LEASE PORTFOLIO
— RECOVERY SERVICES —

How Capital Leases Can Become Higher Risk Transactions

As we approach the upcoming convergence of FASB and IASB lease accounting standards all equipment leases will almost certainly wind up on the balance sheet. Exactly when this will occur is uncertain but leasing companies have been preparing for this change for years. Many lessees view the change as in effect “making all leases capital leases” and while this is not strictly accurate the upcoming change provides an inflection point in which equipment lease risk can be examined and perhaps financial professional awareness of the risk of equipment finance can be raised. This would be a good development since over the last 10 years “capital leases”, viewed by most finance professionals as low risk, rent to own “$1 out” contracts, have increasingly become high risk high cost arrangements. High risk capital leases began to hit the market in earnest after Sarbanes Oxley was put into place and we anticipate they will have a significant impact on the future of equipment leasing.

With the passage of Sarbanes Oxley many US CFO’s decided to stop using off balance sheet financing of any kind if possible. One easy way to achieve that goal was to stop using operating lease structures when leasing equipment. Most CFO’s saw an additional benefit. Since their equipment leases would now be all capital leases, they would also be low risk rent-to-own transactions. CFO’s anticipated no more extension payments on equipment or unexpectedly large buyout costs for equipment which could not be returned to the lessor at end of lease. However, a funny thing happened on the way to the balance sheet.

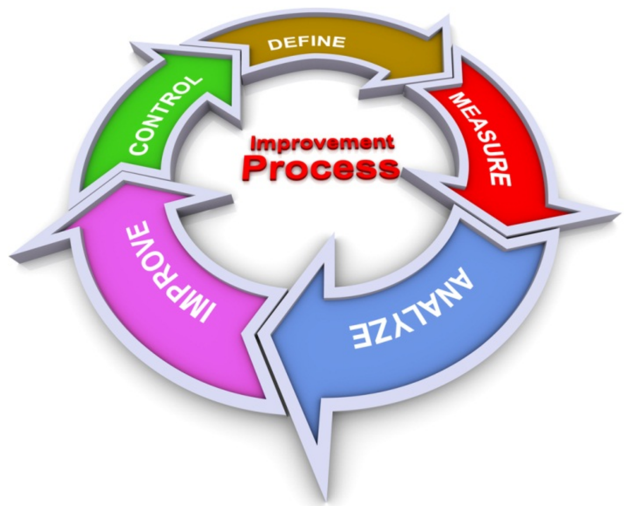
Lessors like extension rents (and other charges beyond regular term rent) a lot. Many leasing companies would see a significant dip in profit without them and also would not be able to price competitively with larger competitors (banks, vendors) on true finance transactions. This move to “capital” leases could have destroyed the business model of many leasing companies, particularly independents. However, lessors have always known that under FASB 13 a capital lease is not defined as a $1 out rent-to-own straight up financing. A capital lease is simply a lease that does NOT meet operating lease criteria. A capital lease breaks any one of the 4 bright line test rules:

- The lease cannot convey ownership at end of lease term
- The lease cannot include a bargain purchase option
- The lease cannot term cannot be for more than 75% of the asset’s economic life
- The lease cannot have rents with a present value that is 89.9% or more of the value of the equipment

To meet the call for more capital leases all lessors needed to do was two simple things:

1 – Have the deal break one of the bright line rules by pricing the financing above 89.9%, or offering the dollar out purchase option and emphasizing that as a part of sales cycle.

2 - Put in a $1 out option with very restrictive requirements making it difficult or impossible to achieve. This allowed all concerned to answer the question “is the a dollar out lease” in the affirmative



These “capital” leases can be structured to have the same level of risk as any operating lease. For example the dollar out option may be void if notice is missed or the lessee is in default. Default may be triggered by something as simple as any payment which is paid ten days late.

As we look forward to the convergence in accounting our expectation is that the popular understanding that the new integrated accounting standards are “making leases capital” will continue this trend of leasing companies offering low rate high risk capital leases. It is important that financial professionals change the simple view of capital leases as low risk and devote the resources necessary to ensure that all leases risks are understood and that their all-in financial performance is measured.