



Industry Canada

# **CAPITAL LEASING PILOT PROJECT**

**ASSESSING CANADIAN RATING AGENCY  
REQUIREMENTS FOR INCLUSION OF CSBFA  
GUARANTEED LEASES IN SECURITIZATION  
VEHICLES**

**FINAL REPORT  
AUGUST 2000**

*prepared by*

**Aon Structured Finance Services**



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# **CAPITAL LEASING PILOT PROJECT**

**QUESTIONS & ISSUES ARISING FROM RATING AGENCY  
PRESENTATIONS**

**FINAL REPORT**

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## **Results of Rating Agency presentations regarding**

### **“Assessing Canadian Rating Agency Requirements for inclusion of CSBFA Guaranteed Leases in Securitization Vehicles”**

#### **INTRODUCTION**

Industry Canada (“IC”) and Aon Structured Finance Services (“ASF”) made presentations to Dominion Bond Rating Services (“DBRS”) and Canadian Bond Rating Services (“CBRS”) on July 20, 2000 to outline IC’s Capital Lease Pilot Program and to obtain the Rating Agencies’ confirmation that leases guaranteed under the Capital Lease Program will be eligible for inclusion in a securitization transaction. This report outlines the issues and questions that arose from these discussions and suggests appropriate courses of action going forward.

The Rating Agency presentations were considered an integral part of the development of the Capital Lease Program as these Agencies play a large role in securitization transactions. Rating Agencies review all aspects of a securitization transaction including the eligibility of assets for inclusion into the securitization pool. Should the Rating Agencies conclude that leases guaranteed under the Canadian Small Business Financing Act (“CSBFA”) are not eligible for securitization, it may have an impact on the take up of the program by certain lessors, as a traditional source of financing their operations would not be available.

The presentations were a qualified success as the Rating Agencies indicated that some leases could be included in a securitization program under certain conditions. A number of issues were raised and these that must be dealt with before the Rating Agencies will give an unqualified answer to the question. These issues are noted in this report along with suggested courses of action.

The inclusion of some CSBFA guaranteed leases into a transaction at this time may be possible on the same basis as some Small Business Loans Act ("SBLA")/CSBFA loans have been included in current securitization transactions. These loans have been included in some securitized asset pools on the basis that they represent a very small portion of the pool. There was some consensus at the two presentations that this rationale might apply to the inclusion of a small number of CSBFA leases into securitization asset pools. In other words, inclusion of these leases would be on an exception basis, which does not address the basic issues of the program.

It was suggested that should a lessor wish to place a significant amount of CSBFA leases into a securitization asset pool, some structural issues would need to be addressed, i.e. credit enhancement levels. Consequently, a number of program issues must be addressed before a majority of CSBFA leases will be eligible for securitization transactions.

The major issues raised at the Rating Agency presentations as well as ASF's recommended course of action are outlined below.

### **RATING AGENCY ISSUES and COURSES OF ACTION**

The presentations to DBRS and CBRS focused on the proposed Capital Lease Program parameters and restrictions. The goal was to describe the operation of the program and its various restrictions in an effort to explain possible impediments a Special Purpose Entity ("SPE") might face in obtaining payment on defaulted leases. The program is still in its formative stages so some program parameters were not finalized at the date of the presentations.

The presentations uncovered two main issues along with some miscellaneous needs for additional information and/or clarification of some of the parameters once these are finalized. These issues are noted below:

- 1) Lack of historical data as this is a new program
- 2) Possible restrictions on payments to the Special Purpose Entity ("SPE")
  - a) Ineligibility of guarantee
  - b) 90/50/10 rule
- 3) Miscellaneous

The issues are discussed in more detail below.

1) **Lack of Historical Data**

Both Rating Agencies cited the lack of historical data on this program as their first concern. They suggested that without historical data it is impossible to evaluate the performance of these leases.

The Rating Agencies noted that the lessees involved in this program will be young, small companies with little or no financial track record. Many of these companies would not normally qualify for a lease without the CSBFA guarantee. This assumption is valid however the goal of the program is to allow these companies, which have a young but satisfactory credit history, to obtain a lease where it would normally be turned aside based on length of time in business. This is consistent with the goals of the core program, i.e. "incrementality".

IC suggested using some historical information from the existing loan program as a substitute for the lack of historical data on the Capital Lease Program. The Rating Agencies agreed that it would be of some value as the loan program has close to a 30-year track record. Many of the current borrowers mirror the characteristics of projected lessees under the Capital Lease Program. These borrowers would be borrowing funds for new equipment from small or medium sized lenders. It is anticipated that the loss history of these borrowers will have certain similarities with the expected loss experience under the proposed lease program. Consequently, this historical loss experience may be of some assistance to the Rating Agencies as they attempt to project loss experience for the lease program.

