FROM ROUGH ROAD TO SUPER HIGHWAY: 40 YEARS OF US LEASING

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When I think of the equipment finance industry in the United States today, a sleek, sophisticated automobile comes to mind, one loaded with features and gratifying power. If I think about our industry 40 years ago, however, the vehicle I would picture would more closely resemble a Jeep Wagoneer.

I say this because in 1979, equipment finance was still a young industry, its road to growth strewn with obstacles requiring the navigation of a four-wheel drive. Most companies that were part of the industry then were still trying to agree on their business profiles. In fact, so many changes had occurred so quickly in the US political and economic arenas that by 1979, members of our community were rethinking the entire industry.

The early days

Let me back up to explain. A handful of US companies started the Association of Equipment Lessors (AEL) in 1961 to promote leasing as a financing option and to monitor federal and state laws and regulations affecting the business. Little known in the wider business community and even less understood, equipment finance at that time was a very small industry whose product was generally viewed as a last resort for companies that did not qualify for bank loans. *[Note: AEL eventually became the American Association of Equipment Lessors (AAEL).]*

The timing of the Association's formation was auspicious because the following year, President John F. Kennedy proposed stimulating the nation's economic growth with an investment incentive that would give businesses a tax break on the first $5,000 of newly purchased equipment.

Congress enacted the Investment Tax Credit (ITC) late in 1962 and included in it an increased deduction for the depreciation of equipment and other assets. As a result, large lessors realised major tax benefits for true, or operating, leases. They also found that they could pass along a portion of those benefits to lessees, thereby lowering customers' leasing costs and making leasing more attractive to airlines and other businesses with little taxable income to shelter.

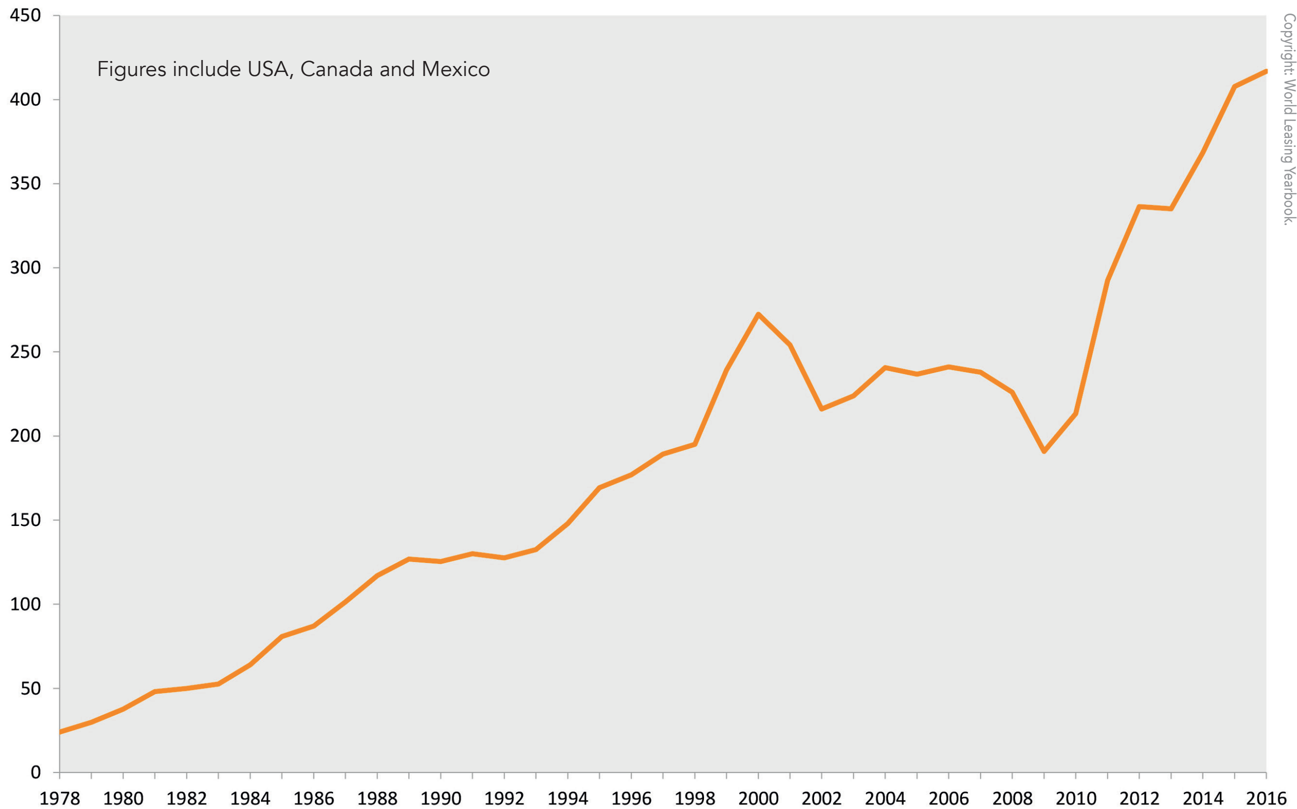
Thus, the ITC provided the US leasing industry with its first engine for growth as such major companies as General Electric Credit, CIT and Greyhound actively began to engage in tax-oriented leasing.

