



Aon Structured Finance Services

CAPITAL LEASING PILOT PROJECT

IMPACT OF SECURITIZATION ON THE CANADIAN SMALL BUSINESS FINANCING ACT

A Presentation to Industry Canada

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Introduction

Industry Canada has undertaken a pilot project to examine the possibility of extending the Canada Small Business Financing Act (“CSBFA”) to include capital leasing as a form of financing under the Act. Capital leasing is defined by the Entrepreneurship and Small Business Office of Industry Canada on their “Sources of Financing” website as “One where substantially all of the benefits and risks of ownership are transferred to the lessee. It must be reflected on the company’s balance sheet as an asset and corresponding liability.”

Leasing companies are interested in funding their operations through the use of securitization, which by extension, would also need to be considered when drafting new regulations under the Act. Consequently, Industry Canada is seeking a better understanding of the securitization industry.

Industry Canada has engaged Aon Structured Finance Services (“ASF”) to submit a written report on the securitization market in Canada and its use in the leasing industry. ASF has been requested to address the following issues in this report:

Overview of Securitization

- Definition of securitization
- Benefits and Drawbacks of securitization
- Historical growth in Canada and the United States
- Securitization structures used in the leasing industry
- Accounting and Legal issues
- Profile of typical user of securitization

Impact of Securitization on the Canada Small Business Financing Act’s Capital Leasing Pilot

- Review of the CMHC guidelines to review their approach to securitization
- Review of CSBFA definition of Lender and the potential impact of securitization on this definition



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- Recommend amendments to the current program to account for the use of securitization as a financing tool.

ASF has prepared the following report to address the various issues noted above. The report provides information on the Canadian securitization market and discusses its use by the leasing industry. ASF has reviewed the current CSBF Act and provides its views on the potential impact of securitization on current CSBFA legislation, including the effect on its definition of lender. ASF has also made recommendations as to how the current CSBFA program might be adjusted to account for the use of securitization as a financing tool. In addition, ASF has included a Question and Answer section to address several specific issues raised by personnel at Industry Canada. Lastly, a Summary and Observation Section has been added which outlines ASF's views on the project.

Aon Structured Finance Services is a joint venture formed in 1999 resulting from the strategic alliance between Aon Canada and Intrepid Partners. Aon Canada, comprising Aon Re, Aon Reed Stenhouse, Aon Parizeau and various other subsidiaries, is the leading provider of insurance and reinsurance brokerage services in Canada. Aon employs 2,000 people across Canada and generates premiums in excess of \$1.5 billion annually.

Intrepid Partners is a consulting and advisory firm that specializes in securitization and structured finance. Intrepid Partners has been involved with more than \$3.6 billion in off balance sheet transactions encompassing major credit cards, auto leases and consumer loans. Intrepid Partners' clients include major financial institutions as well as independent leasing companies.

The alliance has a mandate to provide consulting and placement services related to structured finance. ASF services clients around the world, as well as, in Canada. Additional information is available in our corporate brochure, which is enclosed with this report.

Overview of Securitization

Definition of Securitization

Securitization is a method of financing one's business. In most simplistic terms, securitization transfers financial assets from their owner (a "Seller"), or a lessor ("Lessor") in the case of a leasing transaction, to a Special Purpose Entity ("SPE") that, in turn, funds the acquisition by issuing publicly rated securities ("Notes") to various parties ("Investors").

The Seller maintains relationships with the debtors underlying the securitized assets as it acts as the servicer of these assets on behalf of the SPE. In addition, the Seller also participates in the future excess profit spread generated by these assets. This spread is equal to the difference between the interest earned on the assets (i.e. the interest charged to a lessee) and the interest paid on the Notes held by Investors and used to fund the purchase. Consequently, the Seller is able to participate in the future income generated by the securitized assets.

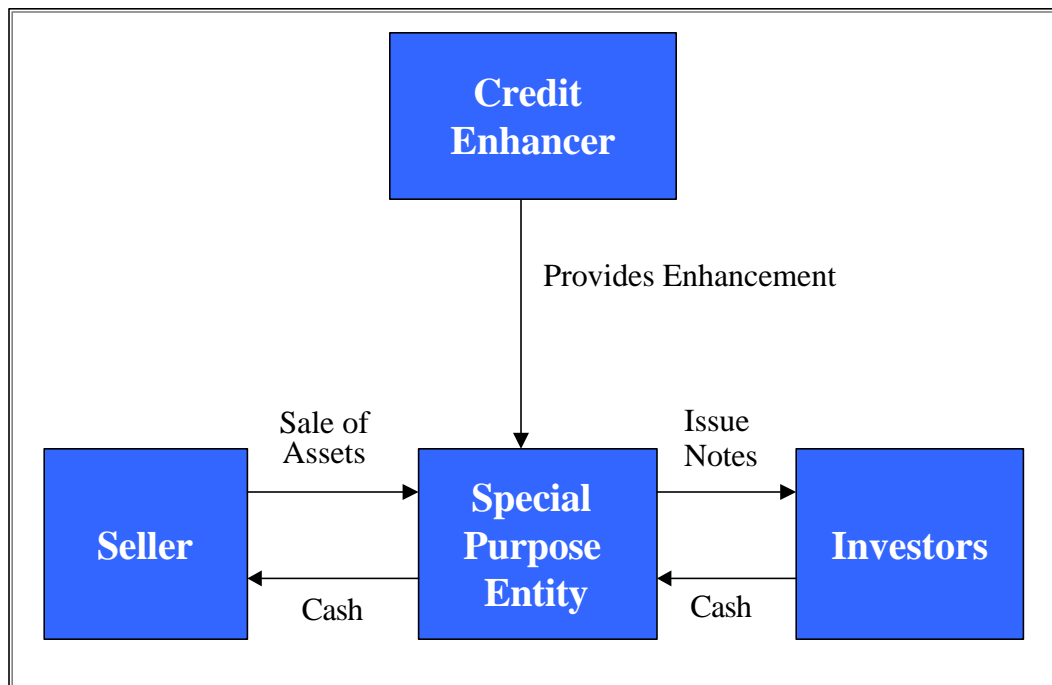
From an Investor's standpoint, the process of securitization transfers the credit risk from the Seller to the actual assets sold. Investors need not be concerned about the Seller's credit worthiness, only the credit worthiness attributed to the asset pool held in the SPE. The Seller's financial health is a concern only as it relates to its ability to act as the servicer of the assets, once securitized. The SPE is normally a bankruptcy remote (from the Seller) trust that is structured to hold assets on behalf of the Investors. It does not engage in any other commerce.

At a recent conference on Asset Securitization, securitization was specifically defined as "the issuance of securities payable primarily from the cash flow from a pool of self-liquidating assets, where the creditworthiness of the securities "does not depend" on the creditworthiness of the seller of the assets."

Whether you view securitization as a Seller or an Investor, the effect is that the Seller receives payment for assets that have not yet matured and the Investor purchases a highly rated debt instrument.

