



Supporting Stable Financing – Consultations on Leasing

Comments on Finance Canada’s

Consultation Document on Canada’s Leasing Framework

By

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I N D E P E N D E N T • R E A S O N E D • R E L E V A N T

This brief responds to the federal Department of Finance’s request for comments on the consultation document on Canada’s leasing framework: “Supporting Stable Financing – Consultations on Leasing.” The purpose of the consultation is to assess the desirability of changing the legislative and regulatory regime governing leasing activities by federally regulated financial institutions, and “to determine whether broadening the potential suppliers of lease financing will support the availability of financing and, in the medium term, contribute to a competitive and well-functioning financial system.”¹ The Department of Finance Canada requested input from market participants on four specific questions, listed below.

The summary message of this brief is that we believe that the lease financing market should be more open, to all federally regulated financial institutions, to provide benefits to consumers through increased price competition and improved stability of the Canadian financial system.

Task Force on the Future of the Canadian Financial Services Sector

The Task Force on the Future of the Canadian Financial Services Sector was the last exhaustive public review of Canada’s financial services industry. The Task Force, which published its report in September 1998, examined restrictions imposed on federally regulated financial institutions’ powers to enter the retail lease financing market, more specifically (light) motor vehicles.

The Task Force recommended elimination of legal and regulatory restrictions on lease financing, on the basis that:

- Increased competition will be beneficial to consumers.
- Most developed countries, including the US, do not impose limitations on lease financing powers. The Task Force noted that the US market – although dominated by captive financial arms of auto makers – is more competitive, with banks enjoying a respectable share of that market, hence leading to competitive pricing to the benefit of consumers.

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1 “Supporting Stable Financing – Consultations on Leasing .” <http://www.fin.gc.ca/activty/consult/leasing-eng.asp>.

- Concerns with respect to coercive tied selling or abuse of personal information can be mitigated through appropriate legislative safeguards.²
- Given the dominance of non-bank financing companies in the auto retail leasing sector, and the relative ease of exit and entry into that market, it is unlikely that new entrants would be able to sustain anti-competitive pricing behaviour.
- In other segments of the leasing market, specialized financing companies dominate the market showing the difficulties encountered by banks in competing with specialized firms, equipped with specialized skills and having a direct access to the customer base.³

Although the auto leasing market – with the rapid development of securitization as an affordable source of funding for leasing companies and the recent financial turmoil – has evolved since 1998, we believe that the gist of the arguments raised by the Task Force remains valid.

Lessons Learned in Lending and Leasing Markets

The key differences between lending and leasing is that a) when leasing, the lessee typically needs only to finance the difference between the selling price of the vehicle and its end-of-lease residual value, and b) much of the risk associated with an uncertain residual value is retained by the lessor and, under the terms of the lease, this risk is presumably carried at a price paid by the consumer. Borrower default risk is present in both the lending and leasing cases.

Chartered banks in Canada in the past twenty years have tended to maintain on their books \$10-\$15 billion in net new passenger vehicle loans. This lending activity, which generally competes as a source of financing with leases provided by other institutions, had risen to almost \$19 billion by the end of 2004.

On the other hand, vehicle manufacturers' captive finance companies have historically dominated the auto leasing market. The development of large and sophisticated securitization markets in the United States – and to a lesser extent in Canada – enabled these companies to access funding at low rates, savings which in competitive markets would presumably be passed on to consumers. In fact, aggressive vehicle financing conditions became an integral component of manufacturers' pricing model, and the vehicle and its lease financing arguably came to be viewed as a joint product. From 2004 through 2007 the dollar value of leases booked in Canada rose from about \$15 billion to \$19 billion – from \$10 billion as recently as 2001.⁴

The asset-backed commercial paper debacle of August 2007 created a near-standstill of new activity on securitization markets. Perceived risks from so-called toxic mortgages spread to most securitized asset classes, increasing the cost of new securitizations and sharply decreasing the number brought to market. Automakers' perceived market difficulties also harmed the ability of their captive finance arms to obtain bank financing on advantageous terms, and likely contributed to limiting the ability of captive finance companies to obtain funding for their leasing operations from traditional sources at attractive rates.