The next opportunity for growth materialised just a year later when the federal government ruled that national banks could engage in leasing. But AAEL members opposed the ruling, seeing it as an opening through which the camel's nose could enter the equipment-finance tent. AAEL continued its opposition until 1970, when Congress gave banks even broader powers by allowing them to form holding companies. The structure of bank holding companies enabled them to more easily participate in equipment finance and provide many of the same services offered by large finance companies.

In 1971, AAEL opened its membership to "any company in the US or Canada" engaged in the leasing of equipment to other commercial users. The Association grew quickly after that, and the complexion of the industry changed dramatically. Banks hired leasing talent and formed divisions and corporations to bring equipment finance to their customers. Banks also devised what is now the standard method for computing lease yields on a pre-tax basis after taking cash flows from tax benefits into account. Today, banks represent a major portion of Association membership and of the US equipment-finance industry.

Move forward now to the mid- to late-1970s when Congress, emboldened by new thinking that viewed regulation as burdensome to the economy, deregulated the airline, transportation and telecommunications industries. Around the same time, the Financial Accounting Standards Board adopted FAS 13 and legitimised the leveraged lease. Suddenly, opportunities in the industry seemed as plentiful as the Japanese automobiles flooding the US market. Not only had equipment finance gained respect from banks and the overall business community; it had also grown in efficiency, profitability and size as banks, manufacturers and other companies entered the industry to offer equipment financing to their customers.

To better serve the industry, AAEL began publishing what is now called the Survey of Equipment Finance Activity



*Volume includes leasing only; total U.S. equipment finance volume in 2018 is $1 trillion.

(SEFA). Providing a snapshot of the industry through member companies' accounting methods, residual valuation, financial statements and financial ratios, to name a few items, the 11-page Survey allowed industry executives to benchmark their business operations and accounting practices against those of their peers. So helpful was the information that the Survey became an annual event. Now more than 300 pages, it is conducted by one of the world's largest accounting firms. In 1978, AAEL moved from Milwaukee, Wisconsin to Arlington, Virginia and hired full-time staff.

ERTA and Safe-Harbor leasing

If new legislation and revised accounting rules brought a sheen to equipment finance in the late 1970s, the Economic Recovery Tax Act (ERTA) of 1981 gave it high lustre, temporarily, at least. Designed to lift the US out of a recession that began in 1978, ERTA increased the tax deduction allowed for equipment depreciation by assigning shorter, set timeframes to the useful life of assets. Buildings, for example, were assigned 15-year depreciation schedules. Other shorter-lived assets, meanwhile, were given three-year schedules.