How Securitization Works

The Structural Overview Chart presented below outlines a basic securitization structure.

Structural Overview Chart

The Seller sells a pool of assets to the SPE, which funds this purchase through the issuance of Notes to Investors. These Notes are supported by the credit quality of the assets purchased by the SPE. Most senior debt issuances within a securitization program are designed to attain the highest possible public debt rating i.e. "AAA". Investors tend to be large institutional investors such as pension funds who require AAA investments as part of their portfolio.

The majority of SPE's have been established by the Investment Banking arms of the large Canadian Chartered Banks; TD Securities, Nesbitt Burns, ScotiaMcLeod, CIBC World Markets and Royal Bank. In the past, SPE's have been created as either a "Single Seller" conduit, where all assets in the pool are originated by the same Seller, or "Multi-Seller" conduits, where several Sellers sell different asset classes into the same conduit. The

distinction between these two types of conduits has been disappearing in recent years, as several single seller pools have multiple sellers and multiple asset classes. Conversely, many multi seller pools have only one or two sellers. Accordingly, reporting on the two types of conduits is being amalgamated into one report by some rating agencies and all SPE's will basically become multi-seller conduits in the future.

Dominion Bond Rating Services ("DBRS") notes in its publication "Securitization, Year-end Review of Canadian Asset Backed Securities" dated January 2000 that it currently rates 81 active programs (conduits). Approximately 40 of these programs are multi-seller conduits. DBRS also reports that they have rated 301 active multi-seller conduit transactions within these 40 or so multi-seller conduits. In other words, there are over 300 transactions currently housed in the multi-seller conduits. Attached as Exhibit "A" is a list of the multi-seller conduits rated By DBRS as at November 30, 1999.

Of the total Asset Backed Securities ("ABS") notes and commercial paper outstanding at the end of 1999, the major Canadian Banks' Investment Banking Subsidiaries administered about 97% of the outstandings housed in multi-sellers vehicles and 93% of the outstandings located within single seller conduits. As can be seen, SPEs established by the major banks dominant the ABS market.

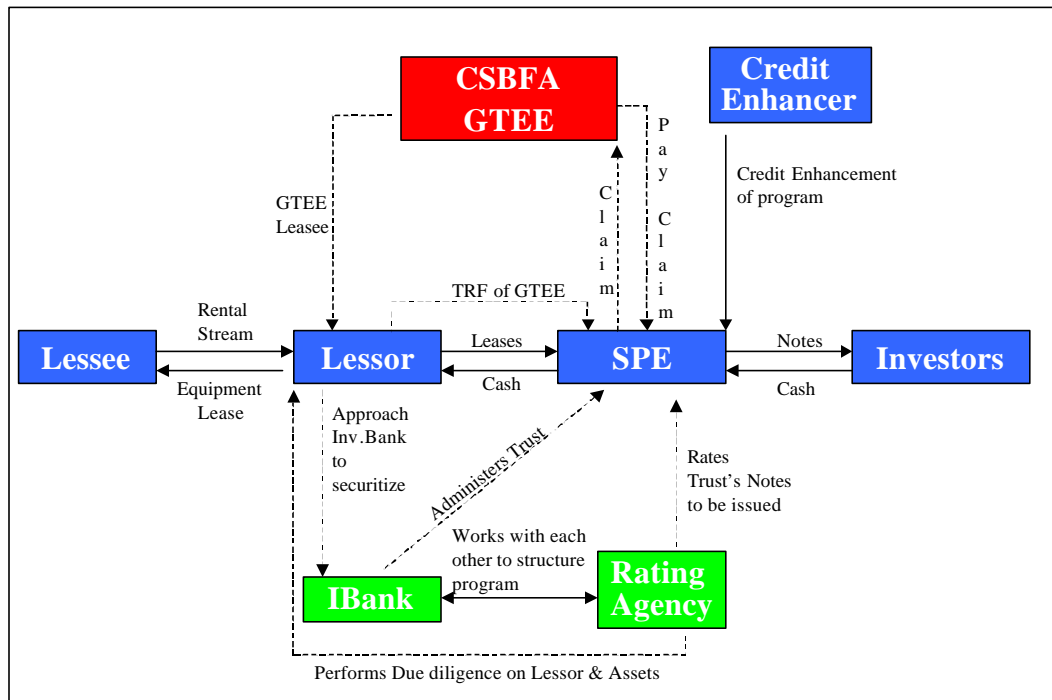
Securitization effectively separates the credit risk of the assets being securitized from the credit risk of the Seller. The assets are often credit enhanced to ensure the highest credit rating is attained. Credit enhancement is frequently provided by a third party "Credit Enhancer" and can take the form of a Letter of Credit or a Guarantee that can be called upon if the performance of the pool of securitized assets deteriorates. This added protection to Noteholders often results in a securitization rating that is higher than that assigned to the Seller's other corporate debt instruments.

The Chartered Banks often provide their own credit enhancement to their programs. Other credit enhancement providers have included the Japanese and French Schedule II banks in Canada. Credit enhancement providers must have a long term rating of "AA" or better. Several Japanese Banks have recently lost their "AA" rating due to the decline in the Japanese economy and consequently have lost their ability to provide enhancement, unless they cash collateralize their guarantee, a very expensive proposition. The insurance industry has been investigating the possibility of providing financial guarantee insurance as a form of credit enhancement in Canada, similar to that provided in the United States.

The Structural Overview Chart above describes a basic securitization structure. Now, let us look at a proposed lease securitization transaction that includes a lease supported by

a CSBFA guarantee. The following chart outlines a conceptual transaction, from the time the lease is signed through to the completion of the securitization and issuance of Notes to Investors.

Conceptual Securitization Transaction



In this example, we assume that the Lessee is not credit worthy on a stand-alone basis and consequently, the Lessor has applied for and obtained a CSBFA guarantee of the capital lease. We also assume that a Lessor has amassed enough leases (guaranteed and non-guaranteed), e.g. \$25 Million, to make securitization economically feasible.

When a Lessor decides to securitize assets, a chain of events is set off which ultimately culminates in the closing of the asset sale to the SPE. Referring to our chart, there are a number of external parties that will play a large role in the process.

Here is a brief outline of events:



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The Lessor will contact an Investment Banking firm to discuss the securitization transaction. The Investment Banking firm (“IBank”) will review the Lessor’s financial condition, historical performance with respect to the asset class being sold, as well as the Lessor’s internal systems and procedures. Although the credit risk is being transferred with the sale of the assets, the Lessor will become the servicer (“Servicer”) and as such, must be in a position to service the assets and report to the SPE on a consistent and accurate basis. The CSBFA guarantee will be examined to determine if it is assignable/transferable and to ensure that it will remain on the lease until the lease expires.

The sale will only occur after completion of a stringent due diligence process by key parties to the securitization transaction, (e.g. Investment Bankers, Rating Agencies and any providers of third party Credit Enhancement). Consequently, once the IBank is convinced that the Lessor is an eligible Seller, with quality assets and a good track record, it will begin to structure the deal to move to closing.

