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SVO Research

Chapter 11 for Nations?

*By Jennifer Brett, SVO Associate Credit Analyst and
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In a bid to reform the international financial architecture, the International Monetary Fund (IMF) has proposed that a bankruptcy tribunal be created to preside over sovereign defaults. The plan would allow for majority voting on restructuring terms and protect nations from creditor lawsuits. Over the last twenty years, the market for sovereign finance lending has shifted, particularly for developing economies, from a highly concentrated bank loan market to the much broader bond markets. This transition has made it much more difficult for distressed sovereigns to coordinate workouts and restructurings; this bankruptcy tribunal proposal is an attempt to address these difficulties. As an active part of the institutional investment market, this controversial proposal could have an impact on U.S. insurers who hold around \$31 billion in fair value as of year-end 2001 in sovereign debt.¹

■ What is the proposal?²

The proposed IMF mechanism is a framework for restructuring sovereign debt. The IMF outlined four core features of a Sovereign Debt Restructuring Mechanism (SDRM):

1. Majority restructuring provisions would enable a specified majority of creditors to make decisions binding on all creditors. Creditor claims would be aggregated across different types of debt instruments, similar to domestic insolvency laws. Certain international bonds already contain this element in the form of Collective Action Clauses (CACs). The intent of majority action is to prevent a dissenting minority from disrupting negotiations.
2. Following a suspension of payments, a nation with an unsustainable debt burden could request a temporary stay on creditor litigation. Activation of the stay should be conditional upon IMF endorsement since, according to the Fund, it can best decide whether a debt burden is truly unsustainable. An alternative is for bondholders to vote on granting a stay.
3. A system of supervision and incentives would protect creditor interests during the process. Conditioning of additional Fund resources on the adoption of appropriate policies would incentivize a country to cooperate with creditors. The IMF could supervise a nation's behavior toward creditors. For example, a sovereign might be prohibited from making payments to non-priority creditors.

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¹ NAIC, 2001 Life and Property/Casualty Annual Statements, Schedule D.

² This section is based on Krueger, Anne O., "A New Approach To Sovereign Debt Restructuring," International Monetary Fund, 2002.

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From the Director

By Chris Evangel, SVO Managing Director

Quite often I will undertake the duty to write a short article to reflect some thoughts from the SVO's Managing Director. However, undertaking this assignment and perhaps after having organized those thoughts and perhaps even completing a draft, events of the day negate any prior commentary.

The recent events I refer to stems from the stock price collapse of WorldCom, Inc. and the potential ramifications. Many investors, either individual or institutions, may have expressed a sigh of relief that their portfolios did not contain any WorldCom holdings. These investors having either the foresight, or luck, of not holding any WorldCom holdings may be feeling quite good about their financial prowess. In fact, these investors may have been so savvy that they never held, or sold in a timely manner, the other name entities experiencing similar market value meltdowns.

Unfortunately, the story does not end there. What we are discovering are the knock-off effects of these financial failures. We now know others have or soon will be impacted by these events. Suppliers will see past orders go unpaid with future orders cut, office complexes may witness these companies exit their facilities, and company employees may lose their jobs. Investors, consisting of debt and equity holders, could, and probably will, lose substantial amounts. Many of these investors continue to be highlighted in business stories with their losses mounting. Even within the insurance companies' financial holdings, many companies will never recover much of their investment.

While we should currently be familiar with the investors and their losses, there lurks a "victim" I have not heard much concern over—the future treasuries of our national

and state governments. Without regard in discussing the merits, the U.S. tax code allows taxpayers to offset capital losses with capital gains. Can you venture a guess who will potentially claim a capital loss from their investment decisions? The real question is not who will claim the capital loss but when will that claim be made to offset a capital gain. As you may also know, if that investment loss cannot qualify as a capital loss due to holding duration, then that loss will likely be an income loss which would offset income earned. Furthermore, the ultimate claim will be difficult to calculate since an investor's initial investment serves as the benchmark. For example, the WorldCom equity investor with the purchase of that stock at \$60 per share may claim the entire loss when they decide to sell at the current price of a quarter.

Those states with tax systems that closely mirror the federal tax system may experience future revenues below expectations. Since the decision of when to exercise this claim rests with the investor, the predictability of these offsets to other gains could hamper future government revenue flows. The magnitude of the revenue loss could be staggering, particularly when one considers that the reported losses of the entire NASDA alone will exceed \$2.7 trillion. I was just getting comfortable with billions but trillions is when one should pause and say is it even possible to have that many dollars.