The historical loss information would encompass the following:

- Borrowers for new equipment only.
- Dealing with small and medium size lenders, i.e. not the major chartered banks.

***Course of Action***

Industry Canada is in the process of reviewing its information systems to determine if this data is readily available in the requested format. If this is not the case, IC will need to determine what information is available and how this might satisfy the Rating Agency needs. This will probably entail ongoing dialogue with the Rating Agencies to ensure that the available information provided is sufficient to allow some analogies to be drawn to the Capital Lease Program.

2) **Possible Restrictions on Payments to the Special Purpose Entity**

Any limitation on the ability of the SPE to receive payments on assets it owns is of significant concern to the Rating Agencies. Two restrictions were identified during the presentation and additional information is required to provide the Rating Agencies with the comfort that these issues have a very low probability of occurring. This, in turn, will go a long way to ensuring that CSBFA guaranteed leases are allowed into securitization pools.

a) **Ineligibility of Guarantee**

The Rating Agencies wish to see as ironclad a guarantee as possible in order to protect the SPE. They are concerned that the proposed lease guarantee may fall away for some reason leaving a securitized lease with no government guarantee.

The CSBFA guarantee for the core loan program can become invalid for several reasons. These reasons range from non-payment of fees to the loan being made against ineligible assets.

With respect to non-payment of fees, consultations with stakeholders have resulted in the recommendation that all fees be paid up front to eliminate the administrative burden as well as to ensure that the guarantee never falls away for this reason. This should provide a great deal of comfort to the Rating Agencies.

Many of the other reasons why the guarantee may become invalid relate to administrative errors made by lenders that can not be corrected. IC staff is investigating these types of errors to determine how often they occur.

There may be other reasons why the guarantee falls away and these will also need to be investigated in order to demonstrate to the Rating Agencies that the guarantee will not fall away under normal circumstances. This will help to relieve some of the Rating Agencies' uncertainty about the program.

***Course Of Action***

IC officials are reviewing the various reasons why the guarantee becomes invalid in the core program and are attempting to project if these issues will occur under the capital lease program. Where possible, changes will be made to the new program to eliminate the frequency of client induced errors.

Once an analysis of the reasons why loan guarantees become invalid is completed, the results will be reviewed in light of the new Capital Lease program. The results will be made available to the Rating Agencies in an effort to demonstrate the low probability of this event occurring with CSBFA guaranteed leases that have been securitized.

b) **90/50/10 Rule**

IC applies a calculation to each loan program period (five year duration) that serves to cap the government's contingent liability with respect to the loss sharing arrangement with each lender. Under the existing loan program the following ongoing calculation is made to determine the Government's maximum contingent liability with each lender. The calculation sums the total of 90% of the first \$250,000 of loans, 50% of the next \$250,000 of loans and 10% of all loans made thereafter during a given period for each lender to determine the maximum amount of funds the government will pay out to that particular lender. This calculation is called the 90/50/10 rule and the concept will be applied to the leasing program and individual lessor.

The concept did not appear to be a contentious issue for the Rating Agencies, however, both were interested in understanding how this rule worked and what the relevant impact may be on the new program. They are naturally concerned about any issue that may limit a lessor (and by extension a SPE if the lease is securitized) from being paid in the event of a claim.

The rule was explained on a conceptual basis, as the actual limit for the first two segments of the calculation, i.e. 90% and 50% have yet to be finalized. Illustrative numbers used during a stakeholder consultation session held on July 18/00 were strongly resisted by the participants who want the limits to be the same as the core loan program. Consequently, the potential impact on the lease program, irrespective of securitization, will not be known until the calculation limits for these levels are established.

Industry Canada is attempting to balance the needs of the leasing community with the reality of their fiscal constraints. The appropriate limits for these portions of this rule have yet to be finalized and this project may come to a standstill vis a vis securitization until it is resolved.

### ***Course Of Action***

The limits that will be applied to these two levels need to be resolved in order to determine the effect on the program. Once these limits are established, their potential impact on any securitization program should be explained to the Rating Agencies in order to demonstrate what effect, if any, it will have on securitized CSBFA leases.

### 3) **Miscellaneous**

There are a number of program parameters that remain to be finalized and their impact on securitization won't be known until the parameters are set.

One issue raised was how the CSBFA guarantee would be assigned or transferred to the SPE when a guaranteed lease is securitized. In addition, the process for payment of claims to the SPE was also discussed. Greg Nelson at DBRS indicated that he would expect claim payments on CSBFA guaranteed leases sold into the SPE to be made payable to the SPE and not to the Issuer/Servicer.

