Industry Canada

CAPITAL LEASING PILOT PROJECT

OUTSTANDING ISSUES REGARDING CSBFA DRAFT REGULATIONS

FINAL REPORT

APRIL, 2001

prepared by

Aon Structured Finance Solutions

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Additional Issues regarding the CSBFA Draft Regulations

INTRODUCTION

Industry Canada has engaged Aon Structured Finance Solutions ("ASF") to assist in assessing certain issues raised by interested parties, including the Canadian Finance and Leasing Association ("CFLA"), during the consultative process with respect to the Capital Lease Pilot Project. The CFLA tabled a comprehensive submission dated April 4, 2001 that articulated its views on certain key issues. Many of these issues, including some which were outlined in ASF's March 13, 2001 mandate letter have now been satisfactorily addressed. The focus of this report is to highlight and suggest courses of action for certain unresolved points raised during an April 23, 2001 meeting attended by Industry Canada, ASF and the CFLA. This will hopefully assist the Government with the finalization of the Pilot Project's draft regulations.

ASF has attempted to keep the CFLA's concerns in mind while, at the same time, balancing their considerations with our understanding of Industry Canada's mandate, political limitations and desire to make this program complementary with the Canadian Small Business Financing Act ("CSBFA") loan program. Industry Canada has clearly stated that the rationale for the program is to allow the leasing industry to offer a product that will compete equitably with the lending institutions' CSBFA loan product. Industry Canada's goal is to ensure that one product is not developed in such a fashion that it becomes more attractive than the other, recognizing that there are inherent differences between loans and leases and the ways in which the two industries conduct their respective businesses.

Industry Canada is attempting to provide a loss share program that is equitable, but structured to ensure that lessors are assuming some risk on leases guaranteed under the program. The program must also address the Government's objective of cost recovery. Accordingly, ASF suggests that three areas be viewed together to ensure that the program functions as planned. These areas are: i) the specified rate of interest used to calculate the value of leases at inception, ii) the specified rate used to calculate outstanding lease balances when a default occurs, and iii) the loss-sharing ratio between the Government and lessors.

This report will now focus on the four unresolved issues that were discussed at the April 23rd meeting.

OUTSTANDING ISSUES

To reiterate, the CFLA submitted written comments on April 4, 2001 and a number of their issues have already been agreed to by Industry Canada. However, Industry Canada felt that certain issues required clarification and a meeting was held with the CFLA, Industry Canada and ASF on April 23, 2001 to discuss these items. Industry Canada has requested ASF to provide its views and suggestions on the following matters which relate to the Draft Regulations.

1) Section 1 - Definition of Specified Rates as noted in
   i) Definition of "capital lease" part (c)
   ii) Definition of "outstanding balance of a capital lease" parts (b) and (c)

2) Section 1 - Definition of lessor as it relates to parts (c) and (d)

3) Section 9 – loss-sharing ratio

4) Section 36 - securitization

ASF COMMENTS AND RECOMMENDATIONS ON EACH ISSUE

1) Section 1 - Definition of Specified Rates

i) The Specified Rate as noted in definition of "capital lease" part (c)

It is recommended that the specified rate used in part (c) of this definition be defined as the interest rate implicit in the lease. This approach is consistent with Canadian Institute of Chartered Accountants ("CICA") guidelines for classifying leases (as either capital or operating leases) from the lessor's perspective. As such, this recommendation is suggesting the use of an easily recognizable, objective, and widely accepted business standard.

ii) Specified Rates pursuant to parts (b) and (c) in definition of "outstanding balance of a capital lease"

It is recommended that the rate used in parts (b) and (c) be defined as, "that rate which the lessor typically uses to value its investment in the lease (for accounting purposes in accordance with CICA guidelines) at time of origination or purchase". We believe most lessors will probably employ the interest rate implicit in the lease, although there may be situations where the lessor's rate for incremental borrowing will be used.

