

Letter of Comment No: 125
File Reference: 1082-200
Date Received: 09/09/02

August 29, 2002

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Exposure Draft of the Proposed Interpretation for Consolidation of Special Purpose Entities, an Interpretation of ARB No. 51; File Reference No. 1082-200

Dear Ms. Bielstein:

I am writing on behalf of 42 North Structure Finance, Inc. to comment on the Exposure Draft of the Proposed Interpretation of Consolidation of Special Purpose Entities.

42 North is a private corporation headquartered in Boston, Massachusetts whose business activity consists of structuring and arranging financing for users and/or owners of equipment and real property. Each year, we arrange approximately \$3.5 billion of financing for U.S. and foreign corporations with an average transaction size in excess of \$100 million. Financings often take the form of a lease or partnership arrangement, and cover the range of tax-advantaged and finance leases and operating leases. Many transactions involve the use of special purpose entities which the proposed Interpretation would effect.

We support the Board's overall objective to consolidate special purpose entities, particularly those entities that are considered "orphans" without any true ownership stake. It is our understanding that certain transactions involving SPEs that are considered abusive did not comply with current accounting requirements. The Interpretation reflects an understanding that there are SPEs that are not used for the purpose of achieving particular accounting results, but instead accomplish other objectives for legal, tax or capital raising purposes. Thus, the scope out in Paragraph 8 of the Interpretation for SPEs that are consolidated into substantive operating entities is appropriate and fits well with many instances of SPEs used in leasing transactions. Certainly, leasing arrangements are disclosed under current GAAP and there has been an increase in the quality of disclosure provided by reporting entities. Our comments here are designed to give the Board examples of common practice and illustrate the lack of consistency or clarity that could result from the proposed Interpretation.

Leveraged True Lease

- A typical leveraged lease of, say, an aircraft would consist of a grantor trust being formed for the purpose of purchasing an asset and leasing it to a single lessee. A single equity investor, normally the leasing subsidiary of a financial institution or finance company, contributes equity to the trust equal to 20% of the purchase price of the asset.
- Third party lenders make a non-recourse loan to the lessor through an indenture trust in an amount equal to 80% of the purchase price of the asset. In most cases with large size transactions, no individual lender holds more than 50% of the outstanding debt or has voting control. The lenders are secured by a first lien on the assets of the grantor trust including the aircraft and the lease. The debt may be issued in the form of equipment trust certificates, normally a widely dispersed, public distribution that creates greater liquidity and lower interest rates because the certificates are rated higher than the unsecured debt of the airline. The loan principal fully amortizes during the lease term from rent payments by the lessee and the lender has no exposure to the residual value of the asset.
- The lease would be for a term of 20 years to an investment grade lessee. The lessee has a one-time option at the end of year 15 of the lease to purchase the asset for a fixed price. This price is determined so that it is not deemed compulsive by the IRS, normally a price that is in excess of the expected future value of the asset and more than the discounted value of remaining lease payments. If the lessee does not elect the early buyout option, it has no control over the residual interest in the asset except by exercise of purchase or renewal options that would be available at fair market value.
- The lessee accounts for the lease as an operating lease and the present value of minimum lease payments is less than 90% of the fair value of the asset. The lessor, on the other hand, has a direct finance lease and accounts for the lease as a leveraged lease.

Issues and Conclusions

- Two levels of SPEs exist – the grantor trust and indenture trust. These trusts are both newly formed, single purpose entities with no independent financing or employees.
- It is not clear that the equity investors or lenders are substantive operating entities (SOE) because the guidance provided by the Interpretation is limited. The equity investor is a special purpose subsidiary of a financial institution but it does not necessarily qualify as a SOE itself. Similarly, the lenders are separate legal accounts held at various life insurance companies. Neither the equity investor nor lenders have employees even though they each contain substantial assets. Each entity's activities are managed by a service company affiliate. The equity investor is consolidated into its parent which is most likely an SOE because it is a large, diverse consolidated entity. The lender is technically an account held by life companies which appears on the consolidated balance sheet of that entity.

- In this example, it would appear that the SOE scope out would apply to the equity investor and its interest in the lease appears on the consolidated balance sheet of its parent as a net equity investment in a leveraged lease.
- The indenture trust, however, has no single party that consolidates the trust through voting interests. This subjects the trust to further analysis of variable interests under the proposed Interpretation. The lenders each have the same type of interest in the trust, but in differing amounts. Under the Interpretation as currently worded, we believe it would be proper to conclude that the lender with the highest notional amount, if even greater by \$1, should consolidate the indenture trust. This would balloon the lender's balance sheet with the loans made by other lenders.

