Where have all my profits gone?
Common issues in pricing versus reported profits
By Bill Bosco, President, Leasing101

We in the leasing industry all try to grow our businesses and price new business to a Return on Asset (ROA) or Return on Equity (ROE) target designed to meet the financial objectives of our shareholders but things get in the way like the external market (the competition), internal organizational issues, and the complex nature of the products we offer. In the end we often do not achieve the priced returns when we look at our financial results. In this article I will examine and comment on some of the factors that affect profitability and growth. My work experience has mostly been with large bank lessors and the problems I note are more big company problems. My experience is the smaller leasing companies seem have fewer of the issues I cite.

External Factors
No matter how complex and accurate your pricing model is you still have to deal with the market. There always seems to be some competitor out there with lower rates than what you need to get to hit your return targets. There is not much one can do about the crazy competitor but wait them out, but there are some factors that they may be employing to reduce their price.

Treasury

Does the competition have a lower cost of funds? The cost of funding the business is the highest cost we have to deal with in the leasing industry. The larger the organization the more likely there is that there will be a treasury function within the organization that takes care of providing the funds to the leasing division. I have had the unfortunate experience of working for a large bank owned leasing company where during one of its organizational incantations the treasury unit was turned into a profit center run by the Investment Banking side of the business. Treasury gave the Leasing business the matched funds at a rate that perfectly matched the fixed rate deals we did and they used various funding, gapping, prepayment assumptions and hedging techniques to raise the funds they gave us. In the end they made a lot of money that was not allocated back to the individual leasing business units and the treasury staff made some hefty bonuses. The theory was they did not want the Leasing division management funding their own portfolio as they would be taking treasury risks that they were not qualified to manage. The problem with that strategy is that the Leasing division, with a high cost of funds, had to meet the competition's pricing (probably lower due to having a more rational treasury process) so they had to cut rates to win business. Which deals should they cut rates on (longer tenor vs. shorter tenor) and how much could or should they cut? By having to cut rates to win deals, in the end, the Leasing company does take treasury risk in an uneducated way.

My answer is to force treasury to manage to a zero sum target for profits. That means Treasury should be giving the Leasing division funds with a cost of funds rate equal to treasury's best guess as to what the "real" cost of funds is that they can achieve given their funding strategies and the interest rate environment at the time of funding each deal. Any treasury profit or loss that results should be allocated back to the leasing division. Under this structure the Leasing division will be more comparative with more rational pricing and theoretically the company as a whole will show greater revenue.

Tax benefits

Unfortunately in this low rate environment tax benefits are not worth as much but still cannot be ignored as a pricing tool or that they do contribute real profits.

Are competitors maximizing tax benefits? More competitors are using like-kind-exchange (LKE) to lower their cost of funds and pass some or all of the savings on to their customers through lower rates. The LKE allows them to keep the deferred tax balance by deferring payment of the tax on the gain on sale from true leases where the equipment was sold at expiry or early termination/buyout and roll the deferral into the pricing of the next lease of like equipment. It should be noted that LKE offered no benefit under the 100% bonus MACRS in effect last year as the deferred tax balance that would have been deferred was immediately offset when the 100% MACRS write off was taken. On the other hand LKE will be worth more on 100% bonus MACRS assets as they come off lease as they will all have zero tax basis and will generate more sizeable tax gains ripe for LKE deferral. There is some additional work involved to manage the LKE process but there are systems applications available to ease the operational burden.

The answer of course is to implement LKE in the business segments in your organization that have tax gains on sale of assets coming off of true leases. The major obstacles to overcome in my experience are to get senior management's attention as to the LKE benefits and to get operational and financial management to not be obstructionists and do the work needed to implement the systems changes.

If you are a captive you have the benefit of the gross profit tax deferral in true leases that qualify as sales-type leases. The gross profit is recognized for book purposes up front while the tax gain is spread over the lease term. This creates a deferred tax liability. This of course presumes the parent can use the tax benefits. The captive should also be employing a FAS 166 debt for tax off balance sheet financing strategy to maximize those tax benefits and minimize the use of their capital and balance sheet. The rules for securitization/off balance sheet transfers of financial assets have been tightened through the issuance of FAS 166.

Pricing for risk

The industry's competitive forces continue to drive down spreads. This is good if you are a lessee as the lease product has always seemed to me to be under priced for the risks. I worked for large bank lessors and always felt that the lease product was the most complex banking finance product with the tax issues, residual issues, options given to customers and complexity in the many varied structures offered by the industry. Why don't we price deals to reflect the costs and risks? It is an industry wide problem with no relief in sight.

Dealing with reality

How many times have you seen new business opportunities early in the year where management held fast on pricing only to lose, yet when that same type of business comes up in the fourth quarter, they drop rates to make budget. The lesson learned is to know the market and human nature and price deals reasonably in the beginning of the year.

Internal Factors

There are internal factors – some that can be controlled and some that can't be controlled.