If one asks will this financial market downdraft stop, the answer is yes. However, the losses are here to stay, particularly since some of these investments are no longer viable and/or the investor may no longer want to retain these holding in the hope of a recover. Therefore, over the near-term, it may be more wishful thinking in believing the recover of government revenues will track the economic recovery. In fact, those government revenues dependent on capital gains could lag and revenue growth may need to be achieved from other revenue streams.

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4. Funds lent to the nation after enactment of the stay would be senior to all pre-petition private claims. The seniority of new financing, contingent upon approval by a majority of creditors, would encourage new lending, limiting the economic consequences of a default.

■ Background on Sovereign Debt Crises

In the 1980s, the governments of several developing countries found themselves lacking sufficient funds to cover loan payments. The ensuing crises led to restructurings of the distressed sovereign debt. At the time, the vast majority of borrowing was in the form of loans made by a handful of large commercial banks. It is important to note that incentives were in place to encourage cooperation among these institutions during the lengthy process. Creditor committees successfully negotiated new terms for the loans and, with the help of regulators, were able to pressure fellow creditors to cooperate by accepting the conditions of the restructurings. The particular terms of the original lending agreements also minimized incentives for holdout creditors to pursue litigation, as any proceeds would have been divided among all creditors.

Since then, sovereigns have increasingly relied on bond issuance for debt financing rather than borrowing from large institutional lenders. These securities are more liquid than bank facilities and are traded in the secondary market among a larger number of participants. As the number of creditors has increased, it has become more difficult to coordinate any type of rescheduling or restructuring of the sovereign debtor's obligations.³ Governments nowadays have vast numbers of individual fixed-income investors, many of which are foreign lenders, as international capital flows have evolved. Investors, academics and public sector officials all agree that coordinating large numbers of bond investors across creditor classes is a virtually unmanageable task.

■ Exchange Offers

As a result, sovereigns have sought out alternatives to creditor committees to restructure their outstanding debt. Currently, when a state faces a liquidity crisis, it has the option of putting forth a voluntary exchange offer. By doing so, the sovereign hopes creditors will accept new restructured bonds in exchange for the old bonds that it can no longer service. The new bonds usually contain some sort of rescheduling or restructuring such as reduced interest or principal payments, or longer maturities. Pushing the payment schedule out or reducing the nominal amount of the payments is intended to alleviate the credit crunch. One incentive for creditors to accept these less favorable terms is that the likelihood of repayment increases as a result of the restructuring. In

essence, the sovereign informs its major bondholders that they can either accept the new securities or the government will be forced to suspend payment.

However, in many cases there is no way to force individual creditors to accept the new terms, even if the sovereign is able to convince the majority of investors to participate in the exchange offer. Holdout creditors retain all of their legal rights to payments as defined in the original agreement.⁴

■ Holdout Creditors

Further complicating matters is the fact that some creditors might not be willing to relinquish their contractual rights. These holdout creditors can refuse to participate in the restructuring and/or accept a rescheduling of debt. Rather, they demand payment according to the terms set forth in the original bond.

The situation has been exacerbated by the aggressive legal strategies employed by so-called "vulture funds," which buy distressed sovereign debt on the secondary market and then sue for contractual interest and principal payments. The case of Peru's debt restructuring illustrates the litigious holdout creditor problem to date, a problem IMF First Deputy Managing Director Anne Krueger summarized in a speech given last November:

In 1997 Elliot Associates bought \$20m of commercial loans guaranteed by Peru. Rather than accepting the Brady bonds offered when Peru tried to restructure its debt, Elliot demanded full repayment and interest. In June 2000 it obtained a judgment for \$56m and an attachment order against Peruvian assets used for commercial activity in the U.S. Elliot targeted the interest payments that Peru was due to pay to its Brady bondholders who had agreed to do the restructuring. Rather than be pushed into default on its Brady bonds, Peru settled.⁵

As this example demonstrates, "rogue" creditors, paradoxically, can profit from the forbearance of cooperative creditors. Elliot gained at the expense of the investors who were willing to work with the Peruvian government and accept new securities in order to allow the Peruvian government to remain liquid.

■ N.Y. and English Law

Central to the holdout creditor problem is the question of jurisdiction. As a matter of practice, the governing law

³ "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring" Address by Anne Krueger, First Deputy Managing Director, Economists' Club Annual Members' Dinner, 11/26/01.

