Industry Canada

# CAPITAL LEASING PILOT PROJECT

## PROPOSED LESSOR APPROVAL PROCEDURE under CSBFA DRAFT REGULATIONS

## FINAL REPORT

## MAY, 2001

*prepared by*

**Aon Structured Finance Solutions**

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## INTRODUCTION

Industry Canada has engaged Aon Structured Finance Solutions ("ASF") to assist in preparing an overview of an approval process for companies that wish to participate in the Canadian Small Business Financing Act's ("CSBFA"), Capital Lease Pilot Project ("Program"). These applicants will be existing leasing companies, as well as other entities such as securitization trusts and companies that purchase or fund leases ("entities"). These entities wish to be designated as "lessors" under parts (c) and (d) of the proposed definition of lessor noted in the Program's draft regulations. In addition, Industry Canada wishes to implement an annual review process to confirm that approved lessors continue to qualify for the Program and has also requested ASF to assist in this process. Only entities that will be registering leases with the Government need to be approved as lessors in order to qualify under the Program.

This report addresses two areas: i) the initial credit approval process for entities applying to become "lessors" under parts (c) and (d) of the draft CSBFA regulations' definition of lessor and ii) an annual review process of lessors to ensure they continue to meet the Program's criteria. The purpose of these procedures is to ensure that lessors that participate in this program are reputable and financially sound throughout the life of the program.

The initial approval process will differ for entities applying under part (c) from those applying under part (d) of the definition of lessor. Part (c) applicants will be either publicly rated entities or non-rated entities approved for, or engaged in, a securitization program. Accordingly, they will have passed the financial scrutiny and due diligence process of recognized third parties. This will make their approval under this Program relatively straightforward.

Entities applying under part (d) of the definition will have to pass a different approval process as their credit information is not normally available to the general public. This process will be initiated and managed by the Government and this report is being written to assist Industry Canada in developing an appropriate approval process. This annual review process will also apply to lessors approved under part (c) ii) of the draft regulation's definition of lessor.

In developing this overview, ASF has made the assumption that Industry Canada has experienced credit granting personnel available to analyze and approve the credit worthiness of each applicant. In addition, personnel must be available to perform annual credit reviews on selected accounts. If experienced credit personnel are not available in house, Industry Canada will need to consider using external resources as these reviews are a vital and required part of the Program.

The initial approval procedure for applicants under part (d) will include financial analysis, review of credit and banking references and a review of some historical data on each entity to ensure that only the most reputable entity receive permission to offer CSBFA guaranteed leases. ASF understands that the number of applicants under part (c) of the definition will not be arbitrarily limited, but the number of applicants under part (d) of the definition will be limited to 150. The geographical distribution of these lessors is expected to mirror the population demographics of the country.

Industry Canada wants all credit worthy entities, both large and small, to participate in this Program. However, the number of initial participants will be limited as this Program is a pilot project.

## DEFINITION OF LESSOR - INITIAL APPROVAL PROCESS

*Part (c)*

The initial approval process for applicants under both subsections of part (c) of the definition is straightforward and requires no additional comment. These applicants must produce one of two documents to ensure approval: i) a copy of their latest public credit rating as assigned by a Canadian bond rating agency, or ii) confirmation from a Canadian bond rating agency or the applicant's external chartered accountant that the company is either; a) approved for a securitization program within the past three years or b) is currently participating in a securitization transaction.

Confirmation of the above will ensure that the lessor is approved under either subsection of part (c) of the definition. The approval procedure is clear and does not require a credit decision by the Government. The procedure is quite similar to the existing loan program approval process and ASF expects that Industry Canada will utilize the existing process to communicate application approvals to newly designated lessors. Applicants under this part of the definition are being included in this report as ASF suggests that an annual monitoring process be instituted for lessors approved under part (c) ii) of the definition. The rationale and procedure for this monitoring will be discussed in more detail later in the report.