Our suggested approach recognizes Industry Canada's firmly held view that the Federal Government will be extremely reluctant to agree to any valuation technique that could result in payouts for defaulted leases under the CSFBA Lease Program which are greater than the value of the leases themselves. This approach also adheres with Canadian Generally Accepted Accounting Principles and should be consistent with lessors' own (accounting) valuation practices.

In ASF's opinion, if the Government was prepared to consider payouts which were greater than the value of the leases, it would certainly result in the implementation of a higher fee structure in order to address their cost recovery objective.

ASF recognizes that its recommendation is different from the CFLA's proposed discount rate (i.e. liquidated damages rates of say, 5-6%). Moreover, the CFLA is correct in pointing out that liquidated damage rates are often applied in the commercial marketplace and enforced in courts of law. The more conservative approach suggested here might also have a negative impact on the take up of the Pilot Program. However, in our opinion, these factors are more than offset by the Government's position that payouts cannot exceed lease values, cost recovery is required, and the Capital Lease Pilot Program must be consistent with the existing CSBFA loan program.

2) Section 1 - Definition of lessor as it relates to parts (c) and (d)

Industry Canada has attempted to define lessors in such a manner that allows for automatic inclusion of large lessors into the program with minimal scrutiny. The objective is to establish an efficient screening system to qualify lessors for the program without creating an inordinate amount of work for Industry Canada. Also, it became apparent during the consultative process that there are companies which fund leases, but do not actually source lease arrangements and consequently would not be included as lessors under the original draft definition. Industry Canada has attempted to address both these issues with the revision of parts (c) and (d) of the definition of lessor.

The CFLA had suggested the automatic inclusion of leasing companies that have made voluntary disclosure under the Excise Tax Act. However, the point was made by Industry Canada that size or sales volume alone would not, by themselves, be an acceptable basis for inclusion. Lessors must be scrutinized using other evaluation methods to ensure they are credit worthy.

ASF has reviewed the various suggestions and had ongoing discussions with Industry Canada to arrive at suitable definitions. ASF suggests the following wording for part (c) of the definition of lessor:

a) **Part (c) of Lessor Definition**

(c) a leasing company,
   i. a Canadian leasing company or Canadian lease funder, which has a credit rating of BBB or better from a Canadian bond rating agency, or
   ii. a Canadian leasing company that does not carry a credit rating from a Canadian bond rating agency, but has been approved for a securitization program by a Canadian bond rating agency during the past three years, or is presently participating in a Canadian bond rating agency approved securitization program.

It is suggested the word "funder" also be defined in the regulations. After discussions with Industry Canada, ASF suggests the following wording:

> Funder means "an entity which purchases or accepts assignments of leases from a lessor"

b) **Part (d) of Lessor Definition**

The currently suggested definition is as follows:

(d) any other organization designated by the Minister as a lessor for the purposes of these Regulations.

The intent of this wording is to allow creditworthy lessors that do not access the public markets to become eligible under the program.

ASF suggests that the wording remain as drafted as there will be a qualifying process in order to prove to the Minister that the applicant is credit worthy. Efforts were made at the April 23rd meeting to introduce some credit parameters. It was suggested that minimum lessor parameters be set as follows: five years in business, $5 million of equity and sales of $50 million. In addition, the applicants would have to provide audited financial statements. Suggestion was also made that lessors which did not meet this minimum criteria could still be eligible if they agreed to use a third party servicer for their leases.

ASF agrees with the imposition of minimum credit criteria on applicants to ensure that lessors are credit worthy. However, the parameters must not be so restrictive as to preclude smaller but credit worthy lessors from participating in the program. Industry Canada has indicated that it does not want to exclude small lessors from this program, and as such, the minimum criteria outlined above may need to be revisited to ensure that this does not occur.

Based upon experience and recent market research, ASF is of the opinion that the basic criteria should be downsized, particularly in light of the fact that all applicants under this section must still pass through a credit adjudication process. This process, which will be established to qualify companies as lessors under the program, will contain a number of credit evaluation tests including size, financial stability and length of time in business. The process will be designed to ensure that these lessors are credit worthy.

