[Twenty-Five years and Counting: We Have Lived in Interesting Times - Monitordaily]

Twenty Five years and Counting

We have lived in interesting times

By: Bill Bosco, Leasing 101

The leasing industry is driven by factors that change frequently. The key forces are accounting rules, tax law, funding availability, interest rates, commercial law, regulations, technology and the economy with its cycles. The industry has always been nimble and creative, adapting to each new challenge while continuing to grow.

When the Monitor started in in its current form the industry had FAS 13 as its accounting rules and the 1986 tax act with MACRS depreciation and ITC eliminated. Regulations were fairly stable but technology was rapidly changing. The economy had just taken a hit with the savings and loan crisis.

Accounting environment – Then and Now

Financial Accounting Standard 13 (now known as ASC Topic 840, soon to be replaced by Topic 842) created a great environment for both lessee and lessor structures. On the lessee side the lease classification rules were clear and well understood. Operating lease treatment was the main lessee objective as that resulted in off balance sheet treatment and straight line lease cost equal to the average rent paid over the lease term. That combination created the best Return on Assets (ROA) result for lessees and that is an important measure for investors.

The present value classification test is the key to achieving operating lease classification and the present value of the rents had to be less than 90% of the asset's cost or fair value. This is easy enough to achieve with assets that hold their values as, if the lessor can assume a residual that is high enough to present value to 10.1% or more of the asset's cost/value, that lease was an operating lease. In the late 1970's some creative minds created the synthetic lease structure for equipment leases of common, easy to replace equipment (like auto and truck fleets) that included a minimum short term with the right to renew or cancel with the lessee guaranteeing a portion of the residual, just enough such that the present value of the guarantee and lease payments is less than 90%. The structure was also applied to TRAC leases in the form of a Split-TRAC with a partial residual guarantee. The structure spread to other equipment types too. The product was then applied on a leveraged basis to real estate leases. The market for synthetic real estate and equipment leases continued to grow as it is low cost off balance sheet financing where the lessee gets to keep the tax benefits. The FASB issued rules targeted at large synthetic leases done with thinly capitalized SPEs as the lessor but the market quickly adopted a structure with the lessor being a "normal" leasing company.

The Enron bankruptcy caused in part by off balance sheet SPEs "sold" by Enron while they guaranteed the equity and debt prompted the Congress to issue the Sarbanes-Oxley act that directed the SEC, in 2005, to look for other off balance sheet transactions and found that operating leases were a large off balance sheet item. The Enron issue was one of failure to account for the SPEs yet the result was a knee

jerk reaction that brought operating leases to the attention of the FASB and IASB. The accounting standards setters had been questioning whether operating leases should be capitalized formally through a studies written by the G4+1 (a group of standard setters) in 1995 and 1999 that offered up the “right of use” approach. The 2005 SEC report gave them the impetus to put a joint lease accounting change project on their agendas. It took 11 years to finish and they split on lessee accounting such that the IASB and FASB issued separate standards. The FASB version is the superior version, in my opinion, as it retains the concept of a two lease model where some leases are financed purchases while operating leases are clearly not from a commercial law perspective. That is an important distinction for lenders and credit rating agencies as operating leases are not debt (the lessor gets its asset back and has no claim for the remaining obligation to pay rent).

As 25 years have passed where we do stand with the new rules which must be implemented by public companies in 2019 and private companies that issue audited statements in 2020? In my opinion we will see little impact as operating leases will be capitalized only to the extent of the present value of the lease payments, the obligation will not be presented a debt on the balance sheet and the lease cost will remain as the straight line average rent. The accounting benefit is partial off balance sheet and that means better ROAs than borrowing to buy. The other reasons for leasing remain unchanged. The favorable outlook is due to the ELFA and other industry participants tracking and actively commenting on the project as it evolved. The initial approach would have been disastrous as the operating leases would have been treated as capital leases are, that is, debt on the balance sheet and a front ended cost pattern.

