Law and Business Review of the Americas

Volume 8 | Number 1 Article 11

2002

Trends and Developments in the Canadian ABS MArket

Martin Fingerhut

Trends and Developments in the Canadian ABS Market

*Martin Fingerhut**

After experiencing a period of breakneck growth exceeding 50 percent annually, 2001 saw the Canadian asset backed securities (ABS) market pause to catch its breath.[1] Total outstanding asset-backed securities increased by less than 2 percent.[2] As well, for the first time since 1994, outstanding asset-backed commercial paper showed minimal growth over the previous year. After jumping from $41 billion in 1998 to $53 billion in 1999, and then to $60 billion in 2000, Asset-backed commercial paper (ABCP) closed 2001 at about $62 billion.[3] This pattern echoed the experience of new multi-seller commercial paper (CP) conduits[4]—from eleven in 1999, which issued $7 billion that year; and five in 2000, which issued $6.8 billion; three new multi-seller conduits appeared in 2001, with issuance of about $1 billion. This apparent levelling off may be somewhat misleading and temporary; however, because significantly reduced CP issuance by Canadian banks was offset by increased activity in the corporate sector.

One important development in the Canadian ABCP market was the expanded use of extendable commercial paper (ECP) as a liquidity substitute—33 percent of all new ABCP comprised ECP; and outstanding ECP increased by 73 percent to over $1 billion.[5] Dominion Bond Rating Service (DBRS) expects this trend to continue.[6]

Picking up the slack, the term ABS market continued to mature in 2001. Although CP conduits have historically been the engines that drove the Canadian market, last year's growth came primarily from term issuance. About $5 billion in new paper resulted in an 8 percent increase in outstanding term ABS to just over $21 billion. The most significant development in this sector was the increased prominence of public issuance. Every term transaction was issued in the public market, except for a series of notes out of one of the conduits. At the end of 2001, public ABS stood at about $12 billion, up by 42 percent from 2000, and comprising about 52 percent all outstanding term ABS.[7]

Although growth has slowed, there is solid evidence that securitization is increasingly becoming a more important component of the Canadian corporate treasurer's funding strategy. Asset-backed CP now exceeds all non-government short-term debt—including CP and BAs. With the growing propensity of banks to tighten credit, and the prospect of

* Blake, Cassels & Graydon LLP, Toronto, Canada, martin.fingerhut@blakes.com

1. Statistics are courtesy of Dominion Bond Rating Service *at* http://www.dbrs.com (last visited on Aug. 10, 2002).
2. *Id.*
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*

further downgrades, reliance on securitization should increase as borrowers are denied access to Canada's highest rated corporate CP market and move, voluntarily or otherwise, to diversify their funding sources.

Referring to Enron's use of derivatives, U.S. Treasury Secretary Paul O'Neill recently noted: "Our rules and our laws have not kept up with the speed of evolution of ideas."[8] These remarks equally apply to securitization, as shown by the almost constant review and revision of the rules and laws affecting ABS transactions in an attempt to catch up to leading edge securitization practices, and the ever-increasing size of the market. In 2001, for example:

- The Canadian accounting regulatory body adopted a Canadian version of FAS 140, and repealed the restrictive 10 percent limit on seller recourse which had stood since 1989.
- Basle revised its proposals to overhaul the regulatory capital treatment for the securitization activities of financial institutions, proposals that the European Securitization Forum warned may threaten the future of the whole market.
- The Canadian ABS market took comfort from actions of Canadian and U.K. courts and regulatory authorities, which established a number of useful recharacterization principles, and pointed the way to securitize nonassignable agreements.
- And Canadian and U.S. tax authorities began discussing the total elimination of withholding tax on cross-border payments of interest between arm's length parties, which will undoubtedly lead to the securitization of billions of dollars of Canadian consumer and corporate receivables in the U.S. capital markets.[9]

In 1899, the Commissioner of the U.S. Patent Office announced that everything that could be invented had been invented. This proclamation turned out to be as accurate as the notion that all possible asset classes have been securitized. 2001 saw the first Canadian securitization of annuities and fully cancellable water heater rental agreements, as well as the first publicly issued dealer floorplan ABS. Corporate loans, power contracts, stranded costs, municipal tax liens, and even viatical settlements are currently on the Canadian drawing board.

