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Asset securitisation in Canada: recent important developments

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The Canadian securitisation market continues to be an important part of the business strategy for a large number of Canadian bank and non-bank financial institutions and a funding source for a diverse class of asset originators. However, in 2007 participants in the asset-backed securities (ABS) market saw that the Canadian market was not immune from the global contraction of liquidity. The Canadian market was affected by global concerns about exposure to US sub-prime residential mortgages, collateralised debt obligations (CDOs) and other structured financial assets. This chapter highlights the current state of the market, salient trends and rating methodology changes, legal treatment of securitisation transactions and important tax and accounting developments.

Volume and asset classes

The Canadian asset securitisation market continued to see the reliance on securitisation as a funding source for consumer obligations, particularly auto-related receivable-based transactions. The year 2007 also saw the first Canadian covered bond issuance by a Canadian bank. It is expected that further issuance by other Canadian banks will continue in 2008 as a platform to address liquidity and capital management. Before the liquidity crunch of August 2007, the Canadian ABS market had experienced continued growth over December 2006 with an increase of C$12.1 billion, or 7.3 per cent in total outstandings, from C$166 billion to C$178.1 billion (all figures based on a report produced by DBRS Limited). By the end of 2007, the total ABS outstanding had fallen to C$164.9 billion. The 2007 decline in outstanding ABS reflects important developments in the Canadian market, which are discussed in turn.

Credit derivatives and CDOs

Whereas growth in ABS outstanding associated with CDO transactions fuelled the Canadian asset-backed commercial paper (ABCP) market in 2006, primarily through the issuance of ABCP by non-bank sponsored independent conduits, in 2007 participants witnessed the abrupt cessation of new ABCP issuance associated with CDO transactions. This was in part a response to announcements by DBRS Limited in early 2007. In Canada, prior to January 2007, in order to receive an R-1(high) rating by DBRS (at that point the principal rating agency for Canadian ABCP) on the ABCP of a conduit in respect of CDO assets, the conduit was required to have a committed liquidity facility available during disruptions in the ABCP market that result in the inability of the conduit to meet its maturing asset-based commercial paper obligations. These market disruption liquidity facilities were previously available to be drawn only where there had been no credit deterioration in the assets of the conduit. In respect of CDO transactions, DBRS announced in January 2007 that a liquidity facility whose availability is restricted to the occurrence and continuance of an ABCP market disruption will be insufficient to attain its highest rating. Through its policy change, DBRS required that as of January 2007 dedicated CDO conduits and CDO transactions be supported by liquidity facilities that are available to meet maturing obligations as long as the reference asset (the relevant CDO or other structured financial asset) retains an investment grade rating and is not otherwise in default. The condition that the inability to meet maturing asset-backed commercial paper obligations be as a result of a general market disruption was no longer permitted by DBRS in the context of CDO transactions. This represented a departure from the previous standard. The pace of CDO activity slowed dramatically following that announcement.

In addition, the majority of CDO transactions in Canada are funded by independent, non-bank sponsored arbitrage conduits. During the period of extreme volatility in the global credit markets in August 2007, many of these trusts found that they were unable to issue notes and ABCP to refinance maturing obligations and the liquidity facilities for these trusts were mostly unavailable in the circumstances. As at July 31 2007, out of the total ABCP volume of approximately C$122.3 billion, CDOs made up approximately 25 per cent to form the single largest asset class and the affected trusts held approximately C$35.1 billion of that total outstanding amount. By contrast, only approximately 5.5 per cent of the assets of the Canadian conduits (other than the affected trusts) are structured financial assets and CDO transactions. The crisis impacting on the affected trusts, which began in earnest in Summer 2007, has removed from the Canadian market the central source of ABCP and other issuance backed by CDO assets.

Pricing pressure and tightening demand from ABS investors

The second important development in 2007 was the apparent increased cost and declining investor demand for both ABCP and public term ABS which began in early 2007 as concerns about US sub-prime mortgages first surfaced. The tightening of liquidity impacted on all ABS issuers and most particularly the affected trusts. The affected trusts, together with affected banks, asset providers and major investors, agreed in principle on August 16 2007 to enter into a restructuring that would see the investors in those trusts exchange their current holdings for term notes matching the amortisation and maturity of the underlying transactions. At the time of writing, the work to implement that agreement in principle (the Montreal Accord) is due to be completed during Spring 2008. The restructuring of the affected trusts intended by the Montreal Accord has had far-reaching implications for the Canadian ABS market. With general consensus that these trusts will never return to carry on any new issuance activities, a significant portion of the ABS market has thus permanently disappeared. This will have longer-term implications for ABS activity and new issuance. At this point, new ABS activity is dominated by those asset originators, such as captive auto finance companies, that rely on asset securitisation as their principal funding platform and that may otherwise be less sensitive to the recent increased cost in funding securitisation, whether through ABCP or the term market. Since September 2007 no new commercial mortgage-backed deals have been completed amid investor concerns about the US sub-prime contagion and related concerns about the credit quality of mortgage assets.