The IBank next involves the Rating Agency in the process. The role of the Rating Agency is critical as it is the Rating Agency that rates the Program in order to obtain the desired credit rating on the Investor Notes. There are two Canadian based Rating Agencies, DBRS and Canadian Bond Rating Service (“CBRS”). Their approach to the rating process is thorough and all encompassing as Investors rely heavily on the rating that a Rating Agency attaches to a debt issue.

Rating Agencies evaluate the Lessor, the collateral and the structure of the transaction in order to arrive at an appropriate rating. To do this, the Rating Agencies perform due diligence, stress testing and credit evaluation on these three components of the transaction. In addition, they review the proposed legal opinions that will provide confidence of true sale, enforceability, tax neutrality and bankruptcy remoteness.

When evaluating the Lessor, its historical financial information for the previous five to seven years is reviewed. The Lessor’s performance over the last several years is an appropriate measure of its ability to operate within several business cycles. Although the credit risk of the assets is divorced from that of the Lessor, the Lessor’s financial condition is important when addressing operational risk, i.e. as Servicer of the securitized assets. The Seller of the asset, in this example the Lessor, is normally appointed the Servicer and deals with the asset on an ongoing basis including collecting payments and remitting to the SPE. As such, the Rating Agency wants to ensure that the Lessor is financially sound and has the ability to continue as Servicer throughout the life of the program. Weaker Lessors pose a degree of credit risk that is usually unacceptable to the Rating Agency.



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Newer leasing companies with limited financial history, or companies with inadequate information systems, often find that they cannot satisfy the Rating Agency's criteria and accordingly, will not be in a position to use securitization. These companies may qualify as eligible lessors under the CSBFA but will need to finance their leases utilizing traditional finance sources, at least until they have developed a track record.

The historical performance of the assets to be securitized is also reviewed and the portfolio is "stress tested". Stress testing is a spreadsheet based financial analysis performed by the Rating Agency. Its purpose is to determine if the SPE's ability to repay the Notes issued is compromised by negative financial events, such as a significant reduction in the yield of the portfolio or if bad debts increase significantly. These financial events are exaggerated or "stressed" to ensure the SPE can continue to service its debts in weaker economic cycles. The ability of the portfolio to withstand these varying degrees of severity of financial performance is one of the factors that determine the rating attached to the Notes.

As part of the initial due diligence process, the Lessor's operations are reviewed to ensure that it has adequate information systems to identify, track and report on the performance of the securitized assets to the SPE on an ongoing basis. All operational areas are reviewed, including credit and collection procedures, to confirm they are adequate. Significant emphasis is placed on how the business is run, information systems and reporting, and historical financial performance. Lessors that are unrated, or are below investment grade, are normally subject to greater scrutiny.

Lastly, the Rating Agency reviews the structure of the transaction and advises what amount of credit enhancement or credit protection is required to raise the rating on the referenced assets to the desired level. In addition, the form of credit enhancement is reviewed as there are advantages and disadvantages to each form of credit enhancement, i.e. guarantees, excess spread, cash. Lessors naturally wish to reduce their costs of borrowing and the cost of providing enhancement increases these costs. Consequently, Lessors are interested in the amount and form of enhancements in order to do their cost analysis. Lessors may have input as to the form the enhancement may take but the amount of required enhancement is normally a Rating Agency call.

The Rating Agency will also review the eligibility criteria for assets to be included in the pool. This is a paramount consideration as it will determine the quality of assets which will be going into the pool; initially and going forward throughout the life of the program. Historically, the eligibility criteria includes issues such as the amount of credit concentration in specific debtors, geographical distribution of debtors and the definition of the asset class to eliminate oddities within the asset class, e.g. lift trucks within a car



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lease portfolio. Ideally, the assets are well spread in terms of amount owing per account, geographical location and with limited concentration of debt in any individual account.

With respect to Industry Canada's Capital Lease project, the Rating Agency will, no doubt, want to do a thorough review of Industry Canada's proposed CSBFA lease guarantee program. This will involve a review of the documentation involved and discussions with Industry Canada officials to determine how the guarantee will affect the lease and its eligibility for insertion into a securitized pool. With the absence of historical information, the Rating Agency may wish to review the historical performance of the current CSBFA program to determine if analogies can be drawn. Rating Agency approval is one of the key issues that must be satisfactorily resolved, as failure to obtain approval to include CSBFA guaranteed leases within eligibility guidelines will automatically exclude these leases from any securitization program.

As the Rating Agency concludes its due diligence process, the IBank introduces the Credit Enhancer to the transaction, as the Credit Enhancer will wish to do its own due diligence on the Lessor before agreeing to provide the required credit enhancement. As mentioned previously, credit enhancement is a layer of protection provided on the securitized assets in order to obtain a desired rating by the Rating Agency. Should the asset pool experience serious negative events, such as extremely high losses, the credit enhancement provides a further layer of protection to the Investors. This additional protection often allows the rating on the assets to reach a higher level than that of the Lessor.

To illustrate, let us take a credit card portfolio that is about to be securitized. The Seller will normally retain a very small piece of the portfolio, say 2%. The pool's bad debts are charged against this retained interest. The credit enhancer may be requested to put up a letter of credit amounting to 5% of the pool as credit enhancement. Should pool losses be greater than the Seller's 2% retained interest, the additional losses would be charged against this letter of credit, as it serves as the next layer of protection for the Noteholders. This would probably be sufficient to allow the Rating Agency to provide a "AAA" rating on the remaining 93% of the pool. If the Seller was an "A" rated company, the effect would be that the Notes issued under the securitization program would have a higher rating than the Seller's other debt instruments.

When doing its due diligence, the Credit Enhancer normally relies on the IBank and Rating Agency for most of the due diligence information in order to avoid duplication of work for the Lessor. An onsite visit to the Lessor's place of business, by all due diligence parties, is standard procedure. The information is reviewed and the level of enhancement is negotiated with the IBank representing the Lessor. The Rating Agency has the final say in the rating process but is prepared to entertain some negotiation.



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Once the Rating Agency has approved the transaction and assigned the appropriate rating, the IBank arranges for the closing and the sale takes place to the SPE. As part of the transaction, the Lessor is appointed Servicer of the securitized assets. The transaction is transparent to the Lessor's customers, as the SPE does not interact with the account debtors and the Lessor, as Servicer, maintains its ongoing relationship with the accounts on a day-to-day basis. For example, it receives customer payments in the normal course and remits those payments relating to the securitized assets to the SPE, which in turn, uses the funds to pay interest on the Notes and returns any excess funds to the Lessor.