On the true sale/recharacterization front, Canada had more good news in 2001 from the Supreme Court of Canada and various regulatory agencies. In 1999, the Court firmly held in the *Shell* case, that the legal nature of an agreement should not be recharacterized for economic reasons, or because the agreement was structured to minimize taxes.[10] In September 2001, the Supreme Court handed down the *Singleton* case.[11] Like *Shell*, it is a tax case that does not deal with sales or securitizations. But, it will be a very valuable aid when considering whether a properly structured and documented securitization will be found to be a sale or a borrowing.

The basic question in *Singleton*, as in *Shell*, was whether a transaction's economic result should determine its legal characterization. The tax authorities urged the Court

8. *Id.*
9. *Id.*
10. Shell Canada v. Canada, 3 S.C.R. 622 (1999).
11. Singelton v. Canada, 2 S.C.R. 1046 (2001).

to examine the economic realities of the taxpayer's transactions. The Court expressly declined to do so on the basis that:

- Courts are not permitted to ignore the legal and commercial reality of a transaction in an attempt to give effect to its true economic purpose. They should not recharacterize a taxpayer's *bona fide* relationship as a result of the economic realities of the situation.
- Courts should give effect to sophisticated transactions even though they are designed to minimize tax liability.
- Finally, it would be improper to collapse separate, although related, transactions and treat them as one simultaneous transaction. These transactions must be viewed independently, whether or not they take place on the same day.[12]

By analogy, in a securitization context it should be irrelevant that assets are sold to a special purpose vehicle to enable it to borrow funds on the security of the purchased assets. It should similarly be irrelevant that the seller is, in effect, obtaining financing based on the purchaser's cost of funds.

The recent Supreme Court recharacterization decisions are having a salutary effect on our friends at Canada Customs and Revenue Agency (CCRA). A long-standing Interpretation Bulletin had provided that leases could be recharacterized as sales for tax purposes, if their terms created sale-like economic results, such as a bargain purchase option.[13] In cancelling the Bulletin, the CCRA stated that, as a result of the *Shell* case, they will no longer look to the economic realities of a transaction to recharacterize a taxpayer's legal relationship.[14] A lease is a lease, and a sale is a sale.

Additional support for this approach recently came from another government source—the Ontario Ministry of Finance. An equipment lease containing a bargain option price had been treated as a conditional sale, rather than a lease, requiring payment of retail sales tax on the total contract price at the time the agreement was signed, rather than on each periodic payment, as with a "true" lease. The Ministry will now rely on strict legal concepts to distinguish between leases and sales. According to their new policy, a lease will exist where leasing companies, in the normal course of their business, write leases on lease paper in specific lease language, regardless of whether the option payment is nominal.

It's encouraging to see courts and government officials alike, accept the primacy of the legal effect of the relevant documentation. This can only be helpful if, and when, Canadian courts or tax authorities have to determine whether a particular agreement, which is documented as a sale, is really a disguised loan. These issues may be put to the test in the first securitization case to come before the Canadian courts. The BC Tel action will be heard in late 2002. BC Tel's bondholders are complaining that when BC Tel prepaid their bonds with the proceeds of a securitization, it contravened a covenant against using funds borrowed at a lower interest rate. Time will tell whether we have a Canadian LTV on our hands.

