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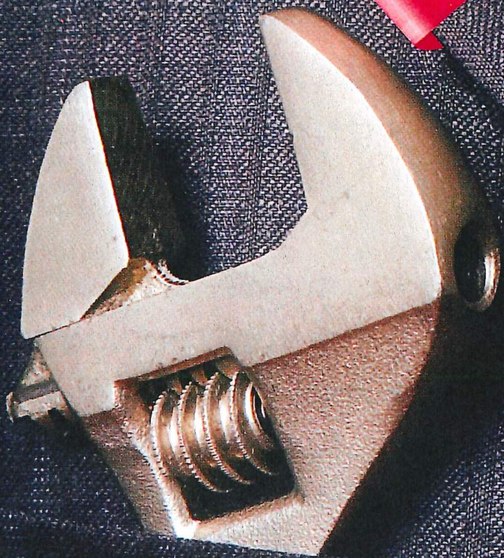
The 12 Secrets of Commercial Credit Scoring

Quickening of Innovation in Asset-Based Financing



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THE QUICKENING OF INNOVATION IN ASSET BASED FINANCING

By David Chaiton

Some would call it evolution: others, revolution. Semantic flourishes aside, financial technologies are increasingly in the foreground as drivers of product differentiation and proliferation in the asset-based financing industry.

Not long ago, at least in Canada, businesses looked to a small cadre of national banking institutions, which relied heavily on time-hallowed, deeply enshrined, restrictive credit policies. Their gaze very much fixated on balance sheets, these engines of commerce dwarfed both in number and size by their counterparts internationally occupied a central role in funding the operating cash and capital requirements of established businesses . Hidebound by a tightly titrated funding model but with a modicum of support from specialized trade and mercantile finance companies, businesses, far from swooning from lack of cash nevertheless managed to maintain positive growth during the post-war, baby booming years in which our industrial economy expanded in great leaps and bounds. Plant and equipment tended to be financed under the umbrella of general corporate needs. Thus, and this was certainly true of "smokestack" industries, one or more layers of omnibus financing by way of trust deeds, debentures and similar instruments became the dominant legal framework for the capitalization of mid- and-large-sized enterprises.

In the ensuing years a service economy began to emerge which increasingly focused on the productive value of specific assets within a corporate enterprise, its intellectual property, royalties, and methods for extracting their value through licensing, franchising and technology sharing arrangements. Advances in technology and accelerated trade in intangibles forced the lending industry in turn to innovate, to find new ways to unlock the intrinsic value of personal property security. And that was done. But this re-thinking was restrained by outmoded concepts of law which could not be so readily moulded to accommodate these new ideas about collateral. Soon, with the inestimable help of the academic and legal communities the government responded with a freshly minted construct forged with inspiration against the anvil of economic necessity. Article 9 of the United States Uniform Commercial Code ("UCC"), which codified a unique and brilliant set of ideas and a spawned its own

language to stealthily elude the restrictions of precedent, was born. These revolutionary ideas, which presaged a Brave New World of legal invention found expression under the appellation of "security interests" and comprised an elegantly simple framework for the articulation of rules governing the creation, recognition, priority, registration and enforcement of security interests in personal property.

Secured transactions enhanced our economic growth

The law of "secured transactions" has accomplished more than perhaps any other legal innovation of the past century to spur fresh ideas about financing, and vice versa. This symbiotic relationship, whether real or perceived, inevitable or serendipitous, enhanced our economic growth. It allowed us to slip past the bonds and artifacts of the common law which, in the realm of lending and security, gave primacy to ancient concepts of possession and the *nemo dat* rule (the ancient proposition of law which holds that a person can give to another no higher property rights than he himself enjoys) which provide the legal foundation for the "first come, first served" analysis in the reconciliation of competing claims to ownership of an asset. Commerce, at least to the south of the Canadian border, was energized. Local variations in the rules of the game continued to some extent—persisting even today—however, the entire playing field had been laid open: no longer would the transaction of business be straight-jacketed by arcane, outdated, ill-conceived, moribund and idiosyncratic rules that no longer served the interests of a highly-evolved business matrix with multi-jurisdictional reach and commensurate financing demands.