Residual setting

This may be the biggest area of complaint from sales. In my experience the asset management department had too much power and their incentive was to give low residuals to create gains that they laid claim to in the bonus justification process. Often sales people had to do their own research into equipment values to fight for higher values – a waste of time.

My answer is to have the asset management people provide a recommended residual as well as a write up of factors regarding the equipment value and give the business unit management some discretion to take higher residuals. The "excess" residuals assumed should be tracked and limited using portfolio risk management and earnings-at-risk management techniques. Over time this process will prove whether it was better to take the conservative residuals with lower losses and lower revenue (from lost business) or win the additional business and have higher revenues but lower gains on sale. I favor doing more business but with lower gains on sales as it would create more revenue in the long run.

Monthly compounding

My experience is that management accounting models work on a monthly basis – that is it is assumed that you pay interest on your treasury borrowings on a monthly basis and you pay any profits monthly as a dividend to the parent. This model requires that you factor monthly compounding into the pricing of any deal where the lessee/borrower's payment frequency is non-monthly. Said another way, when you amortize income on a non-monthly deal you create a monthly amortization schedule. In each month where there is no payment you build up an interest earned not collected asset account and that adds to the assets that need to be funded and that management demands its return on the assets and return on the equity to support. This is not a problem if you discount your paper as the discounting lender matches the frequency of its loan to the frequency of your deal. If you get your funds from a treasury unit it will be a problem that you have to factor into your pricing. Tax lease pricing models like SuperTrump adjust for this issue so the issue is a loan or non-tax lease pricing issue. The following table illustrates the problem (results are more significant in higher interest rate environments):

Payment Frequency	Deal rate	Monthly equivalent	Shortfall
Annual	7%	6.78%	0.22%
Semi-annual	7%	6.90%	0.10%
Quarterly	7%%	6.96%	0.04%

MISF yield vs. ROA tax lease pricing

I continue to mention this issue that there is a disconnect between MISF yield and ROA and many lessors use the MISF yield as opposed to ROA as their tax lease pricing model. The problem is that MISF yield is the yield on the net cash invested in a deal – not the yield on the GAAP asset or the GAAP equity in the deal. The difference in yield/spread between MISF and ROA pricing can be as much as 170 basis points! The fact is many lessors use a MISF yield pricing model so their GAAP returns are less than priced returns. Many lessors also use the MISF yield pricing to pay commissions which is a double whammy – paying for spreads that aren't there! It should be noted that the ROA pricing model that I feel best measures the return on a deal includes the use of present valuing to get the weighted average ROA. This is necessary to reflect the uneven returns in accounting for true leases. I have to say that in reality we all know that the market is the main driver in pricing but we should not be fooled into thinking our priced returns on an MISF basis are the returns that Wall Street measures our companies by. You may not win as many deals if you price using ROA but at least you know what your returns really are.

Tax benefits

When you price in tax benefits in a deal it means you have reduced the deal's yield so therefore you must get the tax benefits reflected in your management accounting if you are to achieve the returns you priced. That seems to be something that does not need to be said as it is such a basic concept in our industry. We have access to wonderful lease accounting systems that can track so many things – why is this still an issue that gets discussed by CFOs at industry conferences? Specifically the issues are getting credit for deferred tax balances, tax credits and tax exempt income.

For the accurate reflection of deferred tax balances, what needs to be done is to have deal by deal deferred tax accounting so that the right accounting entry is made and it flows into the management accounting report for the business as a free source of funds. The proper accounting and mapping of the liability is usually the responsibility for the accounting/financial reporting department. One of the most common issues I have seen is poor tax data (no MACRS depreciation tracked) in the lease accounting system and lack of understanding of the details of pricing, tax benefits and tax accounting. Sometimes the deferred tax entries are made at the "top level" in the organization so that the leasing businesses units don't get the correct credit. The other issue is at what interest rate does the leasing business unit get credit for from the tax balances. In fact the organization gets an interest free source of funds from the US Treasury through the deferral of tax payments. In many cases the credit given to the leasing business by the Treasury unit is at a "transfer pool" borrowing rate, that is, a short term floating rate. Since the tax balances are long term liabilities (you can easily calculate the tax balances over the term of each lease) the credit should be given to the leasing business unit at the incremental borrowing rate in effect in the month of booking of the tax lease. This makes a difference that could be large depending on the steepness of the yield curve. What do you do about this issue? I say you dig into the process with the accounting and treasury departments to see whether you have an issue regarding getting full credit for deferred tax balances and if there are significant issues make sure they fix it!

