Intelligence MEMOS

From: David Powell

To: Department of Finance

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Re: **Filling the Gap: Support Still Needed for Canada's Asset-based Finance Sector**

The pandemic-induced economic crisis is both unexpected and unique.

Otherwise financially viable individuals and businesses may be unable to make their lease or loan payments, which poses the threat of cascading defaults and repossessions of equipment by holders of hundreds of millions in loans.

Between 20 and 30 percent of customers are already requesting substantial payment deferrals less than a month into the COVID-19 crisis, according to the best current industry information. And there is every indication that a more significant wave is to come by mid-April and more in early May.

In a recent ***Commentary***, I recommended a federal emergency funding program for Canada's asset-based finance (ABF) sector, based on its importance to the economy. In 2018, the stock of vehicles, machinery and equipment financed by ABF lenders totaled $416.2 billion. That is equivalent to 22 percent of all non-mortgage loans made by the entire private banking sector.

Some regulated ABF lenders, notably the banks and their ABF subsidiaries, have access to Bank of Canada emergency lending facilities. But nothing has been provided to support similar needs for non-bank, unregulated ABF entities.

Of the $416.2 billion in ABF financed assets in 2018, $300.5 billion was in consumer car loans and $115.7 billion in machinery, equipment and commercial vehicles. Of these amounts, the unregulated ABF sector is estimated to have provided 61 percent of consumer auto financing and about 59 percent of machinery, equipment (M&E) and commercial vehicle financing. Banks and their ABF subsidiaries financed the balance.

Ninety percent of new light, medium and heavy-duty vehicles – from automobiles to big rig trucks – are financed. Non-bank ABF entities finance well over half of those vehicles. Customers – businesses and households – that have lost income will need deferrals to hold on to assets financed by the ABF entities.

The immediate question for the ABF industry is how to support short-term (three to six month) deferrals of customer installment payments and other forbearance requests.

All indications today point to the COVID-19 created crisis in the economy being relatively short-term, a matter of months, not years. But that still presents a large immediate and urgent challenge to customers of all size, industry and location. ABF lenders are unable to sustain this scale of payment deferral requests, and are also going to be challenged by the substantial return of manufacturing equipment and vehicles by customers who can't make their next payments. A large-scale return of financed assets will not only deprive the economy of needed machinery and equipment and vehicles, but will depress resale prices by flooding the used marketplace, undermining lenders' financial position even further.

Moreover, much of the private sector funding of the ABF sector has come through securitization and the commercial paper markets. A significant drop in customer revenue will threaten ABF lenders' borrowing covenants.

The Bank of Canada's support for bank programs to defer mortgage, credit card, installment loan and auto loan payments through, for example, the purchase of Canada Mortgage Bonds or the acceptance of mortgages as part of their Standing Term Liquidity Facility, is only a partial answer.

This does not cover unregulated ABF lenders. Support from the federal government for the deferral of loan and lease installments by consumer and business customers to the ABF industry is needed.

Current thinking expects the severe disruption to last three to four months while cash flow problems are likely to last nine to 12 twelve months before things return to normal. How does government get money into the hands of people and businesses to allow them to pay their bills?

The up-and-running US Paycheck Protection Program (PPP) is instructive. It is a federal Small Business Administration loan (up to a maximum of $10 million) that is designed for businesses to keep their workforce employed during the crisis. But recipients may also use up to 25 percent of the loan for non-payroll costs.

Non-payroll costs, rent, mortgage, loans and lease payments, and utilities, are critical for a business to remain viable. If the government expanded its current programs along the US lines, broadening the eligible businesses and allowing 25 per cent of an enhanced funding subsidy to be used for non-payroll business costs, individuals and businesses will continue to be able to pay their bills, keep their machinery and vehicles and be ready for the recovery.

David Powell is the former president and CEO of the Canadian Finance & Leasing Association, and was previously a partner in the Montreal office of a national law firm.

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