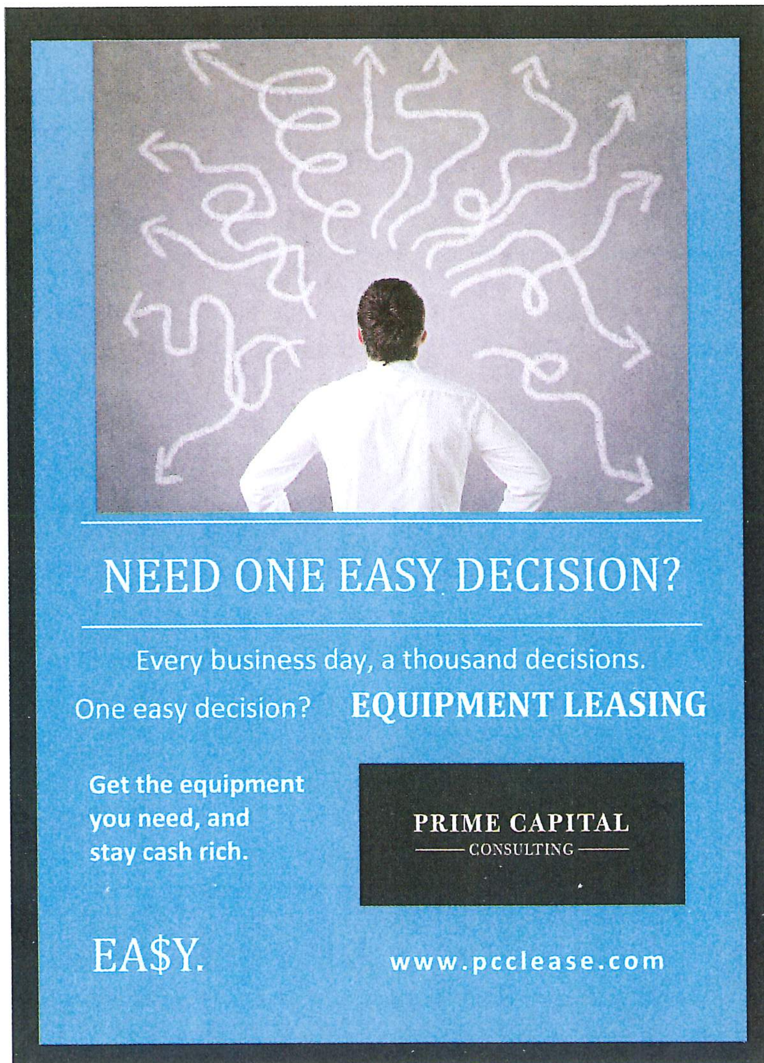
Still, although words like "globalization" were encountered more frequently in business parlance, a fear of foreign domination diminished the free flow of cross-border trade and steadily worsened competition due to extensive, intrusive market regulation. Even though protectionism was the dominant theme of trade policy throughout the entire western world at that time, Canadians suffered disproportionately because of their dependence on trade with the US.

Soon, however, encumbered as we were by these restraints, our reputation as miners, fishermen and hewers of wood began to give way to a secondary economy with complicated needs that demanded much more tangible support from the legal system. This support was to be found in the enactment of the *Personal Property Security Act* ("PPSA") which came into force in the province of Ontario on April 1st, 1976. Founded upon the principles of Article 9, the Ontario Act eventually spawned counterparts in the remaining provinces and territories of the Dominion save for Quebec, which, in time, enacted analogues in its *Civil Code* that emulate some of the PPSA's more prominent features.

Since those early days the inexorable march of globalization has witnessed the evaporation of artificial barriers to cross-border, increasing multi-jurisdictional reach in Canadian businesses and the emergence of a new and vigorous international business class of passport-less companies with a global footprint eager to arbitrage differences in local laws and culture in their tireless search for profit. Canadian banks, no longer in the backwaters, have emerged as global leaders partly in response to this stimulus in trade and in equal measure as a purveyor of world class financial products. Our advanced legal system is viewed with favour internationally, approaching the level of New York (US) and London (GB) as jurisdictions of choice in laws governing consensual international business transactions. The sophistication, predictability and compelling quality of our personal property security laws exert a powerful pheromone in establishing Canada as a major centre of influence in the transaction of commerce.

Strange twist of fate

In a strange twist of fate, innovations in financing techniques coupled with an insatiable appetite for



growth and ROE / ROI combined calamitously to mount in 2007 an unprecedented challenge to the very existence of our most respected financial institutions around the world, sweeping before them a pervasive array of hapless victims like some financial Tsunami of incredible proportions. Some commentators attribute the financial crisis and resulting recession to simple greed; others point to the "system" itself, a tightly wound, enormously levered and potent time bomb, at once intricate and secretive yet plainly well-understood by the participants moving money from one silo to another according to a sublime set of rules governing a financial structure known to the cognoscenti as a "securitization". Ingenious analysts working their computers into a frenzy of statistical models, labouring in isolation far removed from the interpersonal channels and human interactions indigenous to the transaction of commerce, had concatenated an amazing technique for the diffusion of credit risk associated with the payment of distinct financial obligations by involving a multiplicity of obligors, each with a minor share of the total number and amount of obligations, in the lending paradigm.