⁴ "Sovereign Debt: What Happens If a Sovereign Defaults," Moody's Investors Service, July 2000.

⁵ "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring" Address by Anne Krueger, First Deputy Managing Director, Economists' Club Annual Members' Dinner, 11/26/01.

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often determines whether or not creditors may vote to alter the payment terms of the bond. Either English or New York law governs most sovereign bonds (a study by Deutsche Bank found that English law governs 25% of Eurobonds while the rest are governed by New York law⁶). Under English law, any provisions, including terms of payment, can be changed via supermajority vote (usually 66⅔% or 75%).⁷ A majority of creditors can impose a restructuring on the holdout creditor, which eliminates the holdout's ability to disrupt the process.

Bonds governed by New York law, on the other hand, have a unanimity requirement.⁸ Payment terms of the lending agreement cannot be changed unless 100% of bondholders agree to the new arrangement. Recalcitrant creditors are a constant threat to orderly restructurings involving these bonds, as obtaining unanimous approval can be a nearly impossible feat. If the country fails to pay the holdout owning some of the original bonds, a lawsuit can be initiated on the basis of breach of contract. In the absence of a bankruptcy court's protection, the debtor has an obligation to service its debt if the creditor does not voluntarily abdicate his or her rights.

Although most bonds issued under New York law contain the unanimity requirement, there is no statutory restriction precluding the use of English-style supermajority clauses in New York lending agreements.

■ Exit Consents

Some observers of the international credit market have suggested that the use of "exit consents" could solve the holdout creditor problem.⁹ Although the unanimity requirement of New York bonds prohibits any changes to be made to the terms of payment, certain clauses may be altered with the approval of a specified majority of bondholders. The threshold for collective action is sometime set as low as fifty percent.¹⁰ The desired effect is to provide a disincentive to holdouts. At this point, the interests of the majority of creditors align with those of the debtor nation in that they want to force holdout creditors to agree to the exchange offer.

After the details of the debt restructuring are negotiated, creditors exchange their old bonds for new issues. As the exchange is taking place, creditors agree to alter certain clauses of the original bonds to make them less attractive. The old bonds might be de-listed from the exchange on which they trade, making them illiquid, or have the waiver of sovereign immunity removed.

In looking for anecdotal support for this process, in the corporate context, exit consents have successfully "coerced" unwilling creditors to accept an exchange offer.

U.S. courts have upheld this as a legal tool for a corporation trying to protect its viability.¹¹ Exit consents enforce cooperation among dissident creditors, but only if the holdout creditors are not litigious in nature. Exit consents are not likely to discourage aggressive investors like Elliot Associates, who buy distressed debt with a lawsuit in mind. These investors can exploit the lack of collective action clause of New York governed bonds by buying defaulted sovereign debt for cents on the dollar on the secondary market and using the threat of litigation to win a settlement.

■ Potential benefits of the SDRM

Critics argue that a major shortcoming of the management of sovereign debt crises thus far has been the use of public sector bailouts. It is thought that these packages have the unintentional effect of using public funds to bail out private lenders. Following this logic, if the lenders are not made to face the negative consequences of their risky investments, they could conceivably begin to engage in reckless sovereign investment practices, leading to more frequent and severe debt crises in the future. This problem is commonly referred to as moral hazard. It is perceived that, in a bailout scenario, private investors essentially receive a transfer of wealth from the taxpayers of IMF member countries while those living in highly indebted countries are left to pay the price in the form of painful IMF-prescribed fiscal austerity and institutional reform programs.¹²

In the case of Argentina, the market viewed default as inevitable long before the government actually ceased payments. In the interim, a politically palatable solution to the debt overhang was not found. Anne Krueger argues that had the SDRM been in place at the time, the Argentine government could have averted political and economic ruin by filing for a stay while it secured debtor-in-possession financing and created a plan for economic recovery. The IMF's aim is to find a way to encourage governments to deal with unsustainable debt levels before bad situations become crises.

Jeffrey Sachs, an internationally recognized economist, argues that what he refers to as an International Debt Facility (IDF), the conceptual forefather of the IMF's proposal, would benefit creditors and debtors by

⁶ Petas & Rahman, "Sovereign Bonds — Legal Aspects that Affect Default and Recovery," Deutsche Bank, Global Emerging Markets, May 1999.

⁷ "Sovereign Restructuring: Putting Too Much Faith in Exit Consents" Moody's Investors Services, March 2001.