In our Conceptual Securitization Transaction, we have identified one lease that was guaranteed to the Lessor under the CSBFA at the time the lease was signed with the Lessee. We are assuming, for purposes of this example, that this lease met the pool's eligibility requirements and is sold to the SPE as part of the securitization transaction. The result is that the Lessor has sold the lease, along with the accompanying guarantee, to the SPE who now owns the rights to the lease payment stream as well as any payments that may be received under the guarantee.

The SPE contracts out the servicing of its leases to the Lessor as Servicer and, as such, if this guaranteed lease defaults, the Lessor/Servicer will follow its normal collection and realization procedures up to and including the liquidation of the asset and the booking of a loss if one occurs. The loss would be charged to the SPE since it owns the asset and the Servicer would then prepare a claim for submission to Industry Canada on behalf of the SPE. Consequently, from a legal standpoint, the SPE owns the lease rights and the claim payment. On an operating basis, the Lessor interacts with the Lessee and eventually with Industry Canada to file the claim. As such, the definition of Eligible Lessor will need to reference the SPE, either as owner or as some form of assignee. This is definitely a legal/technical question that would be best put before Industry Canada's counsel.

On an ongoing basis, although the fee structure for the CSBFA guarantee has yet to be determined, it does raise an issue as to how it will be collected and who will pay it. The SPE will be quite interested in this issue, as it would not want to find out that the guarantee had fallen away due to lack of payment. The original fee would no doubt flow from the Lessor, although the lessee ultimately paid for it in one form or another. With the sale of this lease to the SPE, the Lessor becomes the Servicer and should as such collect the annual fee on behalf of the Trust. Failure to do so could raise grounds for a replacement Servicer.

It may be beneficial for the CSBFA regulations to insist that the Lessor be responsible for the fees, even when the lease is sold to a securitization vehicle. This would ensure that the fees are remitted to the government and it would also simplify the confirmation process to the SPE that the fees are up to date. Lessors, as the Servicer of the portfolio, could collect the fee from the Lessee in the normal course.

Returning to our example, once the transaction is completed, the Lessor acts as the initial Servicer of the securitized assets and will remain so unless a default occurs under the servicing agreement. Should a default occur, the Lessor is replaced by a back up Servicer who would fulfill all the obligations of the initial Servicer. The back up Servicer would take over the administration of the accounts including ongoing collection of receivables and remittances to the SPE. An example of a Servicer default is failure to remit customer collections within the allotted time period provided for in the legal documents.

The replacement of an initial Seller/Servicer by a back up Servicer is a rare and drastic event. ASF has never heard of a Seller/Servicer being replaced during a securitization program. Back up Servicers are normally identified in the securitization legal documents and are often the large Canadian Chartered Banks. For example, the back up Servicer to a Bank credit card program could be another Bank.

The IBank usually creates the SPE, as a charitable trust, and acts as its administrative agent. This entails working with the Lessor/Servicer to obtain ongoing performance and financial reports, receiving funds for the SPE and ensuring that Noteholders receive timely payment. For example, TD Securities created a multi Seller trust, CoRe Trust, to issue Commercial Paper on behalf of various Sellers. TD runs the SPE and does all its bookkeeping, tax returns and other regulatory duties. In addition, it monitors monthly Seller reports to ensure compliance, and it deals with the Trust's funds until they are disbursed.

A number of asset classes have already been securitized in Canada. These include credit cards, auto loans and leases, consumer loans, trade receivables, equipment leases, as well as residential and commercial mortgages, to name but a few. Many of these transactions were completed through multi-seller conduits, so the identity of the Seller is not known. However, several banks have created single seller vehicles to securitize their own assets. CIBC securitized a portion of its VISA credit card portfolio through CARDS Trust. ATLAS Auto Loan Funding Trust 1999 was used by the Bank of Nova Scotia to securitize a portfolio of auto loans and Canada Trust used Canadian Residential Mortgage Trust to securitize a portion of their residential mortgages.

Benefits and Challenges of Securitization

The Benefits and Challenges of Securitization are discussed below.

Benefits

Alternate source of funding

One significant benefit of securitization is the fact that it provides the Seller with an alternate source of funding. Diversification of funding sources allows a Seller to tailor its financing in conjunction with swings in various finance markets. As an example, a Seller whose debt is not attractive to the public markets on its own, may be able to access the public capital markets by securitizing assets, thereby opening this financing option.

Balance Sheet Leverage

Leverage is another benefit of securitization as it allows a Seller to release equity for other purposes. The sale of assets to a special purpose entity removes the asset from the balance sheet and reduces leverage, as the asset and corresponding liability are removed the balance sheet. This, in turn, allows for continued growth on the same equity base, thereby increasing return on equity and return on assets.

Lower all in cost of funds

In some situations, the all in cost of using securitization (that is, including fees and other transaction costs) is lower than the Seller's direct borrowing costs. This would not necessarily apply to higher rated Sellers, however,

they would look to the increased leverage available with securitization as a mitigating factor to its use.

Potential tax savings

A Seller may experience some tax savings depending on the securitization structure used.

Transparency

Customers of the Seller are unaware of the transaction as the Seller is usually retained to act as the servicer of the securitized portfolio. Sellers welcome the transparent nature of securitization as it avoids third party notification issues and any negative connotations.

Challenges

Asset Class must be acceptable to Rating Agency

The asset class must be conducive to securitization. Large concentrations of credit risk, assets with substantial residual risk, or which cannot be sold free and clear by the Seller, are not acceptable for securitization.

Intrusive to the Seller

Securitization is intrusive to the Seller and considerable time and resources are required to launch a securitization program.

Expensive to establish a securitization programme

The cost of establishing a securitization programme can be quite expensive when taking into consideration, investment bank fees, legal and



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accounting charges, due diligence work as well as Rating Agency fees. Consequently, it makes securitization unattractive for smaller Sellers.

Ongoing reporting issues

Ongoing reporting requirements are extensive once a securitization has been completed. For example, a portfolio report is required monthly. This report details various areas of activity during the month and is normally quite complex. Several other reports are required quarterly and annually. Additions and deletions to a pool of assets usually require additional reporting as well as Rating Agency approval.