The thinking was that shorter depreciation periods would lower corporate taxes and stimulate the economy when businesses invested their tax savings in capital expenditures. Instead, the national deficit sky-rocketed and interest rates rocketed above 20%. Congress subsequently "undid" most of ERTA with another tax bill in 1982 that raised taxes. But one aspect of ERTA that survived was the safe-harbor provision.

"Safe Harbor" enabled any corporation with tax liability to act as a nominal lessor and engage in sale-leaseback transactions. Both lessors and lessees benefited as lessors claimed tax credits and paid lessees for those credits, either in cash or through lowered lease payments.

Congress phased out the provision over the next several years, but in its place legalised the capital lease, also known as the finance lease. Finance leases greatly expanded the choices available through equipment finance with fixed-price purchase options that could be added to contracts. Purchase-option prices were lower than the fair-market-value purchase options available in true leases.

Finance leases also enabled the leasing of special-purpose or limited-use properties, such as amusement parks, quarries or railroads. Such leases transferred all risks and rewards of ownership to the lessee, including maintenance and income derived from the equipment or property. Finance leases were to take effect in 1984 but by then, Congress saw them as revenue-losers and postponed them for another four years. As a compromise, Congress allowed TRAC (Terminal Rental Adjustment Clause) leases for vehicles to be eligible for treatment as true leases. Lessors shook their heads to clear away the confusion. But they also agreed that the government had done little to discourage equipment financing by individuals. By this point, creative thinking and innovation were established characteristics of US equipment-finance companies, and the industry put on its thinking cap to devise new products that would provide financing to more entities in more markets.

Cross-border transactions

Taking a cue from European companies, US equipment-finance firms began offering finance leasing involving the cross-border sale-leaseback of municipal assets. Under such an arrangement, a city in Belgium might sell one of its bridges to a large US equipment-finance company. The finance company would then lease the bridge back to the city on quite reasonable terms, given the tax benefits the finance company would realise from depreciation of the asset. Then at lease end, the municipality could repurchase the bridge for less than the finance company paid for it.

Cross-border leasebacks became quite popular as municipalities received needed funds, equipment-finance companies enjoyed tax benefits, and the bridge, highway or power plant at the center of negotiations stayed right where it was and continued operations.

By 1999, however, Congress viewed cross-border leasing as questionable if not abusive and outlawed LILOs (Lease In, Lease Out), a similar but more complex financial tool. The move dampened cross-border leasing and five years later, the practice was made unprofitable by the American Jobs Creation Act of 2004.

Securitisation

But US equipment lessors, ever imaginative in the face of changing fortune, had already identified other opportunities in the securitisation of lease contracts and in the growing computer industry.

Equipment leases were among the first non-mortgage assets to be securitised in the asset-backed securities (ABS) market of the mid-1980s, and the efficacy of securitisation as a corporate finance tool led to major increases in its volume. Securities backed by equipment-lease receivables for items ranging from photocopiers to computers to fitness-center equipment were issued and sold to eager investors.

In 1994, Congress legalised the securitisation of leases to small businesses, and by 1995, GE Capital, a major participant in the securitisation market and a buyer of leasing companies, had amassed nearly US$200bn in assets to become one of the largest finance companies in the world.

One year later, the Federal Reserve reported that more than 75% of the industry's receivables were owned or securitised by the 20 largest US finance companies. Although unnamed in the report, these companies would have included not only GE Capital, but such other giants as AT&T Capital, General Motors Acceptance Corporation and IBM Credit Corporation.

Large-ticket players

Also influencing equipment finance in the 1980s and 1990s were those entities engaged in large-ticket, leveraged leasing. Because the debt portion of a leveraged lease was non-recourse to equity investors, and because the structure was typically used to finance commercial aircraft, rolling stock and other heavy-duty transportation equipment, investors were mostly big banks, such as Bank of America, Bank of New York and Wells Fargo. These banks and others pursued these transactions–with their 15- to 25-year terms–for a reasonable rate of return in deferral of their tax bill.

So widespread did this type of large-ticket leasing become that it laid a firm foundation for today's equipment-finance industry, thanks to the extensive knowledge of structured finance that it required. Additional finance companies also sprang up to service the large-ticket marketplace, buying the assets from banks at lease end.