⁸ *ibid.*

⁹ Bucheit & Gulati, "Exit Consents in Sovereign Bond Exchanges," UCLA Law Review, October 2000.

¹⁰ "Sovereign Restructuring: Putting Too Much Faith in Exit Consents" Moody's Investors Services, March 2001.

¹¹ *ibid.*

¹² Sachs, "A Strategy for Efficient Debt Reduction," The Journal of Economic Perspectives, Winter 1990.

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“providing the necessary institutional framework for debt reduction.”¹³ He writes that it is in the interest of creditors to make concessions to heavily indebted sovereigns because the resulting improvement in the debtor’s economic performance would actually increase the value of future payments. In order for debt reduction to be achieved, Sachs explains:

Debt reduction, like bankruptcy, needs an institutional setting to bring it about to overcome an inherent free-rider problem. Even when it is in the collective interests of the banks to reduce debt, each individual bank is still tempted to insist on full repayment of its own claims, while free riding on concessions made to the debtor by the other banks.¹⁴

Sachs goes on to dismiss proposals calling for a voluntary scheme for debt reduction. He says, “Such voluntary schemes are doomed to failure, as would be the notion of ‘voluntary’ bankruptcy in a setting with a large number of creditors.”¹⁵

According to Sachs, a legal bankruptcy regime would obviate the need for IMF bailouts. Debtor-in-possession financing is a mechanism that provides a way for bankrupt entities to obtain working capital under the U.S. Bankruptcy Code. In the absence of such an arrangement, which legally grants priority to the claims of investors willing to extend credit during reorganization, lenders would be unwilling to grant loans, given the enormous credit risk. “...As the bankruptcy law shows, you do not necessarily need a lender of last resort, you need a legal regime in order to get working capital in such circumstances.”¹⁶

The IMF makes the case that such a scheme would benefit creditors as well as debtors. Ms. Krueger supports her argument by pointing out that a bankruptcy regime would benefit creditors by ensuring that restructuring was equitable for all creditors in each class. Furthermore, she envisions a system which prevents “cash grab” scenarios in which creditors race to be the first to collect on claims, leaving little in the way of assets to satisfy the claims of other lenders. Another way that creditors may gain from the plan is by minimizing the price volatility of distressed sovereign debt associated with disorderly restructurings. According to those in the reform camp, it would be in the interest of investors who mark-to-market to have a formal system that would help to stabilize the price of their investments on the secondary market. Insurance companies, for example, must carry distressed investments at market as opposed to amortized value. Sachs also points out that creditors would gain from a formal structure, as the value of the lenders’ claims

actually rises as the short-term liquidity crisis is alleviated.

■ Criticism of the SDRM

In an open letter to the IMF, a collective of creditor groups voiced their opposition to the plan, labeling it “a step backward in the area of crisis resolution.”¹⁷ Some in the private sector fear the plan will shift the balance of power to debtors at the expense of creditor rights.¹⁸ Under the plan, the debtor is expected to act in good faith and follow sound fiscal and monetary policies during the restructuring. In exchange for this promise, investors forgo their right to sue a sovereign in case of default. Considering that politicians would be responsible for maintaining this pledge in a time of domestic crisis, some bondholders do not consider this promise to be worth the price of abdicating their contractual rights. The supervision of international monitors is apparently of little solace. The concern might be that sovereign bankruptcy rules would resemble Chapter 9 of the U.S. bankruptcy code, which governs municipalities. In Chapter 9, the debtor has much more control over the process than do corporations in Chapter 11 because of concerns about infringing upon the sovereignty of governments.

Issues of moral hazard do arise; making default a less painful experience might encourage nations to pursue risky economic policies, according to critics. Because of this, market participants expect that enactment of the plan will raise risk premiums for less developed countries.¹⁹ Brazil’s Finance Minister has objected to the plan on the grounds that his country’s price of financing will rise. Indeed, an empirical study of bonds found that the inclusion of collective action clauses alone tends to slightly raise borrowing costs for poorly rated nations.²⁰ If an entire bankruptcy procedure was in place, some expect the market to demand higher spreads to compensate for the increased risk of default.

Another contentious issue is choosing who would operate the mechanism. Ms. Krueger nominated the IMF for this role. Skeptics question whether the Fund, a major lender to heavily indebted nations, could be expected to be impartial. As American Treasury Secretary Paul O’Neill put it, “I don’t think the IMF can be both the judge and the jury.”

