

# SECURITIZATION OF OIL & GAS RECEIVABLES

by  
Albert J. Hudec  
and  
William K. Jenkins

Securitization is a way of restructuring an asset or pool of assets in a manner which allows the asset to be converted into cash through the sale of a securities instrument collateralized by or representing an interest in the asset. The ideal asset for securitization should have a predictable cash flow, be of high quality, have a low level of late payments and credit losses, have diverse obligors, and have substantial principal amortization over its life.

This paper surveys structuring and legal issues associated with the securitization in Canada of financial assets other than government insured mortgages, particularly the securitization of oil and gas company accounts receivable.

## I. INTRODUCTION

### A. Mortgage-Backed Securities

Mortgage-backed securities ("MBSs") were the original asset-backed securities ("ABSs"), having been available in the United States since 1970 when the first government agency

programs were established. Since their inception in Canada in 1984, there have been numerous successful issuances of fixed-income MBSs secured by pools of National Housing Act insured residential mortgages. Since the market was set up by Canada Mortgage and Housing Corporation through establishment of the NHA Mortgage-Backed Securities Program in 1986, Canadian investors have absorbed nearly \$3 billion worth of MBSs. In addition, CIBC Mortgage Corporation, among others, has done a number of private issues.

More recently, there have been at least two successful offerings of MBSs secured by conventional uninsured mortgages. The first was a recent \$120 million offering, by way of offering circular dated October 6, 1988, by Royal Trustco Mortgage Finance Limited. A second example is the offering in October, 1989, by Central Guaranty Trust Co. of \$70 million MBS trust certificates to Canadian institutional investors which was structured by Wood Gundy.

#### **B. Asset-Backed Securities**

In the United States, a substantial market has developed for the securitization of financial assets other than mortgages including, in particular, the creation of asset-backed securities

secured by leases, credit card receivables and car loans. The public ABS market in the U.S. has grown to more than \$40 billion in the past 4 years and Standard & Poor's has predicted that the market could reach \$100 billion within 5 years.

To date, securitization has not developed as fast in Canada as in the United States. This may be because Canadian bankers have traditionally been more imaginative asset-backed lenders than U.S. banks, or it may simply be that financial market innovation and disintermediation is not as advanced in Canada as it is in the United States.

Many commentators believe it is only a matter of time before a more active ABS market emerges in Canada. The private Canadian ABS market has already been active for some time. Wood Gundy, for example, has placed \$300 million worth of ABSs during the past two years. Aircraft leases, trade receivables and commercial loans have been securitized in Canada. In particular, Nova Corporation has recently made at least one private placement of ABSs secured by its receivables. In another innovative transaction, Financial Trustco Limited issued securities representing undivided interests in a portfolio of "junk bonds."

We understand that the first public ABS deal may be announced in Canada within the next few months, assuming legal, accounting, tax and regulatory hurdles can be satisfactorily resolved. In addition, there appears to be a very significant potential Canadian market for ABS private placements.

C. Comparison of MBS and ABS Offerings

In comparison to an MBS, an ABS offering is more attractive because of the absence of substantial pre-payment risk, but less attractive to the extent that the underlying security is not real property. Arguably, also, an ABS offering is more complex since offering structures and terms have not been standardized and since various special legislative provisions applicable to an MBS offering are unavailable (eg. the securities prospectus exemption and a legal-for-life pigeon-hole for issues of government guaranteed evidences of indebtedness).

D. The Attractiveness of Receivables Securitizations

The business reasons for securitization include improved liquidity, regulatory requirements, optimized borrowing costs, reduced exposure to interest rate changes and removal of assets and associated funding from a corporation's balance sheet.

Receivables securitization permits corporations to liquify their receivables, freeing up funds to retire higher cost debt or to be redeployed for other purposes. Pricing is at a premium to benchmark Treasury securities and the issuer's effective all-in financing cost is typically competitive with the issuer's own commercial paper rates, particularly when the cost of equity required to underpin debt financing is taken into account.

Because asset-backed securities derive their credit quality from the quality of the underlying receivables and from the credit enhancement supporting the securities, rather than from the creditworthiness of the issuer, they provide enhanced access to capital markets for the issuer.

