

OFF-BALANCE-SHEET ACCOUNTING REFORM: IMPACT OF FASB INTERPRETATIONS 45 AND 46 ON SYNTHETIC LEASES

The accounting scandals triggered by the collapse of major energy and telecommunications corporations in 2001-02 focused greater scrutiny on legitimate applications of accounting regulations concerning off-balance-sheet finance that conveyed inaccurate impressions of corporate investments and liabilities. The questionable accounting usually involved investments held by Special Purpose Entities (SPEs).

In 2002, the Financial Accounting Standards Board (FASB) responded with a high-priority program to tighten accounting regulations relating to off-balance-sheet finance. The program resulted in two new sets of accounting criteria: FASB Interpretation No. 45 concerning financial guarantees, and FASB Interpretation No. 46 concerning consolidation of assets and liabilities of legal entities related to Special Purpose Entities (SPEs) onto the balance sheets of other entities. Interpretation No. 45 applies to all new synthetic leases. Interpretation No. 46 applies to all new synthetic leases of assets held by SPEs, which includes all new synthetically leased real estate.

The Interpretations differ in grandfathering provisions. Interpretation No. 45 exempts any guarantee that existed prior to the date the Interpretation became effective so long as the guarantee is not modified. Interpretation No. 46 takes effect by mid-2003 in the case of preexisting financial structures (for most publicly traded corporate lessees, on July 1, 2003).

The first thing to note is that new synthetic leases cannot be totally off-balance-sheet financings for corporate lessees. This is due to Interpretation No. 45, which requires any property value guarantee embedded in a new lease to be listed as a lessee balance sheet liability. As explained in [3], the embedded guarantee is an essential structural component of every synthetic lease. Thus every new synthetic lease will generate a lessee balance sheet liability.

The next thing to note is that the capital structure of SPE-held property that was synthetically leased before Interpretation No. 46 became effective must be consolidated on the lessee balance sheet by mid-2003 if the property is not refinanced before that time. This follows because the Interpretation requires lessee balance sheet consolidation of synthetically leased SPE-held property if less than 10% of property capital consists of equity. Since equity capital in synthetically leased property was set invariably at 3% before Interpretation No. 46, it follows that synthetic lease financings that predate the Interpretation will fail the off-balance-sheet accounting requirements in mid-2003.

Interpretation No. 46 imposes more than a simple 10% equity capital minimum on off-balance-sheet financings. The Interpretation requires lessee balance sheet consolidation of synthetically leased SPE-held property except in the case of property with adequate equity capital at risk supplied by sources unrelated to the lessee. The Interpretation specifies that "adequate" is the greater of 10% and an amount that exceeds the expected loss for all financial interests in the asset, where "expected loss" is a quantitative measure described in the Interpretation.

In the case of institutional-grade real estate in major metropolitan areas, the expected loss measurement is likely to be very close to 10%. However, in many other cases the expected loss measurement should exceed 10% by a significant margin.

Examples of synthetically leased property for which the expected loss defined in Interpretation No. 46 could easily exceed 15% are special-purpose real estate, large-ticket commercial real estate in secondary metropolitan areas, and equipment such as airplanes and rail cars.

Another example of synthetically leased property for which the expected loss should exceed 15% is real estate in which the lessee uses the synthetic lease to finance the entire cost of occupancy. The personal

property and expenses financed by this maneuver have no expected value at the end of the lease, which elevates the expected loss for the leased asset several percentage points above the typical expected loss for institutional-grade real estate (see [4] for analysis of the dim prospects for lease renewal in this case).

Interpretation No. 46 does more than increase the minimum required equity capital at risk in off-balance-sheet financings. The Interpretation also modifies the definition of risk capital. Subparagraph 5b(2) of the Interpretation specifies that, in order for equity capital to be *at risk*, the equity owner must absorb investment losses whenever they occur. It follows that the guarantee embedded in a synthetic lease must not protect the equity risk capital invested in the leased asset from economic loss under any loss scenario.

By contrast, equity capital previously was considered to be at risk if any loss scenario existed in which the guarantee would not protect the equity from economic loss. For example, the guarantee in a synthetic lease created under the previous off-balance-sheet accounting standard typically protects the equity against loss unless the leased asset loses more than 85% of its market value during the lease term (see [3] for analysis of synthetic lease guarantees). Such embedded guarantees prevent equity invested in synthetically leased assets from qualifying as risk capital under the criterion established by Interpretation No. 46.

It follows that synthetic leases of SPE-held property that existed prior to the effective date for Interpretation No. 45 cannot be restructured to comply with Interpretation No. 46 without modifying the financial guarantee in the lease. As discussed, modification makes the guarantee subject to Interpretation No. 45, which turns the guarantee into a lessee balance sheet liability. It follows that such synthetic leases cannot be modified to keep them totally off the lessee balance sheet beyond mid-2003. This is a classic Catch-22, and is undoubtedly one of the reasons that FASB advises in Interpretation No. 45 that the two Interpretations should be considered together in accounting analyses of off-balance-sheet financings.

Many synthetic equipment leases created under the previous off-balance-sheet accounting standard have capital structures that do not involve SPEs. In these cases, bank leasing subsidiaries function as SPE surrogates. Each leasing subsidiary directly holds the titles to various synthetically leased assets by virtue of having invested the obligatory 3% equity capital in each synthetically leased asset to which it holds title.

If synthetically leased assets comprise a majority of the value of the assets held by a bank subsidiary, then Interpretation No. 46 views the subsidiary as a SPE-like entity. In this case, the Interpretation applies the capital adequacy criteria to the subsidiary to determine whether the Interpretation applies to the synthetically leased assets. If the equity capital of the subsidiary is inadequate, then the Interpretation requires each synthetically leased asset owned by the subsidiary to be consolidated on the corresponding lessee balance sheet by mid-2003.

It is doubtful whether bank leasing subsidiaries that hold synthetically leased assets have sufficient equity capital to protect their synthetic lessees from the consolidation requirements of Interpretation No. 46. Lessees wishing to avoid consolidation should determine the capital status of bank lessors with regard to Interpretation No. 46 well before mid-2003. In the case of inadequately capitalized lessors, lessees should investigate alternate off-balance-sheet capital structures for the leased assets, since banks are unlikely to invest additional capital in leasing subsidiaries merely to help customers avoid accounting reform.

A bank leasing subsidiary that currently is capitalized adequately with regard to Interpretation No. 46 could fail the adequacy criteria at any future date if the parent bank decides to withdraw capital from the subsidiary. In that case, every synthetically leased asset held by the subsidiary that was created under the previous off-balance-sheet accounting standard would be consolidated immediately on the lessee balance sheet. Because of this possibility, synthetic lessees of assets held by bank subsidiaries would be prudent to consider alternative off-balance-sheet capital structures for the assets even if the current capitalization status of the lessor is adequate with regard to Interpretation No. 46.