---

12. *Id.*
13. CCRA INTERPRETATION BULLETIN *at* http://www.ccra-adrc.gc.ca/menu/EmenuKLA.html (last visited on Aug. 10, 2002).
14. *Id.*

We must keep in mind, that having the courts give effect to the legal, rather than economic, results of a transaction is only half the battle. The other half is getting the agreement right. The operative provisions should be straightforward and consistent, only with an absolute sale. To say, as did an agreement put before an English court, that a particular transfer is being made as security for the seller's obligations, is problematic. A recent Federal Court of Appeal decision from Quebec provided another illustration of an agreement that didn't get it right.[15]

The case held that a purported sale agreement should be treated as an agreement to manage, rather than purchase, a portfolio of receivables.[16] Agreements put forward as sales will stand and fall on the language relied on to express that intention, and it was not surprising that this particular agreement in fact fell:

- The purchase price depended on the amounts collected—if nothing was collected, nothing would be paid by the purchaser. The court found that, without a purchase price, there could be no sale.
- The agreement required the seller to repurchase for $1.00 all receivables remaining uncollected after six months. Retransfer provisions, particularly when they apply to the entire portfolio, can be problematic, as they smack of an equity of redemption, and raise a question as to whether the assets in question were intended to be sold.
- Matters were not at all helped when the seller declared bankruptcy a scant two days after signing the receivables agreement, nor by the fact that it was the seller's secured creditor, rather than the purchaser, who attempted to uphold the sale for the purpose of preserving its rights as a secured party.[17]

This transaction did not pass the smell test.

We are, with increasing frequency, encountering receivables that are expressed to be nonassignable. With the emergence of CLOs, involving loans negotiated without any thought of their eventual securitization, anti-assignment provisions will become even more familiar.

It is clear under Canadian and U.K. case law that, subject to relieving legislation, which does not exist in Ontario or Quebec, an assignee will obtain no rights in an assigned contract which contains a clear nonassignability clause. The transfer of such a contract could not support the necessary true sale opinion. But, it may be possible to securitize these nonassignable contracts nevertheless.

A recent English decision, involving the well-known boxing promoter Don King, may give guidance for a new strategy for securitizing these contracts. In that case, a party to a nonassignable contract declared himself a trustee of the contract for another person.[18] The English Court of Appeal agreed that this effectively transferred the assignor's beneficial rights under the contract to the trust beneficiary without violating the nonassignability clause.[19] There seems no reason in principle why this approach should not work in a securitization context.

15. Banque Royale du Canada v. Canada, 240 N.R. 370 (1991).
16. *Id.*
17. *Id.*
18. Don King Prod. v. Warren, 2 All E.R. 218 (1999).
19. *Id.*

In 1917, Canada introduced a temporary income war tax act. The taxes imposed by this act turned out to be not so temporary.

What does this have to do with securitization? Well, one of the taxes that particularly affects securitization is Canada's 10 to 25 percent withholding tax on interest paid by Canadians to nonresidents. In an era when international cross-border securitization is rapidly growing, this tax creates an economic disincentive for Canadians to securitize their receivables in foreign capital markets—or to attract foreign capital to fund domestic securitizations.

This is not to say that no Canadian receivables are currently being securitized offshore:

- Canadian trade receivables are frequently securitized, without withholding tax, to both U.S. and U.K. securitization vehicles. The receivables are sold at a discount, and the discount is not considered interest.
- Long-term corporate loans, such as commercial mortgages and franchise loans, are also being securitized cross-border free of withholding tax. These transactions take advantage of the common Canadian withholding tax exemption for corporate obligations, which do not require repayment of more than 25 percent of the principal in the first five years.
- Other persons and transactions also escape Canada's withholding tax regime. These include government-guaranteed obligations, foreign entities that are exempt from tax in their home jurisdictions, and nonresident insurance companies that carry on business in Canada.

Nevertheless, there still remains a significant body of Canadian interest-bearing receivables that cannot easily be securitized cross-border. While a domestic securitization of short-term Canadian obligations can be funded with long-term foreign capital, in a way that complies with the 25 percent/five-year rule, the structure is somewhat complex, and may attract an unwelcome capital tax. As well, credit cards, personal lines of credit, car loans, home equity loans, and all other manner of consumer obligations do not fit within the standard withholding tax exemption for long-term corporate debt.