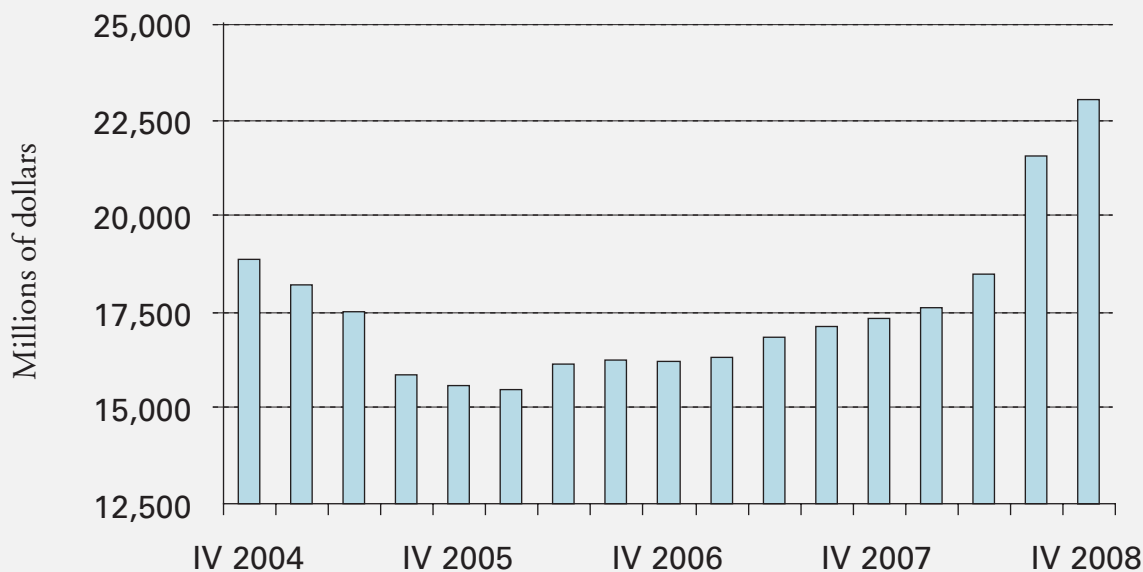
In the period following, during which new vehicle sales were also dropping, the dollar volume of new vehicle leases booked fell precipitously; considerable anecdotal evidence suggests tightened terms and conditions and higher prices for new vehicle leases became commonplace. Contemporaneously, outstanding net new passenger vehicles loans, booked by chartered banks, rose sharply (Figure 1). The implication is that when the supply of new vehicle leases became pinched, many new car buyers turned to bank lending as a source of financing. This raises the question of whether, had banks been permitted to offer vehicle leasing, a significant portion of borrowers might have preferred to take on the distribution of risks and pricing that is available in the leasing model.

2 Note that various safeguards identified by the task force, such as the creation of the Financial Consumer Agency of Canada and banking ombudsmen, are now in place.

3 Task Force on the Future of the Canadian Financial Services Sector. 1998. "Report of the Task Force." Department of Finance Canada; and Task Force on the Future of the Canadian Financial Services Sector. 1998. "Organizational Flexibility for Financial Institutions: A Framework to Enhance Competition." Background Paper #2. Department of Finance Canada.

4 DesRosiers, Dennis. 2009. "Financing the Automotive Consumer (Consumer and Fleet Financing)." Mimeo. DesRosiers Automotive Consultants Inc.: January 15.

Figure 1: Chartered Bank Loans to Purchase Private Passenger Vehicles



Source: Statistics Canada, CANSIM, Table 176-0016: v37755.

Questions and Answers

1. How do you view the role and prospects of lease financing of vehicles in the coming years?

Lease financing grew from less than 15 percent of vehicle sales in 1989 to more than 50 percent in some recent years. One reason leases became so popular is their ability by design to lower monthly payments on new vehicle purchases. Another reason is the very low prices charged by automakers' financing arms.⁵ Unless leasing companies are able to access funding at a lower price than has prevailed since late 2007, either by a revival of securitization markets or better access to traditional sources of funding, lease financing of vehicles will likely remain below the levels recently reached.

2. Are the existing restrictions on regulated financial institutions with regard to lease financing appropriate in the future financing environment? If not, how should these restrictions be amended to support broad access to financing in a stable framework?

Restrictions on regulated financial institutions with regard to lease financing should be waived, as was recommended by the Task Force.

3. If federally regulated financial institutions were allowed to provide lease financing, would you expect these entities to participate in leasing? Do you believe such participation would result in a significant increase in the availability of lease financing?

Specialized finance companies and captive arms of manufacturers have ready access to customers at point of sale. To succeed, new entrants would likely have to bring to market significantly better pricing, terms and conditions than are available through auto dealers, or make new business arrangements with auto dealers to provide lease financing at point of sale. Whether these or other outcomes occur, or whether there is no entry at all, will reflect business decisions and is not a public policy question.

⁵ It is of course possible that the attractive leasing terms offered to retail buyers embodied an underestimate of the default risk and residual value risk associated with the leasing receivables.

We should note, however, that because banks have several sources of capital available for financing leases, including term deposits for example, they are in principle able to offer lease financing even if asset-backed securitization markets do not soon return in their past form. The availability of alternative sources of finance (for lessors) and alternative financing channels (for lessees) presumptively would improve the stability and efficiency of the financial marketplace.

4. Does financial leasing of vehicles and personal household property pose risks to financial institutions? If so, how can those risks be managed?

Financial institutions are already involved in other segments of leasing activities and, for example, most developed countries do not impose restrictions on leasing powers. While residual risks have reportedly been rising – certainly residual values recently have been falling⁶ – these are reasonably well understood and therefore can be priced and managed by banks in the same way as by other institutions. Estimating and pricing credit default risk is a normal banking function.

Entering the vehicle leasing market would expose financial institutions to lease servicing costs and risks. Managing these costs and risks is similar to loan servicing – however, financial institutions may wish to create, purchase or enter into joint ventures with specialized lease servicing firms. None of these outcomes poses systemic risk issues nor, in fact, any significant public policy issue.

Conclusion

Accordingly, we believe that the lease financing market should be more open, to all federally regulated financial institutions, to provide benefits to consumers through increased price competition and improved stability of the Canadian financial system.

⁶ DesRosiers, Dennis. 2009. “Residual Values (Residual Value 2009).” Mimeo. DesRosiers Automotive Consultants Inc.: April 29.