History and Growth of Securitization

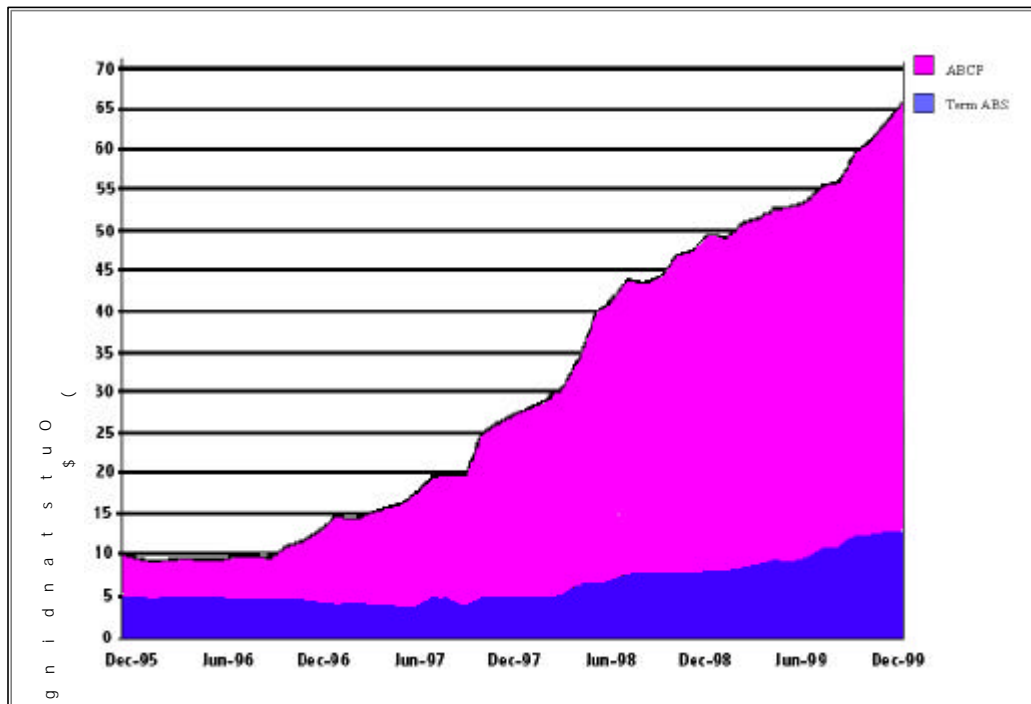
The use of securitization as a financing tool in Canada began in the late 1980's. The first securitization transaction was originated by First Line Trust and consisted of a pool of NHA guaranteed mortgages. There was limited activity in the securitization market until early 1991 when three major issuers started to use securitization extensively. These companies, Chrysler, Triathlon and J.T. Case were all experiencing credit related problems and looked to the securitization market for relief.

The market in the mid '90's remained stable with modest growth until the financial services industry regulators' approach to securitization became more favorable. Once the regulators signaled their approval of the use of securitization in the financial industry, banks moved quickly to securitize their assets. In fact, the majority of growth in the securitization industry from 1996 to date is the result of financial institutions securitizing their own assets.

The "Year-end Review of Canadian Asset Backed Securities" prepared by DBRS and dated January 2000 reports that the Asset Backed Securities market outstandings rose from \$10 billion at the end of 1995 to \$66 billion at the end of 1999.

The following graph demonstrates the growth of the ABS market for the period of December 1995 to December 1999.

Graph from DBRS “Securizations” Year end review dated January 2000

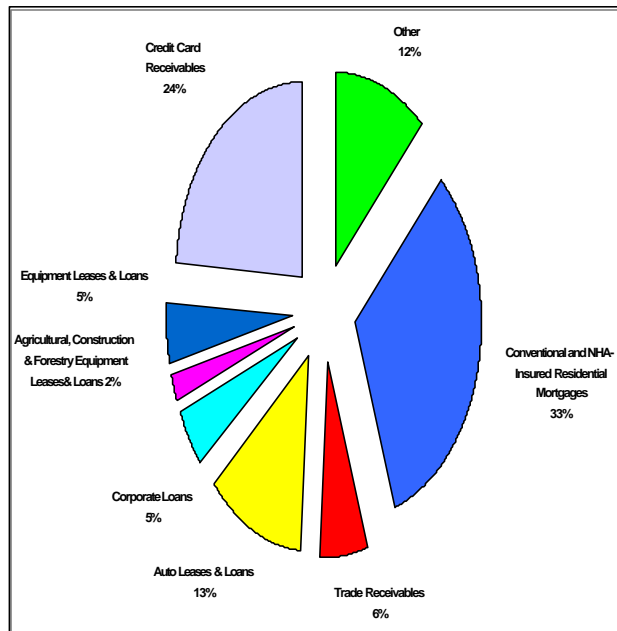


Asset backed commercial paper (noted as ABCP in the chart above) represented \$53 billion of the \$66 billion outstanding at the end of 1999. This represented 49% of non-government short-term debt in Canada.

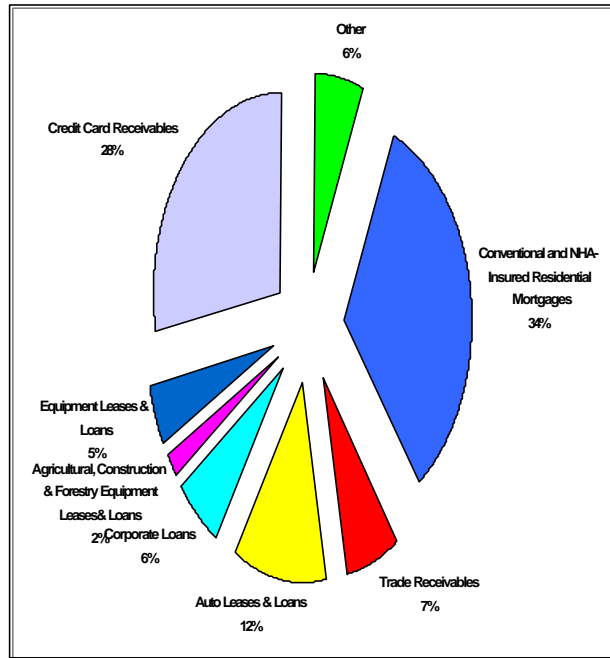
The term note market, (Term ABS) grew from \$8 billion to \$13 billion in 1999 and DBRS is predicting continued high growth in the term market in 2000. The overall ABS market grew by over 33% in 1999 and has increased fivefold over the past three years.

With respect to the various asset classes being securitized, the following DBRS chart outlines the “Total ABS Market Asset Composition” for the year ends of 1997 to 1999.

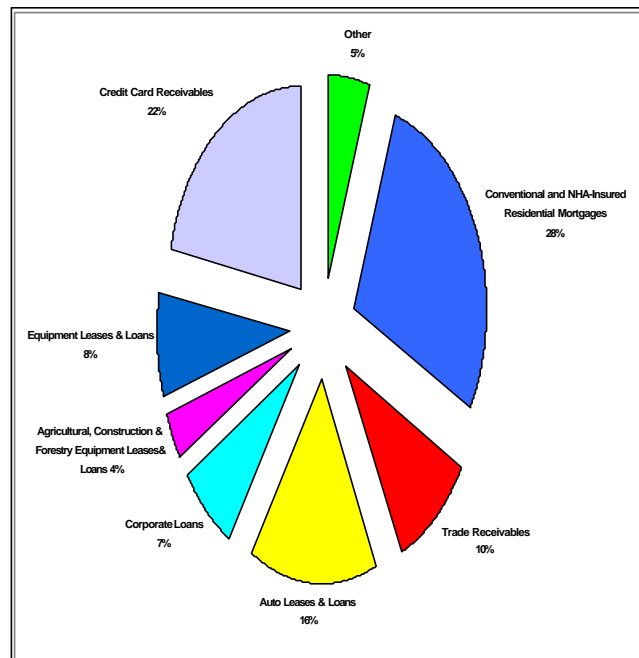
**Total ABS Market Asset Composition
December 1999**



**Total ABS Market Asset Composition
December 1998**



**Total ABS Market Asset Composition
December 1997**



The market composition statistics are provided by asset class and do not separate lease and loan portfolios within an asset class. However, the charts are helpful in identifying which asset classes are most active.

