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Synthetic and Other Off-Balance-Sheet Leases: Prospective Accounting Reforms

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In the August and October issues of *Real Estate Finance*, this author's articles chronicled some of the abuses of accounting principles (referred to as Generally Manipulated Accounting Principles or GMAP) by Enron, WorldCom, and many other former "blue chip" companies. Among the most significant responses to these abuses has been the statutory creation of a more potent accounting industry oversight group. This initiative came under recent fire when it became known that then-SEC Chair Harvey Pitt, who recently resigned, had failed to disclose that his approved nominee to head the Oversight Board, former CIA head William Webster, had some questionable involvement in a previous corporate accounting scandal. Developments like this seem almost commonplace when so many prominent public figures who have come from, or returned to, industry, seem to have close ties to major companies, Wall Street firms, or the major accounting firms.

FASB CONSOLIDATION PROPOSAL

An important reform effort, perhaps equally as important as the Oversight Board, has been moving forward through the Financial Accounting Standards Board (FASB). In addition to addressing the loopholes of GMAP that allowed "roundtrippers" of telecom and cable capacity swaps to inflate earnings, new proposals have addressed the impact on earnings of massive amounts of stock options, and the use of special-purpose entities (SPEs) to conceal debt and liabilities, as well as overstate earnings, and even EBITDA (commonly known as cash flow). The June 28, 2002, Proposed Interpretation of ARB 51 bravely introduced old and new concepts of consolidation of SPEs, with an inevitably broad impact on the real estate and leasing industries.

In the several months since, the FASB has held many public meetings and fielded well over 100 comment letters. Much to its credit, FASB still is considering meritorious suggestions, well beyond the August 29 comment deadline. What seems to be emerging is a sea change in the way companies finance their real estate, equipment and other fixed assets, and a sea change in the form of asset securitization, as well as in real estate investments themselves.

Several comment letters criticized the Proposal's requirement for a minimum, not even a safe harbor, of 10 percent equity to be infused into any SPE, or any legal entity that serves some of the purposes of an SPE. They observed that the credit tenant lease (CTL) and sale-leaseback worlds, as well as the Section 1031 real property exchange markets, would be irreparably harmed by requiring much larger amounts of equity than needed in what primarily has become the securitization of credit-lease receivables. Either corporate lessees would have to pay higher rents to cover

the extra equity, or they would have to risk having to consolidate the leased real estate assets.

Other critics bemoaned the preferential treatment shown to "substantive operating enterprises" (SOEs), which were to be immune from the analysis and consolidation rules proposed. Lease accounting proponents argued that the new rules should amend or at least coordinate with FASB 13, and the various pronouncements on lease classification, instead of superseding them with consolidation rules.

Yet another comment was the creation of new barriers to fair comparisons for earnings and leverage ratios, by focusing on SPEs and competing "variable interests" of multiple participants in a transaction involving one or more SPEs, instead of analyzing the economic merits of each transaction.

The FASB has announced its intention to adopt the new interpretation by the end of the year, and agreed to grandfather preposal transactions and extend a prospective effective date of June 15. This is a massive undertaking and despite major staff and board focus, will doubtless require more than a few months for affected companies, accountants, lawyers, and bankers to absorb and accommodate.

THE DIRECTION OF THE CONSOLIDATION PROPOSAL

From public comments, board announcements and releases, and public proceedings, the FASB has shown receptivity to many of the industry concerns, and a willingness to seek alternatives. The final language remains to be carefully drafted, and interactions with other accounting pronouncements have yet to be determined. All bets are truly off, but as the process nears the finish line, a few positions seem to have become solidified.

The synthetic lease as it has come to be known in billions of dollars of bank-originated transactions will likely disappear in its present form. The concept of an SOE seems likely to be modified, but legally combinable leasing units of real operating companies, presumably with real balance sheets, assets, and financial statements, will be able to acquire and lease properties, and consolidate the leased assets, with no risk that the lessee will be forced to consolidate them in the future. Although the Proposal is highly complex, and the public dialogue is often confusing, it seems likely that such substantial lessors not using traditional SPEs will probably fall outside of the Proposal's reach. They would presumably be free to enter into synthetic as well as long-term leases, with or without significant equity, risk or reward. The fact that the leased assets may be financed with nonrecourse debt would not automatically create a multi-tiered SPE.

By contrast, lessors who use SPEs or other legally separate ownership entities, would need to undergo a "variable interests" analysis to determine the "primary beneficiary" of the transaction. In the synthetic lease, the combination of the lessee's residual value guarantee, which allocates the first risk of loss to the lessee, with virtually all of the upside benefit of appreciation of the leased asset, would seem to clearly require consolidation with the lessee.

Large bank conduits that issue billions of dollars of asset-backed commercial paper have found active suppliers in the banks that initiate synthetic leases and sell their lease receivables to the conduits. This source of efficient capital is likely to be impacted as the analysis of variable interests leaves them vulnerable to consolidation of the SPE lessors.

Other anticipated changes and clarifications would seem to preserve the basic economics of leasing of real property to investors in the CTL, sale-lease-back and Section 1031 exchange markets. Additional equity probably would be required in some cases, but the 10 percent threshold would be rebuttably presumed to be adequate, without being an ironclad requirement. Thus, if the lessee is particularly strong financially—high investment-grade, for example—and the property is unlikely to decline substantially in value, the risks of ownership would suggest that less than 10 percent equity would suffice. An SPE owner in a CTL, sale-leaseback or 1031 exchange might not need substantial equity to meet its ownership obligations as lessor and borrower, but it would probably have to retain some true upside in order to avoid having the lessee become the consolidating party, which would often defeat the purpose of the transaction.

However, lessors that are units of major financial institutions may find the leased assets required to be consolidated on their balance sheets, and this could raise the cost of capital to the lessees.

There may well be another consolidation of lessors—not of assets or SPEs, but of lessors. Active lessors that formerly used SPEs will have to find some enterprise that can and will consolidate the leased assets in order to survive, and may band together or merge into larger leasing companies.

CONCLUSION

The final rules and language of the Proposal remain in doubt, and their impact is far from clear. However, there can be little doubt of its serious impact on off-balance-sheet leasing of real estate.