### ***Course Of Action***

All program parameters must be finalized in order to provide a complete picture to the Rating Agencies. In addition, the various legal issues with respect to the definition of the SPE as an eligible lessor and the procedure for payment of claims must be resolved in order to understand the program's complete implications. Once done, the Rating Agencies should be advised accordingly.

## **SUMMARY**

The presentations to the Rating Agencies accomplished a number of things. First, it allowed IC to explain what the Capital Lease Program is trying to achieve and why they are striving to make the program securitization friendly. Secondly, it served to identify issues with respect to securitization that IC must address in order to allow CSBFA guaranteed leases to be securitized on a large scale. Lastly, it demonstrated to the leasing industry stakeholders that IC is actively pursuing a program that attempts to meet their requirements, including securitization.



The Capital Lease Pilot Program is in a fluid state with several issues and program parameters in need of resolution. The consultative process over the last few weeks, including the Rating Agency presentations, has gone a long way to firming up these parameters and confirming that there is interest in this new product. The ability of lessors to securitize a significant number of these leases at any one time is still not confirmed. The Rating Agency presentations raised valid questions about the program and these are in the process of being addressed.

The primary issue, which arose from these consultations, is the fact that there is no historical information available on the new program, thereby making analysis of data impossible. The provision of anecdotal information from the loan program is useful but it isn't an ideal comparison. The fact that some leases will be securitizable is encouraging but the number of leases available in any one program will not increase materially until positive historical data becomes available. The question then becomes, how many CSBFA guaranteed leases will be allowed into any one securitization program at this time? Lessors will probably determine the answer to this question through negotiations with the Rating Agencies. This process may affect the securitization structure as terms and conditions may be altered, i.e. the level of credit enhancement.

Other issues identified at the presentations include restrictions on the eligibility of the guarantee that may cause a guarantee to become invalid and the potential affect of the 90/50/10 rule on payments to lessors and the SPE. IC is reviewing both issues to determine what changes or improvements can be made to the program to reduce or eliminate any Rating Agency concerns.

Once the program's parameters have been finalized and the Rating Agency issues addressed internally, the finalized program as well as the answers to the Rating Agency questions should be forwarded to them. The actual process will probably require ongoing dialogue with the Rating Agencies in order to ensure that their information requirements have been met and questions answered. The objective is to provide as much information as possible to pave the way for CSBFA leases to be included in securitization transactions on a larger scale.

The real test of the program with respect to securitization will most likely occur when a lessor puts forward a new pool of leases to be securitized that includes a significant number of CSBFA guaranteed leases. This should trigger negotiations between the lessor and Rating Agencies on several issues and serve to develop a framework for securitizing these types of leases on an ongoing basis. Issues will include the level of credit enhancement required as well as the number of CSBFA guaranteed leases allowed to be placed in any one securitized pool.

The Capital Lease Program is receiving a great deal of attention as evidenced by the attendance of representatives of CIBC World Markets and TD Securities at the Canadian Finance and Lease Association stakeholder consultations. There appears to be a real willingness to work towards a solution that will make the program acceptable to all leasing companies. Some interesting proposals were put forward at that consultative meeting and IC needs to review the suggestions in light of their political and fiscal realities to determine the optimum course of action. In the interim, the program is taking shape and should serve its intended purpose. The objective of making the program securitization friendly has been met although the degree to which securitization of these leases is possible will not be determined until an actual transaction is placed before the Rating Agencies for review.

## **RECOMMENDATIONS**

Industry Canada has ongoing issues that must be addressed in order to enable as many CSBFA guaranteed leases as possible to be securitized should a lessor wish to do so. ASF suggests that IC adopt the following approach to this process:

- Adapt IC's Information Systems to capture the type of data Rating Agencies will want to review, specifically:
  - annual volumes and losses under the Capital Lease Program portfolio.
  - annual volumes and losses under the core loan program where the asset is new equipment and the lender is a small to medium size lender. Provision of this information will become less relevant as historical information on the lease program becomes available.
- Maintain an ongoing dialogue with the Rating Agencies with respect to the program's annual performance in the following areas:
  - historical data as outlined above.
  - the number of lessor claims which are found to be ineligible and the rationale for their rejection.
  - results of the 90/50/10 rule and the number of lessors, if any, that exceeded their maximum limit and were denied a claims payment as a result.
  - program changes or modifications which may affect a lessor's ability to securitized CSBFA guaranteed leases.
- On an ongoing basis, survey lessors that use securitization to determine their success in increasing the number of CSBFA guaranteed leases included in securitization pools and to determine what changes, if any, should be made to the program.

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