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Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116
Attention: Director of Major Projects
and Technical Activities
File Reference No. 1082-200

Re: Comments from the Credit Tenant Lease Industry on the
Exposure Draft Relating to Consolidation of Certain
Special-Purpose Entities

Gentlemen and Ladies:

This letter will provide comments from major participants in the credit tenant lease industry, named at the end of this letter, to the Exposure Draft dated June 28, 2002 on consolidation of certain special-purpose entities (the "Exposure Draft"). We welcome the opportunity you have afforded to comment on the Exposure Draft, and hope that this letter will provide you with information on the impacts which implementation of the Exposure Draft would have on the credit tenant lease marketplace. We feel strongly that many of these unintended side effects will adversely affect our industry, the credit markets and the economy.

By way of introduction, the credit tenant lease ("CTL") industry is a \$6 to 8 billion per year business which has been active for over 50 years; more than \$120 billion of CTL debt is currently on the books of institutional investors. This market segment involves major

institutions as credit tenants, lenders and lessors, as well as hundreds of individuals and small businesses which invest in CTL transactions, acquire CTL transactions in tax-free exchanges, develop properties for credit tenants or otherwise play an entrepreneurial role in credit-backed real estate. The signatories to this letter include some of the country's leading insurance company lenders and other institutional lenders, real estate investors, investment banks, accounting firms and law firms, all of which have been regularly involved in the CTL business for many years and are intimately familiar with all aspects of the industry.

Summary. We believe that the implementation of the Exposure Draft as currently written would result in inconsistent treatment of essentially identical transactions making similar companies financial statements misleadingly different, and different treatment of the same transaction over the course of its life without material changes in the business terms. The requirement of a substantive operating enterprise or "SOE" as the only means of avoiding the "primary beneficiary" designation for either the lender or the lessee for transactions that lack at least 10% equity will distort the capital markets, essentially removing many participants from the marketplace, with a consequent loss of competition and likely higher costs to corporate lessees. The notion of consolidating an SPE with its lender is simply unworkable in the CTL marketplace, and the threat of requiring such consolidation is likely to severely restrict credit for this widely used type of transaction.

Introduction. As an initial matter, while we applaud the Exposure Draft as a creative approach to dealing with special-purpose entities ("SPEs") which have been used improperly to hide liabilities and otherwise avoid disclosure, the abuses which the Exposure Draft seeks to remedy are not present in the CTL marketplace. SPEs are widely used in CTL transactions for the purposes of providing a bankruptcy-remote lessor and insulating the SPEs'

owners from liability. Not only have property owners sought to use SPEs to insulate liabilities associated with one property from other properties controlled by the owner, but lenders too have insisted on segregating the assets they are financing to minimize the risk of bankruptcy of their lessor-borrower in an effort to limit the risk of CTL transactions to the credit risk of the lessee. Finally, rating agencies have uniformly required a bankruptcy remote SPE in order to rate transactions based on the credit of the lessee with only minimal concern of the risk of lessor bankruptcy. Unlike abusive transactions using related party controlled partnerships and similar gimmicks, the parties to a typical CTL transaction are unrelated and are participating based on their own independent profit motives. The lessee's goal is to obtain the lowest possible rent, the lender is trying to obtain an attractive interest rate, and the lessor is attempting to maximize its cash return and residual value as well as obtain tax benefits. Therefore, the transactions are negotiated at arm's length between unrelated parties with different economic interests. We believe that current accounting rules for CTL transactions in accordance with FASB 13 are clear and in no way misleading, with the lessee footnoting future obligations under operating leases, the lessor showing the asset and the related debt on its balance sheet, and the lender simply showing the loan as an asset on its balance sheet. And we assume that the Exposure Draft would not change the accounting for capital leases under any circumstance.

The CTL industry is already governed by a system of accounting rules set forth in FASB 13, FASB 66, FASB 98 and related pronouncements. In addition, insurance company lenders which provide most of the debt capital for this market are governed by detailed rules of the National Association of Insurance Commissioners, which among other things, try to insulate the lender from the risk of lessor bankruptcy. The industry has developed into a vibrant economic market under these rules, with all parties understanding which terms are permissible

and which are not. There is uniformity in the accounting treatment of similar transactions. We do not believe that these accounting rules should be changed unless (a) a problem has been identified with the current accounting rules and (b) a new set of rules is adopted which improves on the existing rules through greater transparency, more logical and accurate accounting treatment and avoidance of accounting abuses. It makes little sense to impose new consolidation rules on the CTL industry simply because the industry utilizes SPEs, since the reasons for using SPEs in the CTL industry have nothing whatsoever to do with financial reporting. Our belief is that instead of improving on existing accounting rules, applying the Exposure Draft to the CTL industry will have the unintended results of inconsistent accounting treatment of substantively identical transactions, lessening of competition, financial inefficiency in the marketplace and sometimes illogical financial reporting.