*Part (d)*

Applicants under part (d) of the definition will be required to go through an approval process, similar to that undertaken by non-bank lenders under the existing CSBFA loan program. Leasing Program applicants are entities that do not carry a public rating from a Canadian bond rating agency, nor are engaged in a securitization program. These entities are typically smaller, credit worthy, leasing companies that want to participate in the program.

The Government is currently preparing a “Policy Respecting the Designation of Lessors”, which includes information requirements to be submitted to the Government as part of the approval process. ASF has reviewed this draft section and provided comments for Industry Canada’s consideration. ASF also prepared information requirements it feels should be included in this draft section. These requirements and a suggested approval procedure are noted below. ASF suggests:

- The application policy be revised to include suggestions put forward in our email dated, May 4,2001 which referenced Parts “A” and “B” of the Policy Respecting the Designation of Lessors. Three of the more important issues raised were:

    1. Part A, Section 3 (f): Existing wording is not applicable and should be replaced by a minimum dollar amount of equity
    2. Part B, Section 3: The requirement of a five-year business plan from each applicant may be a burden for smaller lessors and may discourage them from applying for inclusion under the Program.
    3. Part B, Section 5: The amount of outside collateral the Government may request from lessors may not be acceptable to many lessors as it increases their costs and could tie up their existing credit lines. The Government may wish to review the amount of collateral requested in this section to ensure that it does not preclude smaller lessors from participating in the Program.

- Applicants that are active leasing companies should have at least five years of leasing experience, an equity of at least $1 million and an annual volume of $10 million of new leases originated. Applicants that do not originate leases but rather, fund or purchase leases will be evaluated on a similar basis (e.g. number of years experience financing the leasing business, minimum equity and annual volume of leases financed).
- The application should also include the applicant’s current bank information and an authorization to the bank to provide a reference to Industry Canada.
- A credit reference using an independent third party (i.e. Equifax, D&B, etc.) should be requested on each file
- Once the information is compiled, a review of pertinent financial information and the results of the credit reference checks should be undertaken. Financial tests such as liquidity, leverage and profitability would be applied; keeping in mind the type of lessor and equipment it leases in order to ensure that these ratios are within industry norms. The attached addendum provides a conceptual overview of ASF’s suggested approach to the credit adjudication process for Industry Canada’s review and consideration. These are basic credit principals that Industry Canada should bear in mind when reviewing applicants for inclusion in the Program.

Approved applicants under this process would then be advised utilizing Industry Canada's present system.

*Costs*

The costs involved with the creation and implementation of the Program's process are difficult to estimate, as there are significant differences between the loan and lease applications procedures. For example, there are approximately 12 Minister designated approved lenders under the loan program while this Program is calling for 150 Minister designated approved lessors under part (d) of the definition of lessor.

There may be more than 150 applicants under part (d) as some applications may be turned aside. Applicants may be declined after reviewing their credit worthiness, while others may be turned aside for non-credit related reasons. At present, the basis for distribution of approved lessors across Canada has not as yet been determined and this could impact on the number of approvals in any one geographic area. As such, there could be several applications that are turned aside and we have assumed that these will total 100 for our costing purposes.

ASF is of the opinion that the cost to handle a file in the initial approval process under part (d) of the definition of lessor will be close to $1,000 each. This figure is based on several assumptions which are listed below on a **per file basis:**

a) Labour - $600 (includes clerical and managerial time):
   i. initial receipt and processing
   ii. information follow up, if material missing
   iii. draw bank and credit references
   iv. amass final information for presentation
   v. ensure the application meets geographical and any other non credit related parameters
   vi. make credit decision
   vii. enter the decision into Industry Canada's system
   viii. advise the applicant accordingly
   ix. set up appropriate filing and monitoring systems to maintain currency of records

b) External references - $100
   i. Bank reference
   ii. Credit reference, more than one may be required

c) Overhead Burden @ 50 % of labour cost
   i. ASF assumed a burden rate of 50% of labour costs to cover overheads including, premises, communications, insurance, legal, audit and travel, among other items.

