization of the financial assets (i.e., the leases) does not affect the ownership of the assets being leased, merely the cash flow from the lease contracts which now flow to the investor instead of to the leasing company. A default of one of the securitized leases similarly does not generally affect the cash flow of the investor since the lessor sells a portfolio of leases in exchange for promising to pay the investor a set income stream. Only where the default rates differ from what was promised as part of the securitization is there an issue. Thus, the leasing company generally retains both the administration of the leases, and the risk of default of the lease portfolio. This is why bond rating companies are often called upon to rate portfolios of leases about to be securitized, to provide an assessment to the investor that the loss profile claimed by the leasing company is backed up by the financial strength of the lessor. Nothing prevents the investor from relying on the strength of the lessor even if the securitized portfolio is not rated. As a result, not all securitized portfolios are rated.

We are currently not aware of any publicly available source of data on the amount of securitization that is currently taking place, or on the proportion of those deals that involve leasing. Indeed, the impact of leasing securitization on the CSBFA pilot project may well depend on the modalities of securitization deals themselves and therefore cannot be generalised. Such deals are financial contracts between investors and the leasing company that involve the payment of cash in exchange for a stream of income from the underlying portfolio of lease contracts. It is generally understood that the securitization of leases is thought to be more complicated from an accounting standpoint than securitization of other financial assets.[3] This is based on the US experience where securitization has a longer track record than in Canada. We can surmise that offering a government guarantee on leasing will generally increase the quality of the lease portfolio and increase the value of the securitization deal. It should not, however, generally change the relationship between the lessor, the lessee and the government in the event of the default of the lease. The documentation suggests that securitization does make the leasing situation more complex from a legal point of view, particularly complex if and when the lessor goes bankrupt.

The Conference Board has no expertise on the legal ramifications of securitization. For the purposes of the pilot project, it may be sufficient to recognise securitization as a possibility which will in no way affect either the security of the lease (since the leasing company would generally be asked to retains the ownership of the non-financial asset), or the guarantee procedures (since the leasing company retains the administration of the lease). If those two

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[3] See New Development in Equipment and Auto Lease Financing: Securitization, Leveraged Leasing and Titling Trusts , Stuart M Litwin, William A. Levy, Partners, Mayer, Brown & Platt, Published February 2000 by Aspen Law & Business.

basic requirements are maintained, then securitization is unlikely to unduly affect the pilot project. For added protection, it may be advantageous to ask companies wanting to securitize all or parts of their guaranteed lease portfolios to have them rated by a Canadian rating agency. This might increase the comfort level with securitization. More importantly, the legal community should closely review the act, individual leasing contracts and securitization deals to determine their impact on the government guarantee under a variety of default scenarios.

6. e) What Terms and Documentation Need to be Maintained for the Lease to be Acceptable for the CSBFA.

This section is perhaps the most contentious section of the pilot project. It contains provisions that have been described as presenting challenges to the leasing industry. Perhaps the most challenging one would be the maximum rate provisions, which are set at prime or mortgage rate plus 3. This maximum includes a 1.25 per cent administration fee charged each year by the CSBFA on the amount of loan outstanding. In effect, the risk premium accruing to the lender is prime or mortgage rate plus 1.75%.

From the interviews conducted by the Conference Board for this report, this level of interest rate is comparable to that charged on automotive leases. However, it is also considerably less than that charged on a wide variety of equipment leases, estimated by interviewees to be in the range of 10 to 21% currently.

In an earlier consultation on the issue of interest rates in the context of leasing and the SBLA, representatives of the leasing industry concluded that:

> *In discussing the concept of "maximum interest rates," neither a bank "prime plus" nor "residential mortgage rate plus" are relevant yardsticks in leasing. 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 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*[4].

This is reflected in the findings of the interviews. Interest rates were seen to depend largely on a number of variables including the size and length of the lease, new customer or repeat customer, and type of equipment being leased. Much of the discussion about interest rates suggests that services offered by the lessor such as consultations on the type of equipment required, the ability to trade up or trade down on a new lease over the course of the lease are all included as costs within the decision to charge between 10 and 21%. For comparison purposes, a 4 year mortgage at 8.5% suggests that there is currently a 1.5% to 12.5 % service and risk premium on leasing, depending on the type of lease.

How can leasing compete with loans if the interest rate charged is more? Again, the issue lies in the many service differences between lending and leasing. Indeed, earlier work by the

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[4] Excerpt from page 16, *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), The Conference Board of Canada, Ottawa, March 1998*

Conference Board suggested that in the SME marketplace, lessors compete with lending 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.

As described earlier, 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 is a significant operational advantage in a number of situations where the lease payments can be tailored to a customer's revenue streams. Another unique element is the knowledge and expertise of the specific equipment. Leasing thus frequently offers an upgrade path to accommodate technological obsolescence. 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.

Any attempt to limit the interest charged will either remove this flexibility from the CSBFA guaranteed leases, or will limit the type of equipment that will be available under the CSBFA. In effect, it would limit such leasing to "leasing of the plain Jane" variety, devoid of other services and flexibility that often characterize leasing contracts.

