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POP Goes the Market

With innovations like Prompt Offering Procedures, the Canadian market for asset-backed transactions is among the world's fastest-growing.

By Robert Fisher

The Canadian securitization market has grown dramatically in the past 4 years. In this period, it increased from approximately $12 billion to nearly $76 billion, including both as-set-backed commercial paper (ABCP) and public, asset-backed term debt. One of the principal reasons for this tremendous growth spurt was the entrance of banks into the securitization market. Prior to the mid-1990s, Canadian banks had not been active in securitizing residential mortgages, commercial mortgages or credit-card accounts receivable.

Although much of the growth has involved ABCP, term issuance in the Canadian market has begun to accelerate in the last couple of years. Much of the asset-backed term debt was in the private-placement market until early 1999, when public issuance began to pick up.

There are two main reasons for the accelerated growth in term issuance during the last 18 months. First, liquidity constraints in the ABCP market began to come into play with respect to bank-provided liquidity back-up facilities. Additionally, late in 1998, securities regulators in Canada made a change in their approach to securitized product, which made public issuance of term asset-backed notes much easier. Until that time, the overwhelming majority of asset-backed term debt issued in the Canadian market had been via the private-placement market.

Prior to the change, asset-backed issuers were not permitted to use the Prompt Offering Procedures (POP) system. The POP system allows issuers to take advantage of filing efficiencies and to issue notes using a short-form prospectus rather than a long-form prospectus, which speeds up the entire process. Under the POP system, an issuer files its financial statements and an Annual Information Form (AIF) with securities regulators, then simply references those documents in its prospectus. Because the regulators already have information on record for the issuer, their review of the prospectus takes less time as well. Until the changes in 1998, asset-backed issuers that wanted to use the POP system had to be reporting issuers for a period of one year, filing its initial AIF and financial statements for the one-year period. In 1998, securities regulators allowed asset-backed issuers to use the POP system and waived the one-year reporting requirement. This waiver is currently being provided on an exception basis, but regulators are working on amending the rules so that the change will become permanent. This makes sense for asset-backed issuers: In many cases, they haven't existed for many years, and their activities are so limited that a protracted review period is not really needed.

Another positive change that benefited all issuers, not just asset-backed issuers, was implementation of the Mutual Reliance Review System (MRRS). Under MRRS, an issuer files documents with the securities commission in its home jurisdiction. That commission then distributes documents to all the other provincial securities commissions and aggregates comments from them. This makes the distribution of documents and the receipt of comments much more efficient than in the past.

One of the first issuers to take advantage of the more relaxed environment was HSBC Canada. The bank securitized a pool of residential mortgages in a single-seller trust, PRIDE. Until this time, the most active non-financial institution issuer to take advantage of the new process was Honda Canada Finance (HCF). HCF launched a single-seller asset-backed program in March 1998, called Honda Auto Accounts Receivable Trust (HART). In March, 1999, HART came to market with a public asset-backed issuance of term debt backed by retail auto loans. The structure of this transaction was brand new and very innovative. The purchase of amortizing auto loans by HART was financed by issuance of a combination of fixed-rate, non-amortizing term debt and ABCP. As payments come in each month from the auto loans, all funds are used to pay down the ABCP. When the maturity date of one of the term notes comes up, HART will effectively refinance that debt by issuing new ABCP. In this way, very little or no excess cash is trapped in the trust, which results in a very efficient structure.

Cash flows from the transaction were modeled so that, based on the assumptions of losses and prepayments, there would be minimal or no cash build-up in the trust. In the event that the ABCP is entirely paid off prior to the maturity of a series of the term debt, as a result of higher than expected prepayments, then the cash would accumulate and be used to pay down the maturing term notes. If for some reason the trust could not issue sufficient ABCP to retire the maturing term debt, there is a committed bank liquidity facility that the trust can draw on to retire the term notes.

The ABCP issued by HART is rated "R1 High" by Dominion Bond Rating Service (DBRS) in Canada, and the term notes are rated "AAA" by DBRS and "Aaa" by Moody's Investors Service (Moody's) in the United States. HART used this structure again on a deal that closed in November. It involved the sale of a pool of retail leases. The structure was identical to the earlier transaction except that there is no bank-provided liquidity facility in place for the trust to draw on in the event it cannot issue sufficient ABCP to retire maturing term debt. The ABCP and term note structures received identical ratings from the agencies.

Other issuers have mimicked the HART structure in the private placement market, and expectations are that there will be further issuance in the public market using this structure in the future. The next step in developing the Canadian market and using the more relaxed rules will occur when an asset-backed issuer decides to complete a shelf registration and offer securities off the shelf. This has been done in the U.S. market.

One interesting aspect of the Canadian securitization market, in comparison to the market in the United States, is the relative ease with which securitization of leases, and particularly auto leases, can be completed in Canada. In Canada, there is no need to re-title the vehicles involved in the name of the trust. As a result, there is no need to create the titling trust structures that have developed in the U.S. to deal with this problem.

Another aspect that makes lease securitization easier is the difference between Canada and the U.S. in the concept of an executory contract. In the U.S., a receiver can repudiate executory contracts (an auto lease is an executory contract). If a receiver were to do this, it could repossess vehicles that had been sold in a securitization transaction and sell them to satisfy the debts of the lessor. This is another reason for the creation of U.S. titling trusts, which place the vehicles outside the ownership of the finance company and therefore out of reach of a receiver. In Canada, receivers in bankruptcy cannot repudiate executory contracts in this way, negating the need for the more complex titling trust structure.

Until recently, the Canadian market was far less than one-tenth the size of the U.S. market. The U.S. market is approximately $780 billion (approximately 80 per cent ABCP and 20 per cent public term debt). However, with the entrance of banks into the market and the relaxing of securities regulations in Canada to make the issuance of asset-backed term debt easier, the Canadian market is very quickly approaching the 10:1 ratio. In fact, Canadian asset-backed outstandings could surpass this in the not-too-distant future.

There is a large untapped potential in the Canadian market both for issuers and investors. Given the market's past history of inventiveness, this potential will almost certainly be exploited in the near future. Also, new participants have entered the market, providing securitization financing that will help spur the market forward.

One notable new participant is Coventree Capital Group Inc. in Toronto, which has established Rocket Trust and provides an alternative to the trusts established by the major banks. Coventree provides structuring, accounting, tax, legal, and placement expertise all in one place. At present, Coventree is the largest issuer of extendible ABCP in the Canadian market.

Extendible ABCP allows the trust, in the event of a market disruption, to extend the term of the paper for a specified period, with the combination of the original issuance term and the extension not to exceed 364 days. This allows the trust to dispense with traditional bank-provided liquidity and offers the potential of lower costs to the seller of assets to the trust. Coventree allows companies that may not have the critical transaction size required by major banks to participate in the securitization market. Some companies may also be uncomfortable giving confidential information to their banker, perhaps out of competitive concerns. With an independent firm like Coventree, these concerns are minimized.

In closing, the salient characteristics of the Canadian securitization market are:
• its large size and rapid growth;

- its history of innovative transactions;
- its depth and liquidity, and
- most important, its viability for both issuers and investors.