## II. BASIC STRUCTURE

### A. Introduction

Two basic structures are commonly used to structure asset-backed securitizations: (i) the "pass-through" method which involves the purchase by the ultimate investors of participation certificates representing fractional undivided beneficial ownership interests in a pool of receivables and (ii) the sale of receivables by an owner of receivables (the

"Originator") to a corporation, trust or other special purpose entity (the "Vehicle") which in turn issues debt securities or preferred shares collaterally secured by the sold receivables. Less frequently, an Originator may issue debentures or notes directly, with the instruments being secured by a charge over the assets being securitized.

**B. The Pass-Through Structure**

In the pass-through structure, an undivided interest in the underlying assets is sold by the Originator to ultimate investors directly or through underwriters. The form of the investment is typically represented by a participation certificate.

**C. The Collateralized Debt Approach**

In the collateralized debt approach, the Originator transfers a pool of identified eligible receivables to a corporation, trust or other special purpose entity established for the sole purpose of purchasing receivables and issuing securities (the "Vehicle"). Generally, the Vehicle will not be a subsidiary of the Originator, as this would likely negate the "off-balance sheet" objective discussed below.

In turn, the Vehicle will issue high grade collateralized debt securities which will be secured by the receivables purchased. Alternatively, preferred shares may be issued in some circumstances.

Commonly, the Vehicle will purchase receivables from a number of different Originators. Doing so allows the Originator to achieve the minimum size of offering necessary for investor liquidity and at the same time to achieve risk diversification through the holding of the receivables of a variety of sellers.

### III. THE VEHICLE

Generally, receivables to be securitized are sold to a special purpose corporation or trust. For example, in the case of Securitized Mortgage Trust No. 1, offered by CIBC Mortgage Corporation, the vehicle employed was a trust organized under the laws of Ontario, settled with a limited amount of capital, and with beneficiaries to be designated by the trustee from among a group of charities.

Although the Bank may prefer to have the Vehicle as a subsidiary of the Bank for accounting or business reasons, there are legal impediments to this structure. The Bank Act limits the

types of subsidiaries the Bank may have which carry on business in Canada and any such subsidiary must fit into one of the specific categories contemplated by the Act. There are only two categories potentially applicable: factoring corporations and subsidiaries of securities dealers.

Some functions of the Vehicle in a receivables securitization do encompass aspects of the traditional business of a credit factor. Certainly the purchase of accounts receivable is among the things a factor would normally do. However, most definitions of factoring emphasize other services normally provided by factors - such as credit assessment, bookkeeping, collections - that the Vehicle will not be undertaking. Accordingly, it is unlikely that the Vehicle could be characterized as a factoring corporation, although this possibility exists and could be considered further if the Bank wishes to pursue the subsidiary approach.

A second alternative to consider is whether the Vehicle could be established as a subsidiary of an investment dealer, for example, Wood Gundy Inc. Unlike other permitted subsidiaries of the Bank, the rules under the Bank Act governing the types of subsidiaries which a securities dealer subsidiary of a bank may establish are not as developed. The activities of Wood Gundy

Inc. must be limited to trading in securities, but it is arguable that establishing the Vehicle as a subsidiary for the purpose of an asset securitization program would be considered incidental to Wood Gundy's securities business, particularly if it is actively involved in the marketing of ABS securities.

To overcome the gap in the Bank Act, the Office of the Superintendent of Financial Institutions ("OSFI") requires a bank acquiring a securities dealer to enter into an agreement with OSFI which, among other things, limits the activities the securities dealer can undertake. There is no specific provision in the standard agreement or in the accord reached between OSFI and the Ontario Securities Commission regarding their sharing of jurisdiction in this area that would appear to limit Wood Gundy's ability to establish the subsidiary.

If the Bank would prefer that the Vehicle not be its subsidiary (or determines that it is prohibited by the Bank Act from holding more than 10% of the common equity of the Vehicle), there are many structures that could be established under which the Bank could achieve de facto control without holding legal control. For example, convertible debt or preferred shares in the Vehicle could be held by the Bank.