It is not hard to understand the desirability of securitizing Canadian receivables in the U.S. and other foreign capital markets on a withholding tax free basis:

- The less risk adverse nature of U.S. investors is well known. Accessing this market would ease the significant, and growing problem, of placing lower rated or subordinate Canadian ABS.
- Canadian investors are not yet familiar with certain asset classes that have already been securitized in the U.S.—such as CLOs, stranded costs and defaulted receivables. The ultimate success of securitizing less common Canadian receivables may depend on being able to place, at least a portion, of such offerings offshore.
- The massive size of the U.S investor base would relieve anxieties, both about the scarcity of liquidity, and about the ability of the Canadian market to absorb available ABS product.

This withholding tax impediment may soon be history. When the Canada-U.S. tax treaty was recently amended, it was agreed to leave withholding tax on the table for further discussion. It now appears that Canada and the U.S. will completely eliminate withholding tax for arm's-length debt, regardless of term. This was a key recommendation of the recent MacKay Task Force.[20] Canadian officials now acknowledge that the case for elimination is well-understood and logical. I have little doubt that we'll see an end to this obstacle to cross-border securitization some time next year.

Similar action in Australia and Portugal led to the securitization of billions of dollars of residential mortgages in the U.S. capital markets. I think we can expect similar results for Canadian residential mortgages, credit card obligations and other interest-bearing receivables, as well as significant purchases by U.S. investors of subordinate and lower-rated tranches of Canadian deals.

On the legislative front, the last two common law holdouts—the Northwest Territories and Nunavut—have finally adopted the PPSA regime.[21] The laws of eleven Canadian jurisdictions now facilitate a single registration, and a single legal opinion for many cross-country securitization transactions. This was minor victory for efficiency and cost control.

The appearance of a new asset class is always good news. CMBS[22] have taken our market by storm, and introduced a new class of investors to securitization.[23] CLOs[24] will hopefully have the same effect. In addition, a federal government initiative just getting under way, may give rise to another securitizable asset—leases that carry a limited government guarantee.

The Capital Leasing Pilot Project was launched on April 1, 2002.[25] Two key elements of the program will be of particular interest to the securitization community:

- The federal government will guarantee up to 85 percent of the lessor's losses.
- Eligible lessors expressly include Canadian leasing companies that participate in securitization programs approved by a Canadian rating agency.[26]

Over $1 billion of government-guaranteed small business loans were made last year, a portion of which have been securitized. It is likely that, next year at this time, we'll be talking about our experience in the securitizing of small business capital leases.

What can we look forward to in 2002? Volume should at least match 2001, and may increase significantly, as sizeable bank securitizations come up for renewal. Discussions will continue regarding the nature of the rules that should govern bank securitization. We can also expect increased use of the Canadian public market, and perhaps the emergence of Collateralized Debt Obligations to challenge the prominent position currently occupied by CMBS. And cross-border issuance of Canadian ABS into the U.S. market may increase significantly following the elimination of withholding tax, and the resultant availability of a larger and considerably less conservative investor class.

---

20. MacKay Task Force *at* http://finservtaskforce.fin.gc.ca (last visited on Aug. 10, 2002).
21. The term PPSA is commonly used to refer to the Person Property Security Act of one or more of various Canadian provinces or territories. This legislation is modeled on Article 9g the Uniform Commercial Code of the United States.
22. Commercial mortgage backed securities.
23. Commercial Mortgage Backed Securities at http://www.rebuz.com/research (last visited on Aug. 10, 2002).
24. Collateralized loan obligation.
25. Capital Leasing Pilot Project *at* http://strategis.ic.gc.ca/SSG/la01144e.html?what=e (last visited on Aug. 10, 2002).
26. *Id.*