In large part as a response to investor concerns, DBRS announced in September 2007 that market disruption liquidity facilities would no longer be acceptable after December 31 2007 and would be replaced by a new global liquidity standard. Under this new standard, all ABCP issuers (except for those whose assets are running off) would be required to have in place a liquidity facility:

- whose availability is not restricted to a market disruption condition precedent for drawing;
- which is available to meet all principal and accrued interest on maturing ABCP; and
- whose events of default are limited to the conduit's failure to pay obligations or insolvency.

According to DBRS, as of December 31 2007 the global liquidity standard had been adopted by conduits associated with 94 per cent of outstanding non-affected trust ABCP. The adoption of global liquidity and other factors may further sustain the stability of the ABCP of the non-affected trusts. This is evidenced in the fact that, as at the end of 2007 and the beginning of 2008, market participants have seen a return to more normalised spread levels on such conduit ABCP and reduction in inventoried levels of ABCP. This will likely be further sustained by the movement by a number of the bank conduit sponsors to adopt multiple rating agency ratings on the ABCP issued by their conduits.

Accounting developments

In early 2006 the Accounting Standards Board of the Canadian Institute of Chartered Accountants announced the decision to move financial reporting for Canadian publicly accountable enterprises to International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board. The intention is for public companies to move to IFRS for fiscal years beginning on or after January 1 2011. This is a significant shift from the board's previous strategy of harmonising itself with US generally accepted accounting standards. To this end, many new accounting standards issued by the board in the past few years, including Accounting Guideline (AG) 12 – Transfer of Receivables, resulted from standards issued by the Financial Accounting Standards Board in the United States.

Transition to IFRS

IFRS are to a great degree similar to current Canadian generally accepted accounting standards. However, in the context of derecognition of assets, International Accounting Standard (IAS) 39 differs significantly from AG 12. This is because AG 12 is primarily focused on control, while IAS 39 derecognition criteria are primarily based on risk and rewards, and control is a secondary factor. In addition, the concept of a qualifying SPV is non-existent under IAS 39. In summary, it is possible that a number of the existing securitisation structures in Canada and the United States may not qualify for off-balance sheet treatment under IAS 39. However, the International Accounting Standards Board is currently evaluating the derecognition criteria in IAS 39, so it is subject to change.

Amendment(s) to FAS 140

The Financial Accounting Standards Board continues to deliberate on amendments to Financial Accounting Standard 140, including criteria relating to qualifying SPVs and isolation criteria under Paragraph 9(a). At the time of writing, the plan is to issue a revised exposure draft in the second quarter of 2008.

Fair-value measurements

The Financial Accounting Standards Board issued Statement 157, which provides a single definition of 'fair value', along with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. The statement emphasises that fair-value measurement is market-based, not entity-specific, and establishes a fair-value hierarchy in which the highest priority is quoted prices in active markets. Under the statement, fair-value measurements are disclosed according to their level within this hierarchy. While the statement adds no new fair-value measurements, it does change current practice in certain ways.

Many industry participants argue that Financial Accounting Standard 157 is the cause for the decline in the perceived solvency of some financial institutions. The US Securities and Exchange Commission recently sent a letter to certain public companies on this matter (an illustrative letter is available at www.sec.gov/divisions/corpfin/guidance/fairvaluetr0308.htm).