There are three asset classes that contain both loans and leases. They are Autos, Equipment, and Agricultural, Construction and Forestry Equipment and these classes represented 20% of the market as at December 1999 or approximately \$13 Billion. In ASF's opinion, there are more loans than leases in these portfolios, however, this is based solely on ASF's review of various joint portfolios in the past. ASF's very rough estimate of the breakdown between leases and loans is 75% loans and 25% leases, however, ASF stresses that this is not based on readily identifiable information. The availability of the CSBFA guarantee to lessees will no doubt increase activity within these asset classes. Also, new classes could be introduced as the CSBFA guarantee plan is applied to other assets.

The Canadian market has demonstrated rapid growth over the past few years and this growth is expected to continue over the near term. Canadian investors are feeling

increasingly comfortable with the ABS market and Sellers are realizing the many benefits of securitization as an alternate financing option.

The United States, however, continues to be the leader in all areas of securitization and is continuously developing new asset classes, structures and concepts for the securitization industry.

The use of securitization in the United States began in the late 1970's. Growth was modest until the mid 1990's as outstandings rose from less than US \$50 billion in 1985 to approximately US \$250 billion in 1995. The market has exploded since that time and the reported outstandings for the third quarter of 1999 were over US \$850 billion.

The US securitization market encompasses significantly more asset classes such as sub-prime auto loans, student loans, entertainment royalties and stranded utility costs resulting from the privatization of public utilities. Investor appetite is also much larger than in Canada as US investors are prepared to reach down the credit curve in the search for additional yield. This bodes well for Canada as it demonstrates the growth potential in all aspects of the securitization market in Canada.

Accounting and Legal Issues

The securitization process has certain accounting and legal peculiarities specific to the industry. A few of the more noteworthy issues are described in this section to provide a broader understanding of securitization.

The single most important securitization accounting issue is confirmation that the asset sale qualifies as a "True Sale" under Canadian Generally Accepted Accounting Principals ("GAAP"). As mentioned previously, in a securitization transaction, the Seller sells a pool of assets to a SPE and the True Sale opinion confirms that the sale is absolute. This ensures that these assets will not be treated as part of the Seller's property in the event of the Seller's insolvency.

In order to qualify for as a "True Sale", the assets must be sold with only limited recourse to the Seller and currently, recourse of 10% or less is generally considered acceptable under GAAP. In other words, if the Trust has recourse to the Seller for more than 10% of the sold assets, it may not be classified as a sale. Failure to achieve a "True Sale" would



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result in the transaction being classified as a loan and the benefits of securitization would be lost. Consequently, transactions are always structured to ensure this is attained.

Securitization structures are complex and address a Seller's operational, tax and legal considerations. Structures are continuously being refined and altered to meet the needs of new asset classes.

As mentioned earlier, a Special Purpose Entity is normally established to purchase the securitized assets. The SPE must be "bankruptcy remote" from the Seller. In other words, the SPE is used to separate the credit risk of the securitized assets from the Seller's credit risk. By making the SPE bankruptcy remote, the assets are not subject to any call by the Seller's creditors should the Seller find itself in financial difficulty. SPEs can be corporations, partnerships or charitable trusts, although most SPEs are charitable trusts.

Securitization and the Canadian Leasing Industry

The leasing industry discovered the benefits of securitization in the early 1990's. All of the benefits outlined earlier in this report apply to Lessors and this financing option is currently used by captive equipment finance companies as well as independent leasing companies.

Lease companies grow by financing more and more leases. The need for continuous funding is always an acute problem as corporate balance sheets get stretched and conventional funders press for reduced leverage. Traditional sources of financing usually place restrictions on the amount of funds available as well as the leverage that a Lessor may apply to its balance sheet. The result is often a slowdown of a Lessor's growth and missed expansion opportunities.

Securitization deals effectively with both these issues. Lessors have found that securitization provides an alternate source of funds but does not create a negative impact on their balance sheet. By moving the assets off balance sheet, the Lessor improves its leverage ratios as well as its return on equity, as income from the securitized assets is recorded on the income statement.

Of equal importance is the availability of an alternate source of funding. This flexibility allows Lessors to take advantage of market conditions to lower funding costs. It also provides a degree of independence from their traditional sources of funding.

Securitization of lease receivables is usually accomplished by using one of the structures outlined in the following section.

Securitization Structures

Most lease securitizations in Canada use one of two basic structures; the Concurrent Lease and the Sale/Sale Leaseback. The mechanics of each structure are slightly different, but both structures allow a Lessor to reach its goal of securitizing assets.

The concurrent lease structure was first used by IBM and relies on real estate law concepts to provide the SPE, as a sublessor, with the ability to enforce the Lessor's contractual rights of payment against the underlying lessees. Accordingly, the lease contracts are not actually sold to the SPE, as is the case in a sale/sale/leaseback. However, the economic effect of this structure is identical to the sale/sale leaseback.

The sale/sale/leaseback was first used in 1990 and as the name suggests, there are a number of sales prior to the leaseback that results in the SPE having the legal right to enforce payment under sold lease contracts. Once the sale/sale/leaseback is completed, the SPE prepays the rental stream from the leases to the Lessor and collects the lease payments from lessees in the normal course.

With respect to the CSBFA guarantee, both structures sell the lease payment stream to the SPE and, one would conclude, the rights to any claims under the CSBFA guarantee. Once again, the role of the SPE as owner or assignee must be reviewed by legal counsel.

Profile of typical Leasing Company Users of Securitization

Many Lessors have discovered the benefits of securitization. However, the cost of securitization has made it available predominately to larger Lessors.

Historically, securitization has been reserved for larger Lessors for a number of reasons. Firstly, it is expensive to create a program. Second, the initial and ongoing information

and reporting requirements are such that a Lessor needs to have excellent information and financial reporting systems. These requirements are driven by the Rating Agency as the information gathered is used when reviewing assets for inclusion in a SPE. The result is that only larger, sophisticated Lessors normally have the required infrastructure to enter into a securitization arrangement.

Access to capital markets through the issuance of either commercial paper or term notes provides a level of comfort to Lessors who may be heavily reliant on their bank for loans. Often, Lessors are pressured to reduce their leverage by their traditional lenders. Securitization allows this to occur.

Traditionally, large captive finance companies such as Case Credit, John Deere, Navistar, Caterpillar have been large issuers of ABS. Many equipment finance programs are financed through Newcourt Credit, which is a large issuer of ABS. In 1999, it issued over US\$1.8 billion of asset back securities in order to fund itself.

