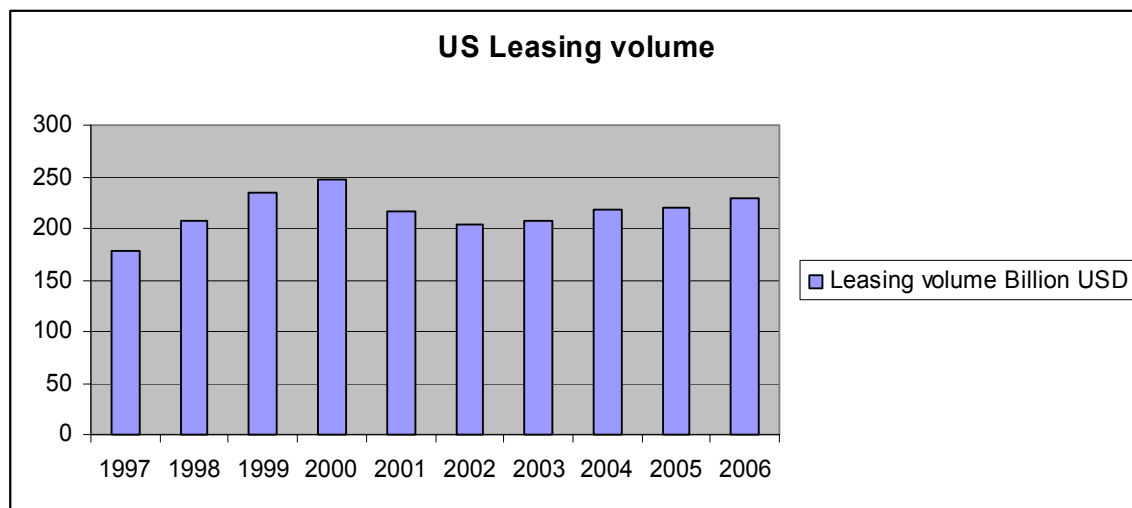


## The State of the Leasing Industry: Review of 2006

By Vinod Kothari

Looking at a broader time frame of several decades, one of the reasons why leasing shot into popularity was off-balance sheet funding. Leasing may not be a hot subject in international finance, but off-balance sheet assets and risks are a bigger issue in finance today than ever before.

Leasing volumes in the USA have been by and large stable. The volume of new leasing business in 2006 was estimated at about USD 229 billion, which is 27% of total industrial equipment acquired. The US volume has almost stabilised over the last few years as revealed by the following graphic:



In Europe, volume in 2006 is estimated to be about Euro 190 billion, which is 9% higher than that for last year.

Leasing volumes generally grew in Asia and Latin America as well.

The global leasing volume as of end-2004 was reported to be USD 579 billion. The annual rate of growth is roughly 10% per annum. A notable feature is that the European volumes are now very close to the US volumes.

### True lease characterisation

The characterisation of a lease as a true lease or disguised security interest has continued to be a matter of litigation from several viewpoints – bankruptcy laws, tax laws, accounting standards and so on.

In bankruptcy law rulings, one of the most significant rulings in recent past has been *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609 (7<sup>th</sup> Cir., decided 26<sup>th</sup> July 2005). The applicable law to determine whether the lease is a true lease or not is state law, and in this case, the Court applied California law. Analysing the following factors under

the California law, the Court came to a conclusion that the lease in this case is not a “true lease”

The “rent” is measured not by the market value of 20 acres within the maintenance base but by the amount United borrowed. The hell or high water clause demonstrates the lack of connection between the maintenance base’s rental value and United’s financial obligation. (ii) At the end of the lease, the CSCDA has no remaining interest. The CSCDA stresses that United will not “own” anything as of 2033; it still would be the Airport’s tenant. But its full tenancy interest reverts to it for no additional charge. Reversion without additional payment is the UCC’s *per se* rule for identifying secured credit. (iii) The balloon payment has no parallel in a true lease, though it is a common feature of secured credit. (iv) If United prepays, the lease and sublease terminate immediately; in a true lease, by contrast, prepayment would secure the tenant’s right to occupy the property for an additional period. The parties have not cited *any* case from *any* state deeming an arrangement of this kind to be a “true lease.”

Lease characterization questions keep coming from taxation viewpoint also. The primary concern in tax laws is the ability of the lessor to claim depreciation and that of the lessee to claim rentals as expenses.

In the USA, the IRS has Revenue Procedure 2001-28 that deals with characteristics of a true lease.

### **Accounting standards**

Accounting for leases is presently governed by FAS 13 and IAS 17. The IAS 17 was last revised to impose some additional tests for a lease to be financial lease, and to require some further disclosures in case of operating leases.

Proposal for fundamental review of the way leased assets are accounted for has been talked about for several years now. There have been two G4 +1 papers: *Accounting for Leases: A New Approach – Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts* (1996), authored by Warren McGregor, and *Leases: Implementation of a New Approach* (1999), authored by UK standard-setters. These papers essentially argue that instead of the current distinction between financial and operating leases, what is more crucial is the recognition of the fair value of assets and the fair value of the corresponding liability.

The IASB has been working on a research project on leasing for some years now.

In Dec 2006, the IASB and the FASB jointly formed a group dedicated to developing a lease accounting standard. It is a joint project by the two boards and involves reconsideration of all aspects of lease accounting. The project is expected to lead to a fundamental revision of the way that lease contracts are treated in the financial statements both of lessees and of lessors. The first due process document to be published will be a

joint discussion paper that expresses the boards' preliminary views. That discussion paper is expected to be published in 2008.

The first meeting of the group was held in Feb 2007.

### **Tax-motivated leases**

Leases motivated to reap arbitrages, whether on taxes or on accounting standards, have been under attack as being undesirable. Regulatory action tries to curb such practices.

Synthetic leases particularly came under attack following Enron's collapse. There are now elaborate rules for special purpose vehicles that require consolidation based on variable interest, as opposed to voting equity.

### **Types of leases**

A 2005 survey by Equipment Leasing Association USA showed that a large percentage of US leasing contracts were still structured as direct finance leases or conditional sales, with operating leasing still being a small fraction:

Direct Finance Lease	28%
Conditional Sales Agreements	52%
Operating Leases	9%
Leveraged Leases (net equity )	1%
Loans into Leveraged Leases	2%
Synthetic Leases	1%
Tax-exempt Leases	3%
Other	<u>4%</u>
Total	100.0%

The percentage of operating leases in Europe is likely to be more as the European market has higher composition of motor vehicles, typically leased under operating leases.