A further alternative would be to constitute the Vehicle as a trust. This approach is commonly taken in the United States and was, as described above, the route chosen by CIBC Mortgage Corporation to structure mortgage-backed securities sold in large denominations in the exempt market (i.e., Securitized Mortgage Trust No. 1).

IV. THE POOL OF ELIGIBLE RECEIVABLES

In the typical deal, the Vehicle will only purchase receivables which meet certain quality-oriented eligibility criteria established by it. Usually, to qualify, the receivable must meet the following standards:

- must originate in the ordinary course of business;
- obligor must not be in default;
- cannot be subject to dispute or offset;
- high quality delinquency and loss experience
- underlying obligors must have good credit history (where receivables are concentrated in a few obligors a credit review may be advisable); and
- must be in all other ways satisfactory to the Vehicle.

Because of its experience in receivables financing, the Bank can be of great assistance in evaluating the credit

worthiness of the Originator's receivables portfolio, collections systems, reporting procedures and internal audit and review systems. Particularly, the Bank may be in a position to estimate variances from scheduled cash flow likely to occur in a stressed environment.

V. RECOURSE AND CREDIT ENHANCEMENTS

Generally, for marketing purposes, it is necessary to provide supplemental credit support for an offering of asset-backed securities. There are three approaches: the Originator can provide some limited form of recourse; or a commercial bank, finance company or insurance company can provide credit support; or a senior/subordinate instrument structure can be utilized.

Examples of the first approach include arrangements for reimbursement by the Originator for losses caused by debtor defaults or delinquencies; substitutions by the Originator of good for bad receivables; over collateralizations (large enough to represent a significant multiple over historic loss experiences); first lost guarantees; recourse to the Originator up to a specified percentage of receivables; reserve accounts and holdback reserves.

Examples of the second approach include bank letters of credit and guarantees from commercial banks, insurance companies or other financial institutions.

The third approach involves use of a senior/subordinated structure whereby tranches of asset-backed securities are issued with varying credit risk. For example, in the recent Central Guaranty offering \$67 million of the \$70 million of MBS certificates carry an AAA rating. The other \$3 million of unrated securities will take the first hit in the event of a default in one of the underlying mortgages.

Frequently, a number of credit enhancement mechanisms are combined. For example, in CIBC Mortgage Corporation Secured Mortgage Trust No. 1: (i) the Vehicle was overcollateralized on the basis of ultimate expected principal repayment (taking into account historical loss performance on the type of mortgage portfolio used); (ii) the Vehicle held back a portion of the purchase price equal to 3 times the maximum arrears ratio experience for the prior 5 years; (iii) the debt securities were separated into tranches with the Class B securities absorbing the reinvestment risk of prepayment; and (iv) CIBC Mortgage Corporation was given an option to purchase specific mortgages from the trust (in contemplation that it might purchase defaulting mortgages to maintain client relationships).

**VI. SERVICING OF ACCOUNTS**

Receivables are customarily sold on a servicing-retained basis, ie. the Originator is appointed as collection agent for the Vehicle, and continues to send invoices, collect payments from obligors and enforce delinquencies. Individual obligors are generally not notified of the transaction.

As servicer of the receivables, the Originator would collect payment on the underlying obligations and remit those payments, net of a servicing fee, to the Vehicle. In the event that an obligor fails to make a required payment, the servicer will also be required to pursue payment.

So long as the rights and duties retained by the Originator are consistent with those which might be undertaken by a third party servicer, this retention of control should not be significantly detrimental to obtaining sale treatment as discussed below.

**VII. REVOLVING FACILITY**

A receivables securitization could be set up on revolving basis with incoming cash from the collection of

receivables reinvested in a new batch of receivables by the Vehicle on a monthly basis at a discount rate reflecting the then current interest rates as established monthly by the investors.

At any time prior to the scheduled receivable purchase date, and subject to appropriate cancellation fees, the Originator may exit from the program by declining to sell additional new receivables to the Vehicle. Where investors are unwilling to purchase all receivables offered by the Originator, an investment dealer may agree to underwrite the deficiency.

**VIII. ONGOING MONITORING OF RECEIVABLES**

To permit the Vehicle to monitor the portfolio's performance, the Originator generally submits monthly reports outlining aggregate collections, overdues, etc. Such information is similar to that routinely generated by the Originator for its own credit management.