The result is an initial cost of $250,000 to establish a procedure and review 250 applications, (250 applications X $1,000 per file reviewed = $250,000). Providing this costing on a variable basis is somewhat misleading as it infers that there are no fixed costs. In effect, there will be fixed costs incurred to set up the process irrespective of the number of applications processed. ASF has not undertaken an in-depth costing analysis within this mandate but suggests that the minimum cost associated with the implementation of this procedure will be approximately $200,000. This amount could vary dependant on Industry Canada's available personnel and space to name some of the key areas. However, ASF suggests that this is a conservative number that should be used for initial costing purposes.

There is a cap on the number of entities allowed into the Program during this pilot period and once attained no new applicants will be approved. Consequently, the cost of instituting this procedure and reviewing the initial applicants should be amortized over the life of the Program, as it is a one-time cost. Once the Program is full, new applications will be returned without incurring any review costs.

It should be noted that this estimate does not address any information system requirements that may arise in order to implement the procedure and track each applicant's progress going forward.

ASF is not privy to Industry Canada's expense information, however, ASF feels that this costing is a reasonable proxy of the costs to set up this Program during the Pilot phase.

## ANNUAL REVIEW PROCESS

Once the initial process of approving lessors across the country is completed, there remains a need to monitor these lessors in order to protect the integrity of the Program going forward.

### *Part (c)*

Lessors approved under part (c) i) of the regulations will be publicly rated companies and, as such, changes in their ratings are made public on a timely basis. Industry Canada may wish to subscribe to various rating agency services in order to monitor changes and confirm ratings on an annual basis.

Entities approved under part (c) ii) of the regulations present a different challenge. These lessors are not publicly rated companies but have been reviewed by independent third parties in order to be approved for a securitization program within the last three years, or are currently participating in a securitization transaction. However, since these lessors are not publicly rated, the Government would not normally be advised of changes in their financial condition. The Government will certainly want to know if there is any deterioration in a lessor's financial condition in order to have the opportunity to withdraw the lessor's ability to offer new CSBFA guaranteed leases should it feel the need to do so. Accordingly, lessors approved under this subsection of part (c) should be required to report their financial condition on an annual basis; similar to lessors approved under part (d) of the definition. This proposed procedure is outlined in the following section.

*Part (d)*

Entities approved under this part of the definition were subjected to an initial credit adjudication process at the time of their application. However, these lessors are not publicly rated and their financial condition is not public knowledge. The Government could find itself in a situation where it is dealing with a lessor that has had major financial setbacks that may affect the credit quality of new leases the lessor is putting into the Program. This, in turn, may result in large claims in the future. This is not to suggest that any lessor that experiences a poor fiscal year should have its designation as lessor automatically revoked. The purpose of the annual review is to track a lessor's progress over a period of time. Movement within acceptable financial parameters is acceptable, i.e. increase or decrease debt/equity ratio within an approved range relative to each lessor's type of business. However, when these parameters have been exceeded, the Government may feel it prudent to revoke a lessor's designation under the regulations. Consequently, the Government needs an ongoing system to review the financial condition of lessors approved under this part of the definition.

ASF suggests these lessors be required, on an annual basis, to submit their audited financial statements as well as an authorization to their bank to provide a bank reference. The Government would review the information, applying the standard financial tests used in the application section of this report, and act if it felt that a lessor's financial situation had deteriorated below acceptable parameters. This would allow the Government to take a pro-active stance with respect to ensuring the ongoing integrity of lessors under this Program and reducing the amount of claims it might otherwise encounter.