ASF suggests that the wording in the definition noted above remain and a process be implemented to perform credit checks on all applicants in order to obtain approval for their inclusion under this section. This approval process is presently being developed and will be ready when the program is introduced to the leasing community.

3) Section 9 - loss-sharing ratio

The CFLA submission of April 4, 2001 provided comment on the loss-sharing ratio and an example was presented at the April 23, 2001 meeting to clarify the issue. The CFLA echoed its concerns that a low loss-sharing ratio would result in higher losses for its members when dealing with lessee defaults.

ASF recommends that Industry Canada consider a more aggressive loss-sharing ratio than the 80/20 ratio presently contemplated. This suggestion is based on ASF's belief that loss-sharing percentages must be developed in conjunction with the other parts of the program (including discount rates for lease valuation purposes) to adhere to the Government's objective of cost recovery. In ASF's view, the suggested use of an "accounting based" discount rate is a conservative approach which may allow the Government to increase its portion of the loss-sharing ratio.

4) Section 36 - securitization

This section of the draft regulations was originally inserted to address the use of securitization as a method of lease financing. The purpose of the section was to allow the transfer of a lease by a lessor, who had registered the lease under the program, to a securitization trust and the confirmation that the Minister would pay claims to the trust in the event of lessee default. In its present wording, the original lessor is presumed to have registered the lease under the program and retained the registration even though the lease was sold to the trust. ASF is of the opinion that this may not be acceptable to a trust in a securitization transaction.

In addition, it was determined that this section should also cover transfers to parties other than securitization trusts. An example of this would be the sale

of a pool of leases from one lessor to another. Consequently, there is a suggestion that this section be renamed "Lease Funding " to indicate the broader potential application of the section.

A number of funding scenarios were discussed at the meeting and it was generally agreed that most registrations would take place by the funders, be it the originating lessor or a funder identified early in the transaction who would be financing the lease. Some lessors would warehouse leases and then sell them into a securitization trust. If they waited to register them then this section would not apply. However, if they did register the leases under the program prior to their sale, this section would be used to facilitate the transfer of the leases to the trust.

The transfer provision of registered leases presents new challenges to the purchasing entities. In the case of a lessor purchasing leases from another lessor, the purchaser will want to ensure that the guarantee is transferred to ensure that if a claim is made, there will be sufficient funds in the claims account to make the payment. Accordingly, the purchaser will want to receive the amount of guarantee relevant to that lease from the seller and increase its own cap on claims account accordingly. In this manner, the purchaser is assured control over the process and the amount of guarantee available. This is what we would describe as an "active funder", or one whose business is to purchase and fund leases.

There is a second type of funder, a securitization trust, which we would describe as a "passive funder". The trust is a funding vehicle but does not engage in commerce such as pursuing business, registering leases or making claims when they occur. Its seller/servicer normally does the administrative work in conjunction with the trust's administrative agent.

This presents a challenge because the trust may want to have any claims paid directly to it and accordingly may want the cap on claim transferred to an account it chooses to set up (i.e. the trust's own 90/50/10 account). In fact, in meetings with Rating Agencies held in July 2000 questions were raised as to how the guarantee would be transferred to the trust and how claims would be paid. The Rating Agencies expressed concerned that, where a lessor registered a lease and retained the cap on claim amount in its own account, a trust may purchase what it thinks is a guaranteed lease, only to find that, at the time a lease in the trust defaults, the seller does not have any funds left in its claims account and the trust can not be paid. Accordingly, the Rating Agencies felt this would either make the leases ineligible for inclusion into the pool, or perhaps introduce the need for increased credit enhancement levels for the pool. Accordingly, Section 36 should allow for the transfer of the registration and the relevant cap on claim amount to an account established by the trust if the trust so chooses.