**IX. THE PURCHASE OF THE RECEIVABLES**

It is generally important for tax, legal, and accounting purposes that the transfer of the receivables from the Originator to the Vehicle be characterized as a sale rather than as a secured financing.

A. Legal Characterization As A Sale

A critical legal issue in structuring a receivables securitization programme is to ensure that the sale of receivables to the Vehicle is recognized to be a "sale" and to guard against its recharacterization as a secured (or unsecured) financing. The significance of the distinction relates to whether, in event of the insolvency, receivership or bankruptcy of the Originator, the receivables pool will be regarded as part of the estate of the bankrupt.

The fear is that, if the receivables pool is so characterized, the Originator or one of its creditors could endeavor to recharacterize the receivables sale as a secured financing, such that the transferred receivables will remain the property of the Originator, subject to stay proceedings of the Bankruptcy Act or the Companies Creditors Arrangement Act. For example, Section 69(2) of the Bankruptcy Act gives a court power to temporarily stay a secured creditor from realizing or otherwise dealing with its security. The purpose is to give the trustee an opportunity to consider whether anything can be realized from the secured assets over and above that which is due to the secured creditor. Similarly, Section 11 of the Companies Creditors Arrangement Act gives a court broad authority to stay

actions against a debtor. Such stays would impair the timely application of proceeds from the receivables to make payments on the ABSs.

Based on the U.S. experience, if the issuer desires to obtain a credit rating for the asset-backed security higher than that of the Originator, the rating agency will request a "true sale" opinion from a nationally recognized law firm to the effect that the transaction constitutes an absolute disposition sufficient to remove the receivables from the estate of the Originator in event of bankruptcy.

The opinion should also confirm that the distribution of proceeds will not be recharacterized as a preference and confirm that all registrations necessary or desirable to perfect the Vehicle's interest in receivables and proceeds from receivables have been completed. The absence of registration will not affect the validity as between the parties of the transfer of ownership but will entitle any subsequent registered purchaser or pledgee of the receivables to take priority over the interest of the Vehicle in the receivables pool.

Where the Vehicle is a subsidiary of the Originator, the opinion may also confirm that the subsidiary will not be regarded

in law as the mere agent of the Originator and that the transaction will not be regarded as merely a sham.

Various steps can be taken to reduce the likelihood of a recharacterization of the transaction as a financing arrangement. Unfortunately, each of these steps involves administrative and other costs or is otherwise burdensome. A variety of factors may affect the characterization as a "true sale" or as a financing, as follows:

1. Risk Recourse: In law, the principal factor which could lead to a recharacterization of the sale as a pledge is the existence of substantial direct or indirect recourse against the Originator, as purported seller, in the event of non-payment by the underlying obligor. If the deal is structured in reliance on the Originator's credit, the Vehicle is likely to be treated in bankruptcy as a creditor. For example, a guarantee from the Originator would generally negate a true sale. Clean-up calls may be permissible; ie., the repurchase of insignificant amounts of bad receivables.

A conservative approach would be to limit recourse against the Originator to reasonably anticipated default rates based primarily on historic default rates. The transaction

should not be structured such that the Originator remits a fixed amount to the Vehicle each month, regardless of the amount actually collected on the underlying obligations.

2. Control: Permitting free use of the collections of receivables by the Originator, as purported seller, is inconsistent with the notion that the Originator no longer has a proprietary interest in the receivables (eg. permitting use for 30 days prior to remittance).

The Originator should not retain the right, through the servicing agreement, to control payments received from the underlying obligors and to commingle those payments in its own accounts pending their remittance to the Vehicle or otherwise invest them for its benefit rather than identify and segregate them for benefit of the Vehicle. Rather, sold accounts should be flagged as such in the computer records of the Originator. Proceeds should be segregated with a custodian and commingling should be avoided.

3. Repurchase Rights: The Originator should not have the right to repurchase the accounts. Sale treatment is unlikely if the Originator may, at its option, repurchase the receivables at a later date and thereby retain the future economic benefits.