*Costs*

The annual review process will be less expensive to create and maintain than the initial credit approval process. Firstly, there will be a limited number of lessors to deal with. In ASF's opinion, there will be about 50 lessors approved under part (c) ii) of the regulations. The number of lessors under part (d) of the definition is limited to 150. Secondly, the initial credit files will have been created and historical data inserted. However, more work may be required on fewer files, thereby, increasing the labour component in the proposed costing. For example, there will be additional work required on those files where a decision has been made to withdraw a lessor's designation under the program. Also, there may be a need to follow up with lessors who do not send in their information in a timely manner. It is also important to note that all 200 accounts will require some amount of inspection and this must be factored into the costing calculation as we are attempting to provide a cost per file estimate for these reviews.

The review process itself should be speedier than the initial approval process. All lessors were deemed credit worthy when approved and the annual review should re-confirm this for most lessors. Additional work will arise when a file is found to be either incomplete, requires action due to deterioration in the lessor's financial condition, or is in breach of any other condition of the Policy Respecting the Designation of Lessors.

ASF estimates that it will cost about $500 per file to complete the annual review. Our assumptions are listed below on a **per file basis:**

a) Labour - $300 (includes clerical and managerial time)
   i. Annual receipt or follow up on late submissions
   ii. process information
   iii. draw bank and credit references, if required
   iv. amass final information for presentation
   v. make credit decision
   vi. enter declined lessors into Industry Canada's System
   vii. advise the lessor of the withdrawal of the designation

b) External references - $50
   i. Bank reference
   ii. Credit reference, if required

c) Overhead Burden @ 50 % of labour cost
   i. ASF assumed a burden rate of 50% of labour costs to cover overheads including, premises, communications, insurance, legal, audit and travel, among other items.

Using the estimated number of files to be reviewed and multiplying it by the projected cost per file, the annual cost would be $100,000, (200 files X $500 per file = $100,000). This is an annual cost and should be accounted for in that manner.

## SUMMARY

*INITIAL APPROVAL PROCESS*

- Part (c) approvals are straightforward as applicants have been scrutinized by recognized third parties that will confirm the credit worthiness of these applicants
- Part (d) approvals require the provision of significant information which will be used to make a decision on the financial condition of each applicant
- Projected cost to establish the approval procedure and approve lessors - $1,000 per application, subject to an estimated minimum cost of $200,000.

*ANNUAL APPROVAL PROCESS*

- Part (c) i) lessors will be publicly rated and changes in their financial conditions will be public knowledge
- Part ( c) ii) lessors to follow same procedure as part (d) lessors
- Part (d) lessors to submit annual audited financial statements and banking information for review and confirmation of their continued participation in the Program
- Lessors whose financial situation has deteriorated or are found to be in breach of any other condition of the Policy Respecting the Designation of Lessors at the time of annual review, may have their designation as lessors revoked
- Projected cost - $500 per file.

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## ADDENDUM

### *Approach to the Credit Adjudication Process*

The lending industry utilizes several concepts when analyzing a credit application. One basic evaluation concept is the application of the four "C's" of credit. Each C represents a part of an applicant's total credit picture. Together, the information amassed from the analysis provides an accurate view of an applicant's financial health. The four "C's" of credit are:

- Capital
- Character
- Capacity
- Collateral

ASF suggests that Industry Canada approach the credit granting process using a variation of the four "C's "of credit granting. ASF has removed the fourth C from the list as the Government is not acting as a lender to lessors and, in most cases, will not be taking any collateral security. Accordingly, ASF suggests the credit adjudication process use the remaining three C's as follows:

- Capital
- Character
- Capacity

Analyzing each applicant from the perspective of Capital, Character and Capacity should allow the Government to make an informed credit decision. Each concept addresses a different aspect of an applicant's business, but together, they help to paint a picture of the applicant's financial health. ASF has expanded on each concept in order to provide the Government with some fundamental principals to apply when reviewing each applicant.