We are not certain all trusts will choose to establish their own accounts. Nevertheless, we do feel that a mechanism should be available to trusts that

choose to participate directly in the program. The Rating Agencies have stated that wholesale securitization of these leases will not be feasible at the outset. They noted that the lack of historical data makes evaluation of the performance of the leases impossible. Accordingly, some CSBFA guaranteed leases may be allowed into a securitization transaction but this would not form a material part of a pool and may result in the altering of credit enhancement levels. Some trusts will look to the quality of the seller for protection rather than accepting the transfer of the guarantee and the administration burden associated with it. Industry Canada has stated that it would make every effort to make this program as securitization friendly as possible. ASF feels that this section will achieve that goal subject to certain modifications.

There have been significant discussions between Industry Canada and ASF on the issue of the transfer of the guarantee registration and cap on claim amount to the purchasing party when a transfer under this section is effected. ASF suggests that the guarantee be transferred from the seller to the purchaser. The Minister would then look to the purchaser as the registered party. The cap on claim amount of the seller will be reduced by whatever relevant amount utilizing the seller's 90/50/10 calculation. The purchasing party will increase its cap on claim by 10 percent. The effect would be to eliminate the transaction from the seller's books as if it never occurred, and to show the purchase on the purchasing party's books as a new purchase. Admittedly, this is not the most equitable arrangement for the purchaser as they are limited to increasing their cap on claim by only 10%.

This mechanism should work well for purchasers who are active funders, as they will be purchasing leases prior to registration and building their 90/50/10 account in this manner. This will allow them the benefit of building their account by 90% and 50% of the first few leases. Accordingly, purchases of previously registered leases at 10% should not represent an inequitable burden to them.

However, it may present certain challenges to passive funders, such as securitization trusts. Trusts may elect not to originate leases directly and accordingly, may not be able to take advantage of the 90% and 50% build up of their cap on claims account. It is important to note, however, that as a passive funder, the trust should be looking at CSBFA guaranteed leases as a lease supported by a limited amount of credit insurance. If this lease defaults, the trust will recover some funds under the guarantee and the balance of the loss will eventually find its way back to the seller through the reduction of excess spread.

Keeping in mind the Rating Agencies' comments regarding the limited amount of leases it will entertain in a pool, the mechanism described in this section may be the simplest way of dealing with this issue during the pilot period. Once sufficient historical data is available and the Rating Agencies can be more definitive about the number of CSBFA guaranteed leases that can be

included in any pool, the cap on claims issue can be revisited. In ASF's opinion, Section 36 is necessary and should be included in the regulations, subject to the amendments noted herein.

RECOMMENDATIONS

Industry Canada has requested ASF to provide comment and recommendations on the four points noted at the outset of this report. ASF has expanded on these issues in this report and recaps our recommendations as follows:

1) Section 1 - Definition of Specified Rates as noted in –
   i) Definition of "capital lease" part (c)
   ii) Definition of "outstanding balance of a capital lease" parts (b) and (c)

   i) ASF suggests that the implicit rate of return be incorporated into this part of the definition
   ii) ASF suggests a discount rate that is consistent with CICA guidelines for accounting for leases. This would mean that most lessors would use either the implicit rate of return or their incremental cost of borrowing.

2) Section 1 - Definition of Lessor

   a) Part (c) should include non-rated companies which have been approved for a securitization within the past three years or who are currently securitizing their assets

   b) Part (d) should remain the same. Applicants under this section will be required to submit a formal credit application with accompanying financial information.

3) Section 9 – loss-sharing ratio

   Industry Canada is currently modeling the various components of the program to arrive at a suitable loss-sharing ratio. We suggest a loss-sharing ratio higher than the 80/20 currently under consideration, keeping in mind the Government's objectives of full cost recovery and consistency with the CSBFA loan program.

4) Section 36 - securitization

   This section should remain subject to the amendments described in this report. The section should probably be renamed "lease funding" as it will also cover various funding situations including securitization. It is recommended that the section allow the transfer of the cap on claim amount associated with any lease from the seller to the buyer of the lease.

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