4. Retention of Rights: The Vehicle should not retain the right to unilaterally alter the terms of transfer.

5. Notification of Account Debtors: From a legal point of view, it would be preferable for the Vehicle to notify account debtors of the assignment to protect against subsequent assignee's and secured creditors. Also, the assignment will not be binding on obligors until they receive notice of the assignment. For reasons of practicality, however, notice is typically not given.

6. Payments: The Participant should not be entitled to payments in excess of the purchase price and reasonable servicing compensation.

7. Consistency of Characterization: It is crucial that the legal characterization be consistent with accounting and tax characterizations.

8. Constraints on Vehicle: The business of the Vehicle should be expressly limited and it should not be permitted to incur other indebtedness.

**B. Accounting**

Typically, one of the the Originator's objectives in structuring a receivables securitization will be to account for the transaction as a sale thereby permitting the removal of the receivables and associated liabilities from its balance sheet. This has immediate financial reporting advantages and improves financial performance measures such as returns on assets and coverage and capital ratios.

In the United States, the Financial Accounting Standards Board ("FASB") has greatly enhanced the interest in and volume of asset-backed securitization transactions by stating clearly the range of circumstances in which a securitization transaction qualifies for off-balance sheet treatment.

1. FASB Statement No. 77

FASB Statement of Financial Accounting Standards No. 77, Reporting by Transferors for Transfers of Receivables With Recourse (December 1983) specifies the circumstances under which transactions that purport to be sales of receivables with recourse to the seller may be accounted for as sales, rather than as financings; ie., removal from the balance sheet with gain or

loss recognition. The criteria are not too difficult to meet and are flexible enough to permit sale recognition in a broad variety of circumstances where the Originator retains credit and interest rate risks.

Three conditions must be satisfied in order to obtain sale treatment:

- (i) the Originator must irrevocably transfer the receivables in a transaction that "purports to be a sale or a participation agreement";
- (ii) future payments by the Originator can be contemplated to compensate for credit losses, the effects of prepayments or changes in interest rates so long as the Originator is able to make a reasonable estimation of its obligations under the recourse provisions and such obligations are recorded as at the date of the sale; and
- (iii) the Originator must not have an option or obligation to repurchase non-delinquent receivables, eg., the Vehicle cannot have the

right to "put" the receivables sold to the Originator except pursuant to the recourse provisions.

In short, sale characterization will be denied where the inability to estimate the amount of a contingent recourse obligation results in significant uncertainty as to the amount of risk retained by the Originator. A clean up call is, for example, permissible, if it is keyed to a specific dollar value of receivables but is probably not acceptable if it keyed solely to the passage of time since in the latter circumstance it is not possible to accurately estimate the contingent obligation.

2. FASB Technical Bulletin 85-2

In addition, FASB Technical Bulletin 85-2 Accounting for Collateralized Mortgage Obligations (March, 1985) deals with the circumstances in which a transaction taking the legal form of debt secured by a pool of mortgages can be treated as a sale for accounting purposes. The Bulletin applies, by analogy, to all circumstances where a securitization is structured in the legal form of a debt instrument.

Pursuant to the Bulletin, the following requirements must be satisfied to achieve sale treatment:

1. The Originator must not have a right or obligation to substitute collateral or the right to obtain collateral by calling the obligation;
2. The Originator's expected residual interest in the collateral must be nominal (ie. virtually all cash flows must pass irrevocably to the Vehicle); and
3. The Vehicle can only look to the asset pool or to third party credit enhancements for repayment (ie. the Originator cannot retain even a secondary liability); and
4. Redemption cannot be required prior to maturity.

### 3. Canadian Requirements

Currently, the accounting treatment of asset securitizations is not dealt with in the same detail under Canadian generally accepted accounting principles. The position in the United States, however, will likely provide some guidance for the appropriate accounting decisions in this country.

Currently, sale recognition is dealt with in Section 3400 of the CICA handbook. Generally, for sale recognition, the

seller must have transferred to the buyer the significant risks and rewards of ownership and the seller must not have retained significant risks of ownership such as liability for unsatisfactory performance not covered by normal warranty provisions. Quere whether this would permit the Originator to retain liability for delinquent receivables in excess of historic loss experience? Also, under the existing CICA rule, it is important that the seller not retain any continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership.