Judicial treatment of legal true sale

In 2003 an Ontario Superior Court considered the characterisation of a securitisation transaction entered into by BC Tel in 1997. The court held that the true sale characterisation would enable the use of securitisation proceeds to redeem bonds without violating the 'no financial advantage' clause found in the relevant trust deeds (such clauses prohibit the bond issuer from buying out high-interest bondholders with funds borrowed at lower rates of interest). The decision is less important for the factual determinations made by the judge than for identifying the indicia of 'true sale'. Seven factors were considered by the trial court in ruling that the subject transaction constituted a true sale rather than a secured financing:

- Intention of the parties – the intention to sell must be clear and unambiguous from the wording of the documentation, and the parties' conduct and communications should be consistent with the sale character of the transaction.
- Risk – there must be a transfer of ownership risk in the securitised assets and, in particular, some risk of non-payment of the underlying receivables must be passed to the purchaser.
- Right to retain surplus – in line with UK jurisprudence, the absence of the right of the purchaser to retain the surplus from the collection of the sale of the securitised assets does not necessarily mean that the transaction is not a true sale.
- Identification of the assets – it should be possible to identify on any given day the securitised assets sold.
- Determination of the purchase price – determination of the asset purchase price on any given day is a fundamental element of a sale transaction.
- Right of redemption – whether the seller has a right of redemption in respect of the securitised assets transferred to the purchaser is the ultimate test to be applied in determining whether a particular transaction constitutes a loan or a true sale. If the seller can require the purchaser to return the assets to the seller upon the payment of a specified or ascertainable amount, this will suggest that the transaction should properly be characterised as a loan.
- Responsibility for collection of accounts receivable – it is not inconsistent with a sale to appoint the seller as a servicer of the securitised assets, for example, to deal with invoices and collect debts.

The *BC Tel* trial decision was appealed to the Ontario Court of Appeal. The court allowed the appeal and overturned the trial decision. However, in overturning the trial decision the appeal court agreed that the sale of assets by BC Tel to the SPV constituted a true sale rather than a borrowing. More importantly, for the most part the court adopted the trial court's reasons and, by implication, the seven factors for determining true sale, and made special note of the fact that BC Tel retained no redemption rights in the receivables it sold. The appeal court held that, because the trust deed denied BC Tel the right to redeem by directly or indirectly applying funds obtained through borrowings, the whole answer could be found only by looking beyond the true sale component and at the securitisation taken as a 'single integrated transaction' –

that is, the matter could not simply be resolved by interpreting the nature of the assignment and transfer of receivables by BC Tel to the SPV, but also by examining the borrowing of money by the SPV through the issuance of commercial paper issued on the security of the transferred assets. Accordingly, in determining whether the transaction in question violated a clause in the trust deeds, it was not sufficient to determine whether the transactions between BC Tel and the SPV under the receivables purchase agreement constituted a true sale as this was, in the appeal court's opinion, only one component of the securitisation transaction. The appeal court held that it was also appropriate in these facts to characterise the financing of the assignment of the subject receivables by the SPV's issuance of commercial paper as an 'indirect' borrowing within the meaning of the trust deed. As a result, although the appeal decision did not interfere with the trial judge's disposition with respect to the legal nature of the receivables purchase agreement, the appeal court held that such characterisation was not dispositive on the issue of whether the application of funds by BC Tel to redeem the bonds was indirectly obtained through borrowings. The reversal of the trial decision can be safely interpreted as not overturning the judicial guidance provided by the trial judge on legal true sale, but rather as founded on an examination of the underlying funding of the receivables transfer as a necessary part of the analysis as to the trust deed prohibition.

Substantive consolidation

In Canada, as in other jurisdictions, participants in a securitisation transaction want to minimise the risk of substantive consolidation. The limited Canadian jurisprudence on the equitable doctrine of substantive consolidation has applied the principles discerned from leading US cases. It is clear from Canadian jurisprudence that a court in a bankruptcy proceeding would consider itself to have inherent jurisdiction to order the substantive consolidation of two or more estates. The emerging test is that a court may order substantive consolidation where, for example, debts and assets of debtors are inextricably intermingled and creditors have not been distinguished from the debtors, but they will only do so if, on balance, the benefits of consolidation outweigh the prejudice to creditors. However, to date there have been no Canadian cases on substantive consolidation in the context of a securitisation transaction. To minimise the risk of substantive consolidation and to enable counsel to express an opinion on this issue, clear disclosure (including financial disclosure) of the sale of assets to creditors of both the seller and the purchaser, and the observance of requisite corporate formalities by both the seller and the purchaser are advisable.

Tax matters

Recent amendments to Canadian tax legislation have also affected the Canadian ABS and CDO markets. Recent tax amendments have;

- eliminated certain foreign property restrictions for deferred income plans;
- specifically allowed most investment grade-rated debt obligations to be qualified investments for certain deferred income plans;
- eliminated federal capital taxes and most provincial capital taxes; and
- most recently, eliminated Canadian non-resident withholding taxes on arm's-length interest payments.