¹³ *ibid.*

¹⁴ *ibid.*

¹⁵ *ibid.*

¹⁶ *ibid.*

¹⁷ EMTA, SIA, IPMA, and TBMA Issue Joint Letter Criticizing IMF’s Proposed New Approach to Sovereign Debt Crisis Resolutions.

¹⁸ The IMF’s Sovereign Bankruptcy Proposal and the Quest for More Orderly Sovereign Work-Outs—Remarks by EMTA Executive Director Michael M. Chamberlin.

¹⁹ “Wall Street Showing Resistance to IMF Bankruptcy Plan,” Dow Jones Capital Markets Report, 12/31/01.

²⁰ Eichengreen and Mody, “Would Collective Action Causes Raise Borrowing Costs? An Update and Additional Results,” May 2000.

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There is a wide current of sentiment that the Fund should not assume additional responsibility in the arena of international finance, but that is beyond the scope of this article.²¹

Although the authors are not expert in matters of law, the legal complexities of implementing the tribunal seem challenging. In order to stop holdout creditors, universal legal acceptance would be needed. Otherwise, a creditor could theoretically “shop” for the jurisdiction that allows them to sue depending on what form the SDRM takes. The IMF suggests that universal treaty obligations through the amendment of its Articles of Agreement could lead to a single international judicial entity that would have jurisdiction over all debtor and creditor disputes.²² Internal IMF policy requires any change to the Articles to be approved by 85 percent of its membership. The United States currently has veto power by virtue of its 17 percent share of voting power.²³

■ Factors affecting the success of the SDRM

A critical factor in the success of the proposal is the degree of U.S. Treasury support. The Bush administration’s overall policy toward the Fund has been to encourage the Fund to limit its role to detecting debt crises and advising troubled countries on their economic, monetary and fiscal policies.²⁴ This scaling-down of Fund activities conflicts with the SDRM’s broader role for the IMF. Since the Treasury does consider adding stability to the world financial system as a worthy goal, a resolution of some kind is possible. One potential solution might be for the plan to be amended so that the IMF is not its administrator. Choosing an alternative, however, will be contentious considering the power vested in the mechanism’s operator. [In a gesture to compromise, Ms. Krueger recently suggested that an IMF-approved committee be in charge of administration.]²⁵

Under the Clinton administration, the U.S. Treasury expressed a commitment to maintaining contract rights and unwillingness to “protect countries that run into difficulty from legal action.”²⁶ Today’s Treasury is generally supportive of IMF efforts to bring order to debt restructurings, but considers using collective action clauses a more practical alternative.²⁷ Given the amount of resistance shown by the private sector in these early stages, it is not hard to imagine that creditor groups will increase lobbying efforts against the plan prior to it becoming reality.

When officials from the Group of 7 nations met in Washington in April, all members supported the U.S.

proposal that developing nations include collective action clauses in their future lending agreements. The IMF views this as progress and has been trying to dispel the notion their statutory solution and CACs are mutually exclusive. On the contrary, IMF officials have been emphasizing their view that the two strategies are complementary in nature. Ms. Krueger and her colleagues are trying to maintain momentum by supporting the American proposal as a step in the right direction, but they make the case that, in order to efficiently handle the restructuring of debt across national borders and creditor classes, a contractual approach will prove insufficient in the end. A major problem with the contractual approach is that it will force debtors to renegotiate each of its contracts independently, whereas a statutory solution would simplify the process by aggregating the claims of each class of lenders.

■ Conclusion

It would seem that the IMF has made significant progress in its agenda to act as a catalyst for reform. When Ms. Krueger made her first speech advocating a bankruptcy mechanism last fall, investors protested loudly. However, as the situation in Argentina has relentlessly deteriorated, the rhetoric has shifted. The debate no longer seems to be whether or not the time has come to redesign the system, but which methods are the most practical, efficient and equitable.

Clearly, there is a widespread sentiment that international financial institutions (and the governments that support them) have not been adept at resolving financial shocks in recent years. The current “case by case” approach lacks predictability for both debtors and investors. The question then becomes one of how much tolerance the global bond markets have for this uncertainty before some fundamental change to the international financial architecture is demanded. Until the day that the relevant powers consider the benefits of predictability in crises to be greater than the costs of creditor rights, crises will continue to arise much like the ones we have already experienced.

²¹ Portes, “Sovereign Debt Restructuring: The Role of Institutions for Collective Action,” March 2000.