In the automotive industry, all three major captive finance companies, as well as smaller manufacturers like Honda Canada, use securitization as a funding strategy.

In summary, a Lessor who uses securitization is typically a large, established corporation that has a solid infrastructure in place to support the reporting requirements. Smaller Lessors are starting to enter the securitization market but these Lessors face more stringent Rating Agency conditions and often need to upgrade their information systems before beginning a securitization program. The provision of a CSBFA guarantee may be sufficient to allow a lease to be eligible for a securitization program. However, the Lessor may not be in a position to securitize for the reasons mentioned above.

Outlook for Future

The outlook for securitization in the Canadian leasing industry is extremely positive. Securitization structures are becoming standardized and the resultant cost reduction is making this method of financing more appealing to smaller Lessors.

The opportunity to secure an alternate funding source is driving some Lessors to address the internal issues required to be in place in order to embark on a securitization program. The result is that some of the modest sized players are now in a position to securitize their assets.

Proposed changes in the financial industry may force banks to reconsider what lines of business they wish to pursue. Capital is being redeployed to the most profitable lines of



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business. This has placed pressure on the leasing business as it requires increased financing in order to grow. Securitization relieves some of this pressure and reduces a Lessor's leverage as well.

Impact of Securitization on the Canadian Small Business Financing Act

The initial section of this report dealt with the securitization market in Canada and its current use by the leasing industry. Industry Canada has requested ASF to review the current CSBFA with a view to recommending potential changes to the Act's regulations in light of the capital lease project and its use by Lessors to securitize their assets. In order to achieve this goal, ASF reviewed the CSBF Act as well as the CMHC guidelines with respect to the securitization of their assets. The following section outlines the results of ASF's review.

CSBFA definition of Lender

The Canada Small Business Financing Act contains a definition of lender that is specific to the provision of a loan product. In general terms, this definition defines a lender as a member of the Canadian Payments Association, including credit unions and co-ops, or any other organization designated by the Minister as a lender for the purposes of the Act. These lenders are typically the chartered banks, trust companies and credit unions. Some asset-based lenders have also been approved although they are not members of the Canadian Payments Association.

Leasing companies are not members of the Canadian Payments Association and were never contemplated to fall under this definition. Needless to say, the regulations will need to create a definition of Lessor should the decision be made to proceed with the application of lease guarantees under the CSBFA to capital leases.

Impact of securitization on the definition of Lender

As noted above, the definition of Lender contained in the existing Act will need to be amended to include a definition of an eligible Lessor for purposes of extending the CSBFA guarantee to capital leases. In addition, the definition of Lessor must be broad enough to either include Special Purpose Entities as an eligible Lessor, or else to allow Lessors to assign their interests to an SPE when securitizing. This distinction should be reviewed with legal counsel experienced in securitization transactions.

Securitization entails the sale of eligible leases by a Lessor to a Special Purpose Entity who then becomes the owner of the leases; with all the rights previously held by the originating Lessor. Consequently, any attempt to define “Lessor” in the CSBFA must address the role of the Special Purpose Entity.

The leasing industry is unregulated and caution must be exercised when defining what type of Lessor should have the ability to offer the proposed guarantees. In broad terms, an eligible Lessor would be a leasing company originating leases in Canada and meeting eligibility requirements, which will be created by stakeholder consultation as noted later in this report. This definition may include SPE’s depending on consultation with legal counsel. Back up Servicers would not qualify as they would not be originating leases; only servicing existing portfolios.

Industry Canada Questions & Answers

1. Relationship between Lessor and Government once a lease has been securitized?

Normally, the Lessor acts as servicer of the assets and would report to the government. However securitization structures are complex and this is particularly true with the securitization of leases. Accordingly, these structures need to be reviewed by legal council familiar with the CSBFA in order to determine what changes, if any, may be required to the Act to recognize the involvement of the SPE.

2. Does the Lessor retain administration of the lease contract?

As mentioned previously, the Lessor that sold the lease into a securitization trust would be retained as Servicer and all lessor/lessee contact would be unchanged. Claims would be filed by the Servicer on behalf of the SPE.

3. What are the most common securitization vehicles and how can they be controlled by the government?

The most common securitization vehicle is the charitable trust. These trusts are normally administered by the investment-banking arm of the Canadian Banks. They are bankruptcy remote from the Lessor and cannot carry on any

other business other than holding the collateral and financing its purchase by issuing debt obligations. As such, there does not appear to be any reason why the government would want to exercise control over them.

4. Who monitors leasing companies and their credit policies since they are unregulated? Is it their traditional lending sources?

Lending institutions, such as banks, do reviews on all their clients in the normal course and this industry is no exception. The loan covenants of most lending agreements are designed to identify companies who have not done a good job of managing their credit and collection policies. A breach of these covenants normally allows the bank to take appropriate action to protect their funds. The checks and balances imposed on leasing companies, e.g. maximum debt/equity ratios, are designed to identify and address leasing companies who are not operating in a prudent manner.

5. What are some of the sources of fraud? Should the government exclude specific companies? Types of Equipment? Or restrict the program to new equipment only? Or to Vendor-Lessor?

The leasing association may be in a better position than ASF to answer these questions. Securitization deals with larger Lessors who have leases that meet certain eligibility requirements, including type of equipment. Consequently, the exposure to fraud is significantly reduced. Most programs allow a small percentage of used equipment to be securitized.

On a general note, fraud would seem likely to occur with a lessee who manipulates his application to obtain the equipment. One would expect the Lessor's credit department to catch most of these cases.

Fraud could also occur at the Lessor level. Accordingly, the definition of Lessor for inclusion as a lender under the CSBFA should go a long way to establishing eligibility requirements which shut out most fraudulent Lessors.



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6. Cost of funding in leasing industry?

We do not have first hand knowledge of the industry's cost of funds as it dependant on many factors, such as the source of funds, strength of the Lessor's balance sheet and term of the desired funding.

We can tell you that securitization would allow a Lessor who wished to fund their assets with 30 day Commercial Paper ("CP") to pay a rate of approximately 5.35% to obtain these funds as at March 29, 2000. Many smaller Lessors borrow on a "Prime +" basis from their banks and the prime rate is currently 7%. Accordingly, these Lessors would be looking at a savings of at least 1.65% per annum on their borrowings (Prime 7% - asset backed CP at 5.35%).

Using anecdotal information, we are told that Lessors are writing leases in the 10% to 22% range depending on the size of the lessee, asset class and other considerations. Car leases are currently being written around 11% while some captive finance companies are charging in excess of 20% on some their leases.

We will be most willing to answer any other questions that you may have.

Recommend amendments to the current program to account for the use of securitization as a financing tool.

The following amendments are recommended to change the current program to account for the use of securitization.

- ASF believes that Industry Canada will be able to structure the CSBFA to accommodate securitization of capital leases by the implementation of new regulations under the Act.
- Definition of Lender must be amended to include approved Lessor, as well as addressing the role of the SPE.