A typical asset securitisation in Canada has involved a Canadian resident seller transferring assets to a Canadian resident trust special purpose entity that issues debt securities in the Canadian market. However, the recent elimination of Canadian non-resident withholding taxes on arm's-length interest payments may allow new alternatives in structuring Canadian asset securitisation transactions.

Prior to January 1 2008, if a non-Canadian securitisation vehicle acquired the assets directly from the Canadian resident seller, that special purpose entity may have been subject to Canadian non-resident withholding taxes on certain payments made by any

Canadian resident obligors (eg, interest or lease payments). In addition, if a Canadian resident special purpose entity issued debt securities outside the Canadian market, the interest on such debt securities may have been subject to Canadian non-resident withholding tax. Prior to January 1 2008 the Canadian federal government imposed a withholding tax (25 per cent, although typically reduced under applicable tax treaties to 10 per cent) on interest paid by a Canadian resident to a non-resident of Canada (with the exception of certain types of debt issued by corporations with a term of more than five years and certain government guaranteed debt). One natural consequence of this was that the securitisation of many asset classes (other than non-interest bearing trade receivables) into the US market was previously uneconomical.

As of January 1 2008 any amounts paid or deemed to be paid by a Canadian resident person to a non-resident of Canada as interest will not be subject to Canadian non-resident withholding taxes if:

- the payer and the payee deal with each other at arm's length for Canadian income tax purposes; and
- no portion of the interest is considered to be of a participating nature (ie, computed by reference to cash flow, profits, revenue, commodity price and dividends).

In addition, a new protocol to the Canada-US income tax treaty was signed on September 21 2007 which, once ratified, will phase in a zero rate of withholding on non-arm's-length interest payments over a three-year period. However, this non-arm's-length exemption will apply only to US qualifying persons under the treaty.

The anticipated effect of these withholding tax changes with respect to the structuring of asset securitisation transactions in Canada is twofold:

- There are now more asset classes that may be transferred by Canadian resident sellers to non-Canadian securitisation vehicles (as non-interest bearing trade receivables were previously the only asset class transferred cross-border); and
- Debt securities issued by Canadian resident special purpose entities may now be offered to non-resident persons without Canadian non-resident withholding taxes.

The use of a trust as the preferred Canadian special purpose entity was motivated in part by capital tax considerations. Asset securitisation had offered an opportunity for a Canadian resident seller that is a corporation to reduce its capital tax liability by selling assets to a trust special purpose entity and using the proceeds to reduce corresponding liabilities. Capital taxes are generally imposed on the capital (equity and debt) of a corporation but such taxes do not apply to trusts. However, with the recent elimination of federal capital taxes and the trend towards the accelerated elimination of the various provincial capital taxes, this historical preference for a trust special purpose entity (as opposed to a corporation) may be reconsidered.

With the recent changes to the Canadian tax legislation described above, certain Canadian tax issues will have to be considered when structuring an ABS or CDO transaction in Canada on a going-forward basis:

- What is the nature of the return on the underlying assets and where do the obligors reside? If interest-bearing obligations of Canadian resident obligors, these assets may now be transferred directly to a non-Canadian special purpose entity. The non-Canadian special purpose entity may then issue debt securities into the Canadian market or elsewhere. If the assets are lease receivables from Canadian resident obligors, the assets will generally have to be transferred to a Canadian resident special purpose entity.
- When assets are transferred by a Canadian resident seller to a non-Canadian special purpose entity, the Canadian resident seller's activities as a servicer may have to be restricted to ensure that

the non-Canadian special purpose entity is not considered to be carrying on business in Canada, or does not have a permanent establishment in Canada, as the case may be.

- When using a Canadian resident special purpose entity, that special purpose entity is a Canadian taxpayer and its assets and liabilities must be structured to ensure that it does not have any material income tax liability (ie, its deductible expenses offset its income).
- If a Canadian resident special purpose entity offers its debt instruments outside Canada, it must be determined whether:
  - the holder is considered to be dealing at arm's length with the special purpose entity; and
  - whether any portion of the interest could be considered to be participating.
- Certain types of debt securities with equity features (where the return is based, all or in part, on the performance of assets held by the special purpose entity) may still bear Canadian non-resident withholding tax.

It remains to be seen how fundamentally these recent tax changes will alter the Canadian ABS and CDO markets.