On the other hand, much of the leasing activity for automobiles and light trucks already occurs at prime or close to prime. A limit on interest rate flexibility in leasing may prohibit the offering of CSBFA-guaranteed on certain types of leases that are normally priced higher. The availability of a guarantee may also allow some lessors to charge less on leases that would otherwise exceed the maximum interest rate stipulation. At this stage, it is difficult to see what impact a maximum interest rate might have on the success of the capital leasing pilot project. The pilot program should weigh these various factors in deciding whether and how much flexibility to allow on leasing in exchange for the government guarantee on part of the losses.

The lending provisions in this section include other terms and conditions relating to CSBFA loans, including a limit on the fees associated with the loan, and some change of terms of provisions. There are no likely reasons why such provisions couldn't apply to leasing contracts under the pilot project.

Earlier consultations relating to the possibility of providing a guarantee of the type provided by the SBLA suggested that:

> *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.[5]

The many types of providers apparent in the analysis of the industry structure suggest that it may be advantageous to provide a two-tier service to CSBFA lessors. High volume lessors would benefit from a simplified administrative structure that would feature electronic filing, batch processing of fees and reporting on an exception basis. Otherwise, the administrative complexity of tracking hundreds of $10,000 leases will far outweigh the 1.25 per cent fee charged by the administration on such leases, in addition to making it uneconomic for the high volume provider to offer such leases. Yet, the very types of equipment covered by such leases, computers, printers, photocopiers are routinely leased by the industry. For larger leases, as well as for low volume providers, the provisions described in current CSBFA documents appear to be adequate for most types of leasing.

The provisions for lending describe a claim for loss procedure that seems reasonable in the case of leasing. There are special legal considerations that will have to be examined, and the various wordings relating to lending will need to be adapted to reflect current terminology. In particular, there are some provincial legal requirements that may or may not present obstacles for leasing. In particular, Quebec's *Bill 181* relating to the *Movable Rights Register and to Mandatory Registrations* may complicate leasing matters in Quebec. Again, a legal review of the provisions is required to ensure the guarantee system provides an effective tool to encourage leasing to small business that would otherwise be turned down by the lessor.

There are special considerations in the case of leasing that relate to 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. The consensus of the focus group of leasing companies facilitated by the Conference Board in 1998 was to include such situations as legitimate reasons for default in order to preserve the value of the asset. Doing so may serve to increase the number of defaults, while at the same time reducing the amount of the loss. The pilot project should therefore stipulate that the lessor should apply the same policies and procedures used in their normal assessment of a lease default in the case of leases covered by the capital leasing pilot project.

7. Conclusion

The leasing industry is not a homogeneous industry. At the top end of the market are sophisticated large companies that do a volume business and lease large ticket items (airplanes, fleet of tractor/trailers, etc). Such lessors are large enough to utilize securitization to sell homogeneous groups of leases to other investors including banks, insurance companies, etc. At the other end of the spectrum are about 400 relatively small lessors who specialize and compete on the basis of their knowledge of particular types of assets, or specific parts of the market (cars, trucks, drilling equipment, office equipment, etc).

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[5] Excerpt from page 13, *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), The Conference Board of Canada, Ottawa, March 1998*

Leasing companies of various sizes are differentiated on the basis of number of employees, but do not differ substantially on the basis of either age or types of leasing being offered. Indeed, the majority of leasing companies identified through the Dunn and Bradstreet database – both large and small employers- are more than 5 years old and are active in all areas of the leasing industry. Large companies tend to do a volume business, whereas smaller companies target repeat customers and specific geographical areas. All try to maintain a relationship and encourage repeat business.

Large leasing companies obtain funding directly through securitization and the issuance of commercial paper with banks and other large institutional investors. Small leasing companies are often affiliated with other businesses who require their services, such as a car or equipment dealership, and appear to be largely financed privately (private investors, for example), and through local financial institutions.

The average amount of a lease contract is generally associated with the type of equipment being leased, and not by the size of the lessor. Typical small leases range between $5,000 and $25,000 and relate to office equipment, computers and various small manufacturing equipment. Large leases range from $100,000 to $250,000 and relate to large machinery and equipment such as combines, tractor/trailer combinations and large manufacturing machinery.

Interest rates and loss rates are fairly consistent within types of leases, but vary considerably depending on the business relationship between the lessor and the lessee. The size of the lessee is also a determinant.

The leasing industry appears to be a relatively careful group who carefully screen the clients that apply for lease financing. The requirements are what one would expect in the circumstances. Because they retain the ownership of the asset, they care about protecting the residual value of the asset and expect the lessee to maintain it as his own and purchase insurance on it. For this reason, new (and unproven) clients, as well as small business clients without a track record with leased equipment are considered more risky, are often charged higher interest rates and/or denied lease financing. The CSBFA provides an opportunity for the industry to help finance such clients at reasonable cost.

The industry usually leases new equipment, although both new and used equipment can be leased. There are generally two types of leases, well defined for tax purposes. The duration of operating leases is generally shorter, whereas capital leases are long enough to cover most of the economic value of the assets. It is not unusual for a company to enter in a capital lease in order to obtain equipment that can then be leased through operating leases. The duration of capital leases is usually between 3 and 4 years, although depending on the type of equipment, duration of between 12 and 60 months are not uncommon.