- Industry Canada may wish to use a process similar to that used by the CMHC to approve NHA Issuers. The CMHC reviews an applicant's historical track record, reasonable bad debt loss ratio, audited financial statements and other information to determine if they are eligible to become a NHA Issuer. The difficulty with the use of the CMHC model as a standard is the fact that the NHA Issuers are all large, financially healthy, corporations, whereas, Lessors run the full gamut of financial responsibility. Larger Lessors may be in a position to easily satisfy the requirements, but this may prove more difficult for smaller Lessors. Consequently, the qualification requirements for Lessors will need to address smaller Lessors who are credit worthy and have a good track record.
- The regulations require a separate section addressing capital lease issues. There are a number of differences between loans and leases and these should be clearly addressed. These issues include the creation of eligibility requirements for a lessee, amount of guarantee, allowable interest rate charged, type of equipment acceptable under the CSBFA guarantee, to name a few. These items are part of product design and ASF would be pleased to assist in harmonizing the design to securitization specifics.
- Industry Canada may wish to involve stakeholders throughout the process of developing the program's parameters. Stakeholders should include Canada's two Rating Agencies, DBRS and CBRS, as well as at least one Investment Bank. Rating Agencies will decide the eligibility requirements for the inclusion of CSBFA guaranteed leases in a securitization pool. As such, it may be helpful to review the Rating Agencies' existing eligibility requirements when addressing that subject within the context of the CSBFA.

The Rating Agencies will also be helpful in finalizing the design of the proposed structure, as they will want to understand the mechanics of the program. They may wish to review the guarantee forms and claims procedures, in order to determine to what degree the SPE can rely on the existence of the guarantee for payment. Notification issues specific to the CSBFA program will also be incorporated into the Rating Agencies' eligibility criteria.

In addition, the proposed program would benefit from a review by the investment banking community as a cross check of the program's parameters. The Investment Bank must obtain internal credit approval when dealing with a Lessor that is entering into a securitization program. Consequently, it may be prudent to review the program with an Investment Bank to ensure it meets their lending criteria as well.

ASF is prepared to assist Industry Canada in this consultative process as we are in constant contact with these stakeholders on several ongoing securitization programs.

SUMMARY AND OBSERVATIONS

The concept of extending the CSBFA guarantee to capital leases is attractive and levels the playing field with respect to other forms of financing. However, the progression from concept to implementation is not without certain challenges.

- Industry Canada has identified several program design challenges that need to be resolved in order to finalize the framework of the program. Many of these design challenges will impact on the use of securitization as a financing tool. These issues include the definition of eligible Lessor, the level of financing to be provided under the lease, the level of guarantee required, the maximum allowable interest rate, the fee structure and who will be responsible for paying it. Consequently, the impact of securitization on the CSBFA will not be known until the design challenges are resolved.
- Resolution of many of these design challenges may be aided by the involvement of leasing securitization expertise, as it would bring another discipline to the decision making process with respect to operational and mechanical program issues. In addition, the Rating Agency process is complex and requires an understanding of securitization. Lastly, use of this expertise would align securitization concepts with the program from the outset that would allow Lessors to securitize CSBFA guaranteed leases with a minimal amount of additional work.
- There are a number of issues that will need to be reviewed with the Rating Agencies in order to allow CSBFA guaranteed leases to be securitized. These include the “Limitation of liability in respect of each lender” and “Program liability ceiling” sections of the Act, as well as the fact that the guarantee is a loss sharing agreement. The Rating Agency normally requires a presentation of the information with accompanying explanations in order to do its analysis. This should be undertaken as soon as the design challenges have been resolved. Rating Agency approval of CSBFA guaranteed leases is required to allow the lease to be included in a securitization pool.



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- The Rating Agency's approach to the CSBFA Guarantee may reduce the amount of external credit enhancement required to support a securitization program. This would depend on several factors including the strength of the guarantee and the composition of the portfolio (amount of guaranteed vs. non guaranteed leases in the pool).
- The CSBFA guarantee should increase access to lease products by companies that are not currently in a position to do so.
- The CSBFA guarantee may not reduce the cost of a lease to the Lessee, however, it should reduce the Lessor's cost of borrowing to finance the lease.
- The Pilot project should probably limit the definition of eligible equipment to new equipment until the program has developed a track record. New equipment leases are much easier to securitize.
- The Pilot should also limit the eligible Special Purpose Entities to charitable trusts administered by the Investment Banking Arm of major Canadian Banks and whose programs are rated by a Canadian Rating Agency.
- The leasing industry practices with respect to the taking of security would appear to remain the same if a CSBFA guarantee were to be put in place.
- Maximum term of any lease should be consistent with industry practices, but in no event, should a lease term exceed 10 years.
- Contact with Industry Canada will normally remain with the originating Lessor as either the Lessor, if the lease is not securitized, or the Servicer, on behalf of an SPE under securitization. Should the Lessor be replaced as Servicer for some reason, the backup Servicer would handle all the functions and duties of the original Servicer including contact with Industry Canada.
- Claims under the CSBFA guarantee would be paid to the Lessor, if the lease is not securitized and to the SPE, if the lease is securitized.



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- Industry Canada should consider making the Lessor/Service of a securitization program responsible for the collection and remittance of ongoing fees associated with the guarantee program. This is in keeping with the fact that the SPE does not deal directly with the lessees, however, the SPE will look to the Lessor/Service for confirmation of payment. The Lessor/Service will be dealing with lessees in the normal course and consequently, collection of fees would not appear to be a difficult procedure to implement. The SPE, as well as the Rating Agency, will need to confirm that the guarantee has not fallen off a lease. Should a guarantee fall off a lease the lease will probably be considered ineligible and charged back to the Lessor.
- The CSBFA conceptual program will, with respect to securitization, benefit larger Lessors at the outset, as they are capable of securitizing assets, with or without the CSBFA guarantee.
- Smaller Lessors will benefit from the CSBFA guarantee as it may make more companies eligible to use leasing as a financing tool. These leases may need to be financed through traditional funding channels if the Lessor is not large enough to participate in a securitization program.
- The Canadian Finance and Leasing Association's ("CFLA") proposal of a form of multi seller lease securitization conduit has merit as it may allow smaller Lessors to gain access to securitization as a form of financing in the future.
- The CFLA proposal, however, is a long term initiative that will require substantial time and effort to create the proper structure and align it with CSBFA goals. ASF estimates that it will take 3-8 months to set up a securitization program along the lines proposed by the CFLA. Issues to consider include, who would make the ultimate credit decision on each lease, who would service the portfolio, and how would leases be funded prior to their securitization, among others. The idea has significant merit but must be created in an orderly manner. ASF would be pleased to work on the concept and assist Industry Canada in developing the parameters of such a program.

Aon Structured Finance Services would like to thank Industry Canada for the opportunity to work on this interesting project and is available to provide additional consultations should the need arise.