Treatment of Substantive Operating Enterprises. The Exposure Draft provides that if the owner of an SPE is a Substantive Operating Enterprise (“SOE”), the financial results of the SPE are consolidated with the SOE regardless of whether the “voting interests” (paragraph 9 of the Exposure Draft) or the “primary beneficiary” (paragraph 13-21 of the Exposure Draft) tests would have the same result. Therefore:

a) The lessee’s accounting treatment (which until now has been the most sensitive issue in accounting for leases) will depend on the identity of its lessor rather than on the merits (assuming FASB 13 and related standards are satisfied). Identical transactions would be consolidated with different parties based solely on the nature of the owner of the SPE.

b) The Exposure Draft discriminates against the large number of small investors who provide liquidity and competition to the marketplace even though they are not SOEs. SOEs will have a competitive advantage in the marketplace over lessors which do not

qualify as SOEs. Lessees and lenders in all likelihood will exclude non-SOE lessors from transactions out of fear of being required to consolidate the SPEs themselves. In this regard, it is unclear what entities (other than public or large private companies) will qualify as SOEs. This rule will effectively drive smaller real estate buyers such as developers, individuals participating in tax-free exchange transactions and real estate entrepreneurs from the market as only SOEs will be tolerated by lenders either at inception of a CTL transaction or upon a transfer of ownership of the asset to a new owner. Exclusion of smaller investors from the marketplace would have a huge negative economic impact and result in less competitive pricing since small investors generate a significant percentage of the equity capital in the CTL market.

c) The lessee's accounting treatment will change if the lease is originated with an SOE and the property thereafter is sold to a non-SOE. A transaction could be off balance sheet one year and consolidated the next even though nothing changed except the owner of the SPE. Such a result is illogical and violates the rule that accounting treatment should be consistent year to year.

Absence of Safe Harbor for Lessors. The Exposure Draft presumes that an equity investment of less than 10% is insufficient to treat an SPE as being consolidated with the lessor. And even having 10% equity is not a safe harbor that would provide certainty for participants and consistency among similar transactions. In CTL transactions, the lessor has virtually no need for capital after the closing since the traditional obligations of a lessor (such as payment of real estate taxes, insurance premiums and maintenance of the asset) have been shifted to the lessee, and hence the presumption that 10% equity is needed is inappropriate in this marketplace. As a further anomaly, under the Exposure Draft, if the lessor is an SOE, it would appear that

even the 3% equity test, which has heretofore been widely used as a guideline in leasing transactions, no longer needs to be satisfied.

Consolidation with Lender. The Exposure Draft states that in applying the variable interests test, if the lessee does not provide a residual guaranty, an SPE with less than 10% equity will “probably” be consolidated with the lender. The rationale for consolidation with the lender presumably is that the lender bears the greatest risk of loss in this situation since it is providing most of the capital and will not be repaid if the property has insufficient value, and hence would have a larger dollar loss if it were to lose, for example, 15% of its investment, compared to the equity investor who stands to lose 100% of its investment. However, this approach blurs the age old distinction between debt and equity. A lender providing a non-recourse loan in a leasing transaction with a strong credit lessee is not taking “equity risk,” since the lessee has full responsibility to pay rent sufficient to repay the loan regardless of the value of the property, and the lender has no “upside” other than receipt of its interest and principal.

Moreover, consolidating an SPE borrower with its lender results in misleading financial statements for the lender. If there is a single lender in a CTL transaction, the Exposure Draft would require it to show the asset owned by the SPE on its balance sheet as an asset, and the SPE’s debt on its balance sheet as a liability. The details of reconciling the lender’s securities accounts and the newly consolidated accounts are unclear, but almost certainly will lead to highly artificial and unintended results, as well as likely converting a securities asset into a real estate asset for regulatory purposes, requiring the lender to set aside a greater capital reserve for the transaction. For example, will rent from the asset be treated as income to the lender even though it exceeds the debt service to which the lender is entitled? The artificiality of the treatment is underlined by what would happen immediately prior to the maturity of the loan:

before the final payment, the lender (assuming it is still the consolidating party) would show, say, \$1 million unpaid principal on its investment and, say, \$100 million as the depreciated value of the asset it financed; upon payment of the last \$1 million, the \$100 million asset would disappear from its balance sheet, making year-to-year comparisons of the lender's financial statements a study in volatility that has nothing to do with the financial performance of the lender. If, as often happens, there are several lenders investing in a single class of debt securities in a CTL transaction, the situation becomes even more severe as the lead lender would be required to consolidate the entire transaction on its balance sheet since it holds the largest variable interest, although it perhaps holds only a small percentage of the aggregate debt. We believe this results in a material distortion of economic reality.