The resultant structure gained integrity and strength from the demonstrably trifling impact which default in payment by a small number of obligors would have on the overall performance of the group. By lending into the structure, adding a modest amount of "security" (in the form of cross-collateralization, over-collateralization and reserves) and by contractually spreading the risk of non-payment throughout its constituent parts, the statistical probability of payment of the entire amount to become due approached virtual certainty. How simple, captivating and compelling! Garnering immediate and widespread popularity, the securitization business leapt off the drawing board into vigorous practice in no time at all, only to collapse under its own weight when someone in some distant office far-removed from the worries and concerns of financial regulators, economists and market participants, declined to roll over a series of notes that had fallen due. No one was prepared for the resulting confusion, instilling a panic that instilled terror in every part of the financial sector and beyond. The system, which was highly theoretical, required timely, mechanical action from its participants. There was little or no room for deviation, with the eventual result that one default begat another and another until no one was left standing. The crisis was upon us with incredible rapidity, leaving the financial world breathless.

In the short space of time during which securitization gained prominence and popularity, its principles were extended to any asset class that was amenable to its logic, from credit card receivables to music royalties and beyond. For a while, it seemed as though any asset, no matter how unusual or irregular could be subjected to its structured analysis to generate the desired result by manipulating but a few variables. Traditional credit risk assessment was left at the door and it became possible to monetize and liquidate any property or right that generated a measurable cash flow with virtually any periodicity. In the process, we managed to outfox ourselves, to engage in self-delusion on a massive scale and had unwittingly introduced a pervasive and dangerous infection that would soon hold us all to account. This, too, can be traced to legal and financial creativity as a root cause. It underscores the dark side of innovation and stands as a lesson of historical importance in the genesis of modern financing techniques.

Lessons may not have been learned

In recent years considerable effort has been directed to developing ways and means of monetizing cash flow generating assets like water heater rentals, royalties, fixtures, renovations, and other consumer and commercial assets, reminiscent of the surge in asset diversification that brought us to the brink of disaster in 2007. Although we have a heightened understanding of the risks implicit in financing such assets, with current structural requirements that are more conservative than those in preceding years, it is far from clear that these lessons have been learned. There are legal issues embedded in specific asset classes that can raise their head at the most inopportune times, challenging the wisdom that underlies their commoditization. In the case of water heaters, consumer protection policy has been at the forefront of these developments. Cases are moving forward at this very moment because of challenges to prevailing business practices which have been launched by the Competition Bureau. The insolvency of originators has demonstrated that expectations may not be met due to the exercise of the court's powers and discretion in connection with proceedings and stay orders under the provisions of the *Companies Creditors Arrangement Act* (Canada) and the *Bankruptcy and Insolvency Act* (Canada). PPSA issues have arisen in a variety of contexts involving the application of statutory rules dealing with security interests in fixtures and building materials, and these have impacted the monetization of home improvement loans, condominium retrofit financings and other examples of the confluence of real and personal property security regimes. All of these seemingly unique issues arise from time to time but with stunning regularity, reminding us that monetization is not just a formulaic process. Car leases are very different from renovation contracts and HVAC deals. These differences are not trivial. The challenge for those of us involved in the trenches of equipment finance in Canada is to utilize our sophisticated personal property security and insolvency legislation creatively, but with the requisite degree of knowledge, insight and experience to ensure that we do not run afoul of these increasingly technical laws.

Today, the proliferation of new financing techniques and the development of laws to support their use mean both challenges and opportunities for profit. Reading magazines like this one will help you gain a real appreciation of the boundaries.

ABOUT THE AUTHOR:
As a partner at Torkin Manes law firm in Toronto, Chaiton is widely recognized as an expert in equipment financing, leasing, asset-based lending, corporate finance and banking matters, and has been involved in complex bankruptcy and receivership engagements and represents banks, insurance companies, leasing companies and other purveyors of financial services. A director of the Canadian Finance & Leasing Association, David is a member of its legal committee and was recognized for his contribution to the development of the vehicle leasing and equipment finance industry in Canada when he received its member of the year award.