Variations

- For large assets, two or more equity investors frequently participate. The ownership vehicle used in these instances depends on the ability to separate legal interests. There are three typical methods used. If the assets consist of identical units that can be separated (i.e., railcars), each investor will take ownership of discrete assets through individual trusts of which they own 100% and thus consolidate. For assets producing fungible output (i.e., a power plant) that are not divisible, each equity investor takes an undivided interest in the asset through separate trusts. Each investor owns 100% of its respective trust and consolidates its interest. Finally, assets for which an undivided interest is not legally recognized and the asset cannot otherwise be divided (i.e., an aircraft), a joint ownership vehicle like a partnership would need to be used.

In all three ownership structures, the rights and obligations of the lessee are identical. Ownership is driven by the nature of the asset and legal title constraints. The third scenario with multiple investors in one SPE with no voting interest control is the only one under which the scope out in Paragraph 8 does not apply and variable interests would have to be considered. Let us assume that two investors have an equal interest in the SPE and they share voting rights. Under current accounting, each shows net partnership equity of 10% of the asset cost. Assuming the lease contract is the same as the original example, the equity investors in the partnership have the first risk of loss for a total of 20% before debt investors would suffer a loss. The equity investors' upside is limited by the early buyout option of the lessee, although the investors' would still realize a gain if the option were to be exercised. If the lessee does not exercise the option, the lessor has full upside and downside risk. The lenders' risk is a combination of the lessee's investment grade credit and the value of the asset serving as collateral. The lender's notional exposure reduces during the term. At some point, the notional amount of the lender's variable interest may be less than the lessor's interest. Would consolidation switch at that point in the future? The lessee has the ability to control the asset through its early buyout option; however, the price

has been set at the asset's expected value. There is no downside to the lessee since it can normally re-lease or purchase the asset later at fair market value. The partnership has the greatest variable interest; however, neither equity investor has a differing interest from the other. Thus, the lenders may have the next most variable interest. Since the debt is held by a number of lenders, the ED would force us to determine which of the lenders have the greatest variable interest. The lender with the greatest principal at risk would be the party to consolidate the partnership.

The conclusion of this variation is that neither of the equity investors with the greatest risk of loss is required to consolidate. The lessee's rights and obligations are unaffected. Instead, the largest lender consolidates the partnership, but it is already required to consolidate the indenture trust. How does the lender consolidate the partnership? How do the equity investors report their interest?

- There are multiple lenders but their interests can be varied. Say, for example, three lenders have equal amounts of the debt so that no one party has a significantly greater variable interest in the trust. Does the lessor or lessee then have the next most variable interest in the loans? Lenders frequently have differing amounts of notes in a leveraged lease. Is \$1 more in notes sufficient to cause one lender to consolidate all of the debt? If a lender consolidates the indenture trust, is it displaying this interest as equity even though the interests of the trust represent a class of debt? It is illogical that lenders making their investments through a common vehicle used in capital markets could be forced to show an equity investment in an entity.
- Lessors will sometimes obtain a nominal amount of residual insurance in order to account for their investment as a finance lease. Typically, the lessor arranges this insurance on its own, but it is obtained in conjunction with the closing of the lease and is factored into the lessor's overall return and pricing of the lease. The insurance covers the last loss on the asset, making the policy reasonably priced to obtain. Does the existence of this insurance change the variable interest in the ownership entity, thereby transferring consolidation to the lender or the lessee?

Final Comments

Our overriding concern is that consolidation by certain parties could ultimately distort financial results and negate from the Board's overall goal of transparency in financial reporting.

- SPEs holding debt instruments should be excluded from the scope of the Interpretation when equity interests are behind the debt, even in instances in which an ownership SPE is not consolidated on to the books of a single reporting entity.
- An exception should be made for SPEs when no single party consolidates but that group as a class holds most of the variable interests. In these cases, the rights and obligations of the SPE's counterparty (i.e., the lessee) are the same.
- A more thorough definition of SOEs is required for the paragraph 8 carveout to be effective and not permit abusive ownership stakes.
- Guidance on the term "significant" is requested. Unless otherwise directed by FASB, audit firms will develop their own quantitative benchmarks to be applied universally.
- It is impractical to monitor transactions each reporting period to determine changes in primary beneficiary. Most agreements do not permit parties to obtain ongoing information that would permit them to adequately reevaluate the variable interests of the parties. In the absence of modifications of the parties' contractual rights and obligations, classification should incur only at inception with a view to the variable interests of each party over the life of a SPE. Lease classification, for example, only occurs at inception unless terms change.

We appreciate the opportunity to provide comment to the Board on this Exposure Draft.

Very truly yours,

Mindy Berman

Mindy Berman
Senior Managing Director