The Exposure Draft's requirement that lenders determine, on each of their reporting dates, all the parties who provide variable interests to an SPE, and then determine if they provide a significant portion of the financial support that is significantly more than any other party is unworkable, particularly for institutions that have several thousand CTL loans on their books. This requirement assumes that a lender can find out the amount of equity investment in each SPE by its owners (which may vary over time), whether its owner is an SOE, and who the other lenders in the transaction are and how large a share of the aggregate debt they each hold (the debt securities trade in the secondary private market, and the identities of their holders change over time). This is a massive quarterly undertaking which is unlikely to yield the required information, and which may well involve having to pay for an appraisal of the SPE's assets to determine the amount to be consolidated if the assets are to be marked to market (which they presumably would, on a quarterly basis, if the lender invested with a view to selling or trading its loan). The net effect of such obligations is likely to be for lenders either to sell out

their existing securities holdings in CTL transactions to unregulated entities or engage in costly restructuring to assure that there is an SOE available to consolidate the SPE at all times that their loan is outstanding. While seeking guidance on what a “significantly” greater variable interest would be, lenders may be expected to compete to avoid “lead lender” status, further distorting capital market dynamics. In considering new CTL transactions, lenders will have to insist on an SOE owner for each SPE as the price of avoiding having to consolidate the SPE themselves. Such a requirement will give a huge advantage to SOE sponsors and probably reduce the number of equity players in the marketplace dramatically, resulting in both less competition and probably higher pricing to prospective lessees without improving the financial reporting of any party.

Lack of Certainty. The Exposure Draft will insert new uncertainties into accounting for CTLs, which will have a chilling effect on the market. Unless the lessor is clearly an SOE, lessees and lenders will not be sure whether the SPE has sufficient equity capital, control and risk to avoid consolidation with the lender or the lessee. This uncertainty will cause lenders and lessees to refrain from engaging in CTL transactions which will impair the ability of corporate America to access an important source of reasonably priced capital, again without an offsetting benefit in this marketplace.

Effective Date. The effective date for existing transactions (March 15, 2003) provides no grandfathering. Therefore, leases which are currently off-balance sheet to the lessee in compliance with FASB 13 will become consolidated on the lessee’s or the lender’s financial statements after that date (unless the new rules are satisfied). Many lenders may experience regulatory problems as a result of substituting real estate assets for notes on their GAAP books and, in many cases, inflating their reported “debt” by the amount not only of their CTL investments but of the loans by other lenders in the same transaction. In virtually all cases, the

affected lessee or lender will have no legal right or economic leverage to modify the transaction to satisfy the new rules.

PROPOSALS

We do not believe that it is the intention of the Exposure Draft to damage the CTL industry, particularly in light of the current state of the economy. We believe that the problems identified above result from applying consolidation rules aimed at preventing accounting abuses to transactions where their logic does not apply. With that in mind, we feel strongly that the most rational approach in applying the Exposure Draft to credit tenant lease transactions is to provide an overriding exception for transactions which qualify as “operating leases” for the lessee’s financial reporting purposes under FASB 13 and related accounting rules and in which the lessor is unrelated to the lessee. In this regard, we note that the Exposure Draft has already adopted this approach for SOEs, and extending the approach to other lessors would serve primarily to remove the inequities and inconsistencies of treatment discussed above. If changes to accounting for leases are considered appropriate, the rules of FASB 13 and related pronouncements could be revised where appropriate without utilizing the “blunderbuss” approach of applying the Exposure Draft in inappropriate contexts.

While we strongly prefer the foregoing approach, if it is not acceptable, we request that some of the more problematic effects of the Exposure Draft be modified:

Consolidation with Lenders. Unless a lender actually acquires either the SPE or its assets as a transaction separate from the loan it makes to the SPE, lenders should not be required to consolidate SPEs in CTL transactions. The traditional division between debt and equity should be observed by keeping the tangible asset and the related debt on the books of the borrower (or lessee in certain situations).

Clarify Standards for Non-SOEs. Standards for consolidation with non-SOE entities must be clarified, or such entities will in effect be foreclosed from the CTL marketplace. In CTL transactions, where the lessor typically has no real need for equity capital after the initial purchase, the 10% equity test should be a safe harbor, and the presumption that equity is inadequate if it is below 10% should not be applicable.

Determine Accounting Treatment at Inception. If a CTL is not consolidated with the lessee or lender when it is originated, treatment should not change based on a subsequent sale unless a material economic term of the transaction is changed.

Extend Effective Dates. The proposed effective dates should be postponed until one year following adoption of the final interpretation to enable the market to adjust to the new rules and allow parties time to attempt to modify existing transactions.

We hope that the foregoing discussion is helpful to your evaluation of proposed changes to the Exposure Draft.

Please note that although the individuals listed below are endorsing this letter with the knowledge of their companies, nothing contained herein should be interpreted as a statement by such companies themselves.

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