### *Capital*

All companies require sufficient capital, or equity, to run their businesses. Equity capital must be analyzed in both absolute dollars (i.e. minimum equity test) and in relation to the level of debt being assumed by the company (i.e. debt/equity ratio).

When viewing the debt/equity ratio, there is no absolute benchmark that will work for adjudicating all leasing companies as each leasing company has differing capabilities to manage their financial leverage. A small leasing company that assumes significant residual risk on equipment and has a client base of lower quality leases may, for example, be unable to withstand a debt/equity ratio of 4 to 1. Whereas larger, well-heeled lessors that offer small ticket financing to a diversified base of consumer clients may easily handle a debt/equity ratio of 10 to 1. The key is understanding the appropriateness of debt/equity in any given circumstance. This involves having a basic understanding of the applicant's history, management capabilities, existing business dynamics and future prospects.

The Government is not in a position to undertake an intensive credit review process with each client. Accordingly, it will need to deploy other steps to gain a comfort level when analyzing the adequacy of capital in any given situation. Steps that can be taken to meet this end include review of the following:

- Absolute level of equity capital (can be determined from audited financial statements)
- Trend in equity capital – is it increasing or decreasing? (can be determined from audited financial statements by reviewing year over year figures)
- Debt/equity ratio – is it at an acceptable level? The actual ratio can be calculated from the financial statements. The acceptability of the figure can be determined by assessing and analyzing the following:

    - Year over year trend in debt/equity ratio
    - Lessor's operating income/interest ratio, which provides an indication of a lessor's debt servicing ability
    - Results of contact with the lessor's debt providers to verify their comfort level with the lessor as well as their willingness to provide additional support. Bank and trade credit references can be used to obtain this information, as well as third party credit reporting agencies such as Equifax. This is an important part of the credit review process as lessors that lose the confidence or support of their debt providers or trade credit suppliers often fail.

***Character***

The character of the principals of the applicants is another key consideration in the credit adjudication process. The Government is relying heavily on the integrity of the principals to demonstrate both "willingness and capability" to do the right thing when offering leases under the Program. Failure to meet or maintain minimum standards in this regard may result in higher claims and possibly greater losses for the Program.

The Government will clearly not be in a position to become intimately familiar with the principals of each applicant. As such, the Government will need to place heavy reliance on the third party references noted above. To reiterate these references would include:

- Bank - typically banks are unwilling to provide good references on less than satisfactory relationships and references often provide a good indication of how the business is being managed

- Trade credit - again, slowdowns in payments, legal suits or an inordinate amount of disputes may reflect on the competency of management, as well as,
- Increased awareness through participation in industry related associations, events and the receipt of trade journals. Relevant information that cannot be found in any set of financial statements or trade publications can often be obtained via “industry scuttlebutt”.

To summarize, every effort should be made to gauge an applicant’s “character” as it is perhaps the most important C in the credit-granting process.

***Capacity***

This relates to a lessor’s ability to repay its financial obligations. Companies don’t go out of business because they lose money. Rather, they fail when they are unable to meet their financial obligations as they become due. Some tests that can be applied to determine an applicant’s financial capacity are:

- Operating income/interest ratio - this test has already been described in the previous sections. The purpose of this test is to determine a company’s ability to service the interest on its debt obligations. This ratio should be reviewed on a current basis, as well as on a trend basis. As is the case with the debt/equity ratio, there is no one figure that works for all leasing companies (e.g. those with less risky profiles will have an ability to operate with a lower ratio than lessors that are riskier and more cyclical in nature).
- Analysis of the lessor’s future principal repayment obligations. Clearly businesses that are less profitable, with heavy future principal repayment obligations, will be less attractive candidates for the Program than highly profitable firms with little or no term debt.

To summarize, the approach described above should provide the Government with significant insight into an applicant’s financial condition and ability to operate its business in a prudent fashion. Use of this model will help to identify weaker applicants and allow the Government to make educated decisions on each application in order to maintain its objectives during the life of this Program.