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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

Letter of Comment No: 33
File Reference: 1082-200
Date Received:

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

Gentlemen and Ladies:

Thank you for the opportunity to comment on this Exposure Draft. The RVI Group is the leading provider of residual value insurance to credit tenant real estate loan (CTL) transactions and equipment leasing transactions and as such sees the internal economics of a large number of CTL transactions.

We understand the background for this project and the difficulty of establishing rules which do not allow form to take precedence over substance. Our involvement in transactions which utilize with special purpose entities is deep but narrow. As a result, our comments are limited to the use of special purpose entities in CTL and equipment leasing transactions.

As we understand the ED, an accounting distinction is being made based upon who the other participants to the transaction are as opposed to what they are doing in the transaction. This distinction is made so that so-called "orphan SPEs" do not enable enterprises to base their accounting on form instead of substance. We agree with the pursuit, but we disagree with the method utilized in the ED as it relates to certain leasing transactions.

The ED requires the lender in transactions where the equity does not meet a prescribed substance test or is not a substantive operating enterprise to record the transaction as though the lender were really the owner. We believe that requiring the lender to record the asset/SPE as owned is wrong for two principal reasons. First, if the equity is not capable of bearing the risks associated with the transaction then in all likelihood it is the lessee who is bearing those risks. We believe that when a truly arms-length transaction

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has concluded that the equity investment is adequate, (we discuss later why the equity in CTL transactions is judged to be adequate by the market) then the lessee should account for the transaction as required by lease accounting rules and the lender should account for its investment as a debt instrument. We believe that it is the assessment of each participant's role that is the essence of principle-based accounting.

Second, if we take the ED's guidance beyond the balance sheet perspective, we see what we believe are results which make analysis of financial statements very difficult. Utilizing the ED, when there is a single lender without an SOE, the lender would present an investment in real estate on its balance sheet and its debt instrument would be eliminated against the SPE's corresponding liability. On the statement of income, the lender would show rental income and depreciation, netting to something approximating an interest earnings number. The statement of cash flows however, would start with net income and add back depreciation when the lender consolidates the asset/SPE. This presentation reflects the principal portion of the rental payment as an operating cash flow. Prior to the ED, if the lender presented the transaction as a debt investment, the interest income would be in operating cash flows, but the principal payments would be a cash flow from investing activities.

If we continue this thought and combine it with the need to continually evaluate whether the lender has the most significant variable interest, we allow the lender to increase operating cash flow significantly by making insignificant changes to the transaction. As an example, if there are multiple lenders with equal interests and the equity is not an SOE, no one will consolidate the SPE. If Lender A acquires 1% more of the debt the result may be that Lender A has a significant variable interest and principal payments for all of the lenders may become operating cash flows for Lender A. The lender with the most significant, but minority share of the debt, say 30%, would reflect all of the principal portion of the cash inflows as operating with 70% of the amount shown as an offsetting outflow in financing activity. This lender actually neither receives the 70% inflow in operating cash or made the 70% payment reflect in financing cash flows.

The lender's consolidation of the SPE, and the related income and cash flow statement impacts, probably reduces the investor's ability to analyze the lender's performance. The lender's management evaluates the performance of the loan portfolio considering this investment to be a loan focusing on such statistics as days past due and loan-to-value. Estimates of collectibility are reflected in reserve or allowance accounts or, in some cases, the mark to market valuation. Users of the lender's financial statements will see a real estate investment without disclosures normally associated with debt investments. A presentation that gives the financial statement user information that differs drastically from how management views the business cannot be in the user's best interests. We believe that the result is a less transparent presentation of this investment.

Not being familiar with the SPE transactions which appear to have been presented in a manner consistent with their form and not their substance and which made the need for this ED urgent, we do not have an all inclusive proposal for how to report such transactions. We

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do agree that transactions should be recorded utilizing principles which reflect their substance and not their form.

The substance of many leasing transactions is that the risk to the lender is greatest later in the transaction and the lessor's equity builds in anticipation of that risk. If we look at a credit tenant lease, the lender loans 85% of cost based upon lessee credit and possibly an additional 12% based upon a residual value insurance policy. The equity has invested 5%, possibly less, including transaction costs. The lender has made a credit evaluation that this rated tenant will make its payments when due and will certainly make them for a number of years during which the principal will amortize and the loan-to-value ratio will decrease. As a result, the lender's return is that of a debt investment and the lender does not share in the property's appreciation. The lender having received only an interest yield has invested in a debt instrument.

As the transaction progresses through its term, the lessee has paid rent, which goes to the lender and pays down the principal. The pay down becomes the lessor's equity. The SPE's financial statements would reflect depreciation offsetting a portion this build up of equity. The lender has rights which protect its collateral which is primarily the lease and, for the final payment, the residual value insurance policy. Secondly, the lender has the property as collateral. The lender and equity investor realize and the economics of the transaction reflect, longer-term extensions of credit generally require more equity. As the CTL transaction matures, the loan-to-value ratio changes to benefit the lender.

At the end of the financing term, the equity can sell or refinance the property. Many lenders will extend a loan at the beginning of the CTL term understanding that the repayment will be made from proceeds on sale or a refinancing at term end and not from the lease payments. These loans typically carry a higher capital charge and therefore are more expensive to the borrower than loans, which are made on credit. A residual value insurance policy allows the lender to have a loan, which gets a capital charge based on the insurer's credit, reducing the required yield.

The residual value insurance policy does not take significant risk out of the transaction for the lender or the equity. The policy creates a payment at lease end that the lender can lend against. The policy assures the lender of getting paid, provided there is no intervening default on the loan but offers no protection to the equity investor. If the RVI policy is called on, which can only happen on the last day of the financing term, the equity investor has lost its whole investment, including the equity created by the principal pay downs.

Lenders in the abusive SPE transactions have typically not been the ones who have based their accounting on the form of the transactions instead of the substance. The substance of the abusive SPE transactions as we understand them was that lenders made loans to SPEs and obligated another party who was benefiting from the transaction to take so many of the risks and while receiving so many of the benefits that this party was in substance the equity

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in the transaction. Under the ED, this in-substance equity participant would consolidate the SPE and the lender would account for its investment as debt. When the ED is applied to CTL transactions and many equipment leasing transactions, the lender becomes the party who needs to consolidate the SPE. The result is that in order for the lender to prevent consolidating the SPE it has to police transactions to ensure that an SOE is present at all times.

Many CTL and equipment leasing transactions have an indenture trust or bond trust, which are SPEs through which funds are loaned to SPE transactions. It appears that the ED requires a review of these transactions by the lender for the indenture trust and the SPE, which owns the leased asset. Given that indenture trust has no equity and there is no SOE involved, a lender who is a significant lender in the transaction may be required to consolidate the indenture trust resulting in an increase to the lender's investment balance and the recording of a borrowing due to the other lenders in the transaction.

We believe that the ED needs to recognize the role of lenders to these transactions as lenders and not require that a lender record an investment in real estate.

We believe that a better criteria for determining if the lender needs to consolidate the SPE in these leasing transaction is the following:

If based upon a complete understanding of the entire transaction at inception, to be reconsidered at the time of any modifications of the governing documents, the lender's role throughout the transaction, assuming that all payments are made as agreed, is that of a lender, the lender should account for the investment as it would its other debt investments. The factors to be considered include the adequacy of the contractual cash flows to meet the payment schedule, each party's ability to modify the transaction and the presence of terms not typically included in debt transactions.

Once again, thank you for the opportunity to comment on this Exposure Draft. Please, do not hesitate to call with any questions.

Sincerely,

Daniel P. Egan