For tax credits and tax exempt deals the issue is getting the reduced tax expense reflected in your management accounting report. Often management accounting systems do not take the tax expense from the GAAP books, instead they calculate taxes on income for the business unit at an average rate given by the parent's tax and accounting departments and plug it into the management accounting P&L. There have to be adjustments made to reflect the tax benefits of tax credits in income and tax exempt interest in income. The tax credits and tax exempt income are usually booked to separate P&L accounts. These accounts need to be identified as tax free in the management accounting system. Tax credits need special attention as they could either be amortized as a lease revenue item or credited to tax expense for GAAP accounting. If they are credited to tax expense I would recommend the account be mapped to a revenue line for management accounting. There are two ways to reflect the tax benefits. One way is to gross up the tax free income to its re tax equivalent (be sure to use that tax rate used for management accounting). The second way is to reduce tax expense for the tax effect. I recommend the gross up method as it results in the correct measurement of the spreads in the tax deals.

The handling of tax balances with your parent company is another issue in getting credit for the deferred tax liabilities as an interest free source of funds in the management accounting reports for the leasing business. Do you have a tax allocation agreement between the leasing company and the parent? This deals with paying your current tax liability to the parent and also the parent paying the leasing company if the current tax balance is a receivable. This happens when the true leasing activities shelter more than the taxable income of the leasing company. What you don't want is a current tax receivable that counts as an asset and a use of funds, dragging down ROAs of the leasing company. Current tax liability/receivables are really an intercompany account that should be ignored for management accounting purposes. The ideal situation is where the leasing company reports a large deferred tax balance and little or no current tax asset or liability. The whole area of tax balances is not an issue for other financial products or divisions within a bank or finance company so there may be no special process to help get the financials "right" for the leasing company.

Operating losses

As I explained above, the leasing industry's pricing has historically been very tight yet the product is operationally complex. With low spreads we cannot afford to mishandle a deal. In my big bank lessor experience, I have seen operational problems in the areas of cash application and taxes. The opportunity for errors increases if the management philosophy of your parent is to break up the leasing company processes into functions or "silos" – that is to have operations functions performed in separate "functional" organizations not controlled by the leasing division management. The problem that I have seen when the cash applications function is handled this way is that cash is more prone to be misapplied. Often the centralized cash department loses touch with the business and the customer – they lack ownership in the process. Their goal emphasis consciously or unconsciously is to process cash as fast as possible rather than to do the job accurately. The complexities in leases that are not present in other bank products like credit cards and personal loans is that lease billings include many more items (sales/rental tax, property tax, fees, maintenance, etc) and often customers have multiple schedules. This makes the cash application process more complex. Cash can be applied to the wrong schedule or cash can be applied to the wrong item (meaning rent, taxes, etc.) Errors in cash applications means accounts go into the collections process which results in high overhead costs. The accounts then require reconciliation and adjustments – more costs. The ultimate cost is loss of relationships. I have seen vendor and dealer relationships lost due to the failure to process cash because their customers complain.

The other operational area with risk is state and local taxes. You need experienced lease tax supervision in this area. When taxes are not paid or billed properly you often cannot collect from the customer. Tax problems usually take a while to discover and the accumulated deficiency is often large enough to create a collection problem even if the customer knows it owes the amount.

The answer to operational problems is to avoid the "silo" or functional management style so that the operations are part of the business, managed by experienced leasing people and closer to the customer. If you can't change the silo management style then leasing business management has to work hard on internal communications to make the functionalized units feel like part of the business and act like a team.

Allocations

Bigger is usually not better when it comes to cost allocations. When the leasing company is part of a larger organization, the overhead cost allocations are often the difference between making a profit or not. I saw a private equity firm buy a business from a large leasing company. The business made money except for allocations and the leasing company was happy to sell it. The private equity company had little overhead and its strategy was to leave the company as is –

earning a good ROE without allocations. Allocations are one of those problems that you should always complain about but will probably not get any relief.

Growth

Growth is a priority for all businesses. Through growth we can reduce the basis points in fixed costs that eat into our spreads. Growth in new products, markets and businesses means better spreads and more revenue. Sometimes organizations say they want growth but are not organized or managed to enable growth. In fact some unknowingly or unconsciously stifle growth. Not having common goals for all departments/silos is a growth inhibiting issue. As an example, the credit department should have new business and new product development as a shared goal with management, sales and marketing. Instead they often will not allow anything new to happen through paralysis by analysis followed by rejection. They have little incentive to take an aggressive position. You don't get fired for write offs in deals you don't approve. Compliance is the latest growth industry whose mission is often perverted into such conservative stances as to hurt new business and new profit initiatives. The compliance department is criticized when there is a problem so it also has no upside in being in favor of new initiatives. The same goes for operations where some view new initiatives as just more work instead of as an opportunity. Many of the support businesses have the power to prevent things from happening.

What is the answer to creating a growth oriented organization? First you have to do the math to figure out how much business you have to do to replace runoff and achieve the growth target. Then you have to insure you have the all the disciplines' goals aligned. You have to create a pro-growth attitude in the business. You have to have competent, creative, results oriented staff. You have to keep existing customers. You have to replace runoff. You have to hustle to increase business either from an expanding economy, by taking business from the competition or by coming up with the new initiatives that create new sources of revenue. Not very easy!

I hope you don't have many or any of the issues I discussed. If you do, good luck fighting for what is right!

About the Author:
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