We understand that the Emerging Issues Committee of the CICA is currently considering the release of an elaboration on the appropriate treatment of receivables sales. The Committee is hopeful of presenting a policy in this area before Christmas, to be included in 3400 of the CICA Handbook.

X. OTHER LEGAL ISSUES ASPECTS

A. Securities Law Aspects

Generally, one or more of the following exemptions from securities law prospectus requirements should be available in respect of the sale of asset-backed securities:

- (a) a distribution of securities where the purchaser is a bank, a loan corporation or trust company, an insurance company or a purchaser that has been accorded the status of being an "exempt purchaser" by the relevant securities commissions;
- (b) a private placement where the asset-backed security has an aggregate acquisition cost to the purchaser in Ontario of not less than \$150,000 (\$97,000 in Alberta); and
- (c) a distribution of short-term promissory notes or commercial paper, provided that the minimum denomination that may be purchased by an individual is \$50,000.

Generally, the Bank itself would not be able to engage in the primary distribution of the securities (except pursuant to a transaction structured to qualify for the short-term note exemption referred to in (c) above) other than by way of private placement of debt securities of a Bank subsidiary guaranteed by the Bank.

**B. Legal for Life Tests**

If the asset-backed securities are being offered to pension funds, insurance companies or other regulated financial institutions, it is necessary to determine whether the securities are eligible investments for such institutions.

Depending on the particular statute regulating the investing institution, the investment may be legal-for-life where the securities of the entity providing credit enhancement are eligible investments or, in the case of prudent investor statutes, where the ABSs are highly rated. Under some statutes, receivables of obligors whose securities are legal-for-life may also be eligible investments.

Depending on its target market for the debt securities issued by the Vehicle, the Bank might consider segregating those receivables due from corporations with a "legal-for-life" status in a separate pool each month. Such receivables (or securities backed by them) would themselves be eligible investments for financial institutions required to adhere to the traditional "legal-for-life" tests.

**C. Tax Aspects**

The issue of whether a securitization transaction is truly a sale or only a financing is critical to determining the tax impact of the transaction on the parties.

Generally, for tax purposes, a transaction will be regarded as a sale where title to the asset has passed, or if title remains with the seller, all of the incidents of title such as possession, use and risk have passed from the original owner to the other party.

For intangibles such as receivables, the most significant indicia of ownership is risk. If the risk of loss, or the opportunity for gain, accrues to the investor, this points towards a sale characterization. The existence of puts or calls or other arrangements designed to transfer the risk of loss to the seller would point towards the transaction being characterized as a loan.

The manner in which payments are handled may also be an important factor. If sale characterization is desired, the payment stream generated by the receivables should clearly flow

through to the investor and the Originator, as servicing agent, should not be entitled to co-mingle this payment stream with its own funds.

Revenue Canada has in the past issued rulings in respect of securitizations involving sales of accounts receivable by commercial corporations. These rulings confirm that, provided the sales that originally gave rise to the receivables were included in computing the Originator's income for Canadian income tax purposes, and provided the amounts are reasonable in the circumstances, the Originator will be entitled to a deduction in computing its income pursuant to Section 9 of the Income Tax Act (Canada) of the amount of the discount at which such accounts receivable are sold.

Where a special purpose vehicle is used in structuring a securitization, care should be taken to prevent taxable income from arising in the Vehicle. Because the Vehicle will have no other business or assets that can provide shelter for the income, it could become subject to a tax liability which becomes a significant additional cost on the entire arrangement. Specifically, interest expense on the outside indebtedness and administrative fees should be balanced against income from the

underlying asset portfolio. Adding a participating note feature to the structure is one way of keeping the taxable income of the Vehicle relatively flat.

Capital tax and withholding tax issues should also be considered in structuring a receivables securitization. Because of the thin margins available in securitization offerings, capital tax can be significant, but may be avoidable through the use of trusts or an Alberta-incorporated vehicle (since that province currently does not levy a capital tax).

**XI. CONCLUSION**

Because receivables securitizations are both new and intrinsically complex investment vehicles, the Bank should endeavor from the outset to develop structures and contract specifications that are fairly uniform. Such standardization will be of great benefit in facilitating assessment of structures and documentation by investors and rating agencies.