Over time, however, changing tax laws and accounting rules made leveraged leasing unfeasible. The remaining portfolios and investors transitioned into what we now simply call large-ticket leasing and with the exception of the legacy portfolio, this business has morphed into an operating-lease business with shorter terms.

21st-Century changes

Just after the millennium, the US economy shifted again. The tragedies of September 11, 2001, stunned Americans, took some 3,000 lives and caused billions of dollars in damage to an economy already limping from recession. Less than three months later, Enron, an energy supplier and one of

the nation's largest companies, declared bankruptcy in the face of a widening probe by the US Securities and Exchange Commission. Convictions of corporate and accounting fraud, along with billions in losses experienced by Enron shareholders and employees, resulted in new federal financial regulations and heightened ethical standards at the Financial Accounting Standards Board. The ELFA went to work to strengthen communications with Capitol Hill and educate lawmakers about our industry.

First, we developed what is now known as the Monthly Leasing and Finance Index (MLFI) to communicate with our customers and the general public. We wanted to quantify what leasing does for business and show that it is an integral part of the economy in the US. Today, the MLFI is the only index that reflects capex, or the volume of commercial equipment financed in the US.

Our work with Congress paid off over the next several years as laws favoring the industry were enacted. The Graves Amendment, for example, insulates lessors of motor vehicles from state laws that impose vicarious liability on the owner for negligent acts by the operator. Major bankruptcy reform legislation enacted in 2005 also included changes that favored leasing.

By 2006, however, differences between leases and loans had narrowed so that equipment leasing companies were executing nearly as many loans as leases. Our Association changed its name from the Equipment Leasing Association to the Equipment Leasing and Finance Association (ELFA) to reflect the diversification of financial products offered by member companies. Also, in that year, Valerie Hayes Jester won election as the Association's first woman president.

Finance companies enjoyed a smooth ride for the next 18 months as business flourished and the industry grew by leaps and bounds. But what goes up must come down, and by mid-2007, Wall Street firms were reporting huge losses from subprime mortgages. Much of the rest is recent and painful history.

By October 2008, Congress had approved US$700m to rescue the US financial sector and leaders of Europe's largest economies were working on a package to shore up their own banks. By 2010, the Great Recession had ended and Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act to tighten fiduciary controls on banks.

Today's US equipment finance industry is more finely tuned than ever. Bank members now operate within stricter confines than before the recession but continue to participate and grow their roles in equipment finance. Equipment-finance companies of all types are using technology to enhance efficiency and improve the customer experience and are also implementing new procedures to comply with the lease accounting standard adopted in 2016, which eliminated off-balance sheet treatment of most lease transactions.

And, as states introduce more legislation and regulation impacting the industry – 2,000 such bills are expected from states in 2018 – ELFA works to nurture the many relationships in the US and around the world that keep our companies strong.

While the foregoing narrative is not meant to serve as an exhaustive history of the US leasing and finance industry over the past 40 years, what it does is draw attention to qualities that define the industry even to this day. Through resilience, perseverance, adaptability and fierce determination, leasing and finance practitioners overcame internal and external challenges and pressures to build the modern-day equipment finance industry, one that contributes over a trillion dollars annually to the US economy and makes it possible for businesses of all sizes and types to cost-effectively acquire productive assets.

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Ralph Petta is the President and CEO of the Equipment Leasing and Finance Association (ELFA), the premier trade association representing the $1 trillion equipment finance sector. Petta leads the organisation in executing its mission to foster business development, deliver industry information and analysis, provide educational opportunities and advocate for the industry.

He is also President of the Equipment Leasing & Finance Foundation, which is dedicated to inspiring thoughtful innovation and contributing to the betterment of the industry. Petta, an authority in the business of equipment finance, has been with the association since 1987. Before assuming the role of President and CEO in January 2016, he previously held the roles of Chief Operating Officer, Interim President and Vice President-Research & Industry Services.