Tax Environment – Then and Now

Tax rules and tax benefits have been key to the benefits of leasing. The 1986 tax act took away ITC and generally lengthened depreciation lives watering down tax benefits. In addition Treasury note rates have dropped from about 8% 25 years ago to about 2% now further hurting tax lease pricing as tax benefits are based on the time value of money. Economic cycles including the saving and loan crisis, the internet bubble, Enron/WorldCom bankruptcies and the sub-prime mortgage crisis all hit the tax base of potential investors in tax leases leaving cycles of scarcity of lessor with tax capacity. The early news on the FASB lease accounting project was that leveraged leases would be eliminated as a structure with no grandfathering – this basically killed that market. We now know existing leveraged leases will be grandfathered.

Lilos and Silos had a brief heyday with about 400 very large ticket deals done. They were creative and complex structures that took advantage of tax laws to “create” tax benefits in transactions with tax exempt lessees (government or foreign entities not subject to US income tax). The transactions created large fees and lessee present value savings. The IRS cracked down on them claiming they lacked economic substance. Settlements were offered that many lessors accepted but some sued the IRS with virtually all losing.

I must include the TRAC lease which was officially created by Congress in 1983 (the structure had been offered since the 1940s) as the only lease structure that has a first loss lessee residual guarantee yet it is still a true lease. It applies only to licensed over the road vehicles and is the primary structure, usually in a Split TRAC form, to finance autos, trucks and trailers used by businesses in the US. Volumes have continued to grow and it may be the "best" lease product since the lessee gets operating lease treatment and the lessor has negligible residual risk while still taking the tax benefits. I think it was allowed by the IRS to support the vehicle business in the US as it is such a large part of our economy.

One piece of good tax news is that ITC is available for certain alternate energy assets and those assets are leasable. Since current GAAP is silent as to treatment of ITC other than in a leveraged lease, lessors have been leery. "Flowing thru" the ITC as a credit to tax expense distorts the accounting yield on these transactions. Although amortizing the ITC as revenue is the desirable method, and most often used in practice, it always took some talking to the auditors to get them to agree. Fortunately the new accounting rules will allow amortizing the "grossed up" ITC as revenue. This is a major win and can be attributed to the ELFA lobbying and a few (sadly only a few) other lessors who chose to comment.

Securitization

The non-bank lessors like captives, finance companies and independent lessors got a major lift when securitization of lease receivables began in the late 1980s. This created a huge new source of cheap financing. Formerly those companies got their funding from banks, their own equity or issuing bonds, if they could get a credit rating. In 1983 the FASB issued FAS 77 that codified the rules on securitizing/participating out lease receivables so that the securitization was off balance sheet. The rule even allowed the "seller" to give some recourse. One huge benefit was allowing certain Special Purpose Entities called Qualified SPEs to not be consolidated for accounting purposes yet still be consolidated for US income taxes. SPE's are used in structuring securitization. The use of a QSPE allowed lessors to keep the lease tax benefits while funding the lease receivable "off balance sheet". The FASB revised the securitization rules several times eliminating the use of QSPEs among other changes. The current state is some transfers of financial assets/securitizations are still off balance sheet but many are not but the low cost remains a big benefit.

Other Issues

I have seen the results of over regulation several areas. The biggest impact is the increased required regulatory capital. 25 years ago banks carried 4% capital but the various iterations of the Basel rules have upped that to over 10%. It is really hard to get an attractive ROA/ROE for investors with the high capital requirements.

PCs, software, systems and communications advances have enabled the industry to reduce costs, improve productivity and meet customer needs. I am old enough to remember when our lessor lease management system could not handle a floating rate lease. I can also remember using a "home grown" leveraged lease pricing system. I priced an acquisition on a "portable" PC the size old a sewing machine using Lotus 123 and each iteration took 5 minutes to run, giving me time to pour a drink, sit back and relax.

Conclusion

I have been around long enough to see huge changes in the industry – mostly all positive. The Monitor is one of those positive changes. I started in the industry in 1974 reading the news print version of the Monitor. The Monitor magazine publication and online version have matured to be an important source of hard information for the industry. I am honored to be a part of it.

About the Author:

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 40 years' experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group. He can be reached at wbleasing101@aol.com.