²² Krueger, Anne O., “A New Approach to Debt Restructuring,” International Monetary Fund, 2002.

²³ <http://www.imf.org>.

²⁴ “Statement of John B. Taylor, Undersecretary of the Treasury for International Affairs before the Senate Banking Subcommittee on International Trade and Finance, February 28, 2002.

²⁵ “Sovereign Debt Restructuring and Dispute Resolution,” Address by Anne Krueger, First Deputy Managing Director, Bretton Woods Committee Annual Meeting, 6/6/02.

²⁶ Treasury Undersecretary for International Affairs Timothy F. Geithner, Remarks before the Securities Industry Association and Emerging Markets Trade Association, October 23, 2000.

²⁷ Testimony of John B. Taylor Undersecretary of the Treasury for International Affairs before the Joint Economic Committee, February 14, 2002.

Synthetic Leases

By John Yazzo, SVO Credit Analyst

■ Introduction

Synthetic leases, one variety of off-balance sheet loans, have been a source of real estate finance for over a decade. Bloomberg L.P. estimates that about \$100 billion of real property has been financed this way; these properties range from corporate headquarters to retail stores to railcars and more. More than 2,000 companies including Cisco Systems, Inc., Microsoft Corporation, and AOL Time Warner Inc., among others, use synthetic leases.¹

As yet another consequence of the Enron situation, the use of synthetic leases has been under recent scrutiny by the investment community, the rating agencies, and the Financial Accounting and Standards Board (FASB). New guidelines have recently been developed and more are in process that, taken together, will alter substantially the way in which these vehicles are reported. Additionally, several corporations have recently announced that some planned synthetic leases have been cancelled.

This article provides a background on the development and use of synthetic leases. In addition, recent developments in FASB guidance regarding synthetic leases are reviewed, and the SVO's analytical approach to providing credit analysis of synthetic leases is described.

■ Background

Simply put, a synthetic lease is an "off-balance-sheet" transaction that allows a corporation to control a real property without having to report it as an asset on its financial statements. Synthetic leases have been in existence since the 1980s when they were developed to finance equipment such as aircraft, railcars and cargo vessels. They became very popular in the early 1990s as a result of changes in FASB accounting guidance put into effect in 1990.

Using a synthetic lease to finance a property allows a company to deduct interest payments and depreciation of the property's value on its taxes. For accounting purposes, the arrangement is treated as a standard operating lease and keeps the property and the debt off the company's balance sheet. Synthetic leasing expanded dramatically in the late 1990s as a source of relatively inexpensive financing.

■ Creating a Synthetic Lease

In a typical synthetic lease arrangement, the lessee (e.g. the company acquiring the real property) creates a special purpose entity (SPE), usually with the help of a financial institution (Citibank Inc. and Bank of America Corporation are major facilitators in this market) or other capital source.

Figure 1. Example of a Synthetic Lease Transaction

XYZ Corporation

Amount: \$18,500,000

Lessee: XYZ Corporation

Lessor/Agent: State Street Bank and Trust Company of Connecticut

Lessee Rating: S&P BBB and NAIC 2

CUSIP/PPN: *****

Coupon Rate: 6.96%

Rental Payments: Semi-annual

Amortization: \$9,109,272 balloon payment

Maturity: March 30, 2014

Collateral: Railcars

Credit Support: None

TRANSACTION:

XYZ Corp. transfers and assigns title of railcars to State Street Bank and Trust Company of Connecticut — not in its individual capacity, but solely as an Agent under a Time Charter Intended As Security. State Street Bank issues \$18,500,000 of securities (Lease Intended as Securities) to several investors. The proceeds are used for the purpose of purchasing the railcars for XYZ Corporation.

TERMS:

The lease has a fifteen-year term comprised of a five-year base term followed by a one-year renewal option for ten years. At the end of the base term or any exercised renewal term, XYZ has the option to: 1) renew the lease for one year; 2) purchase the equipment for the outstanding lease balance; or 3) notify the lessor to sell the equipment to an unrelated third party. If XYZ Corp. elects the sell option, cash proceeds for the sale (from the sell of the equipment) will be used to repay the outstanding lease balance. In the event that the proceeds from the sale of the equipment are less than the outstanding lease balance, XYZ will pay a supplemental rent. However, the combination of sales proceeds and supplemental rent from XYZ will be limited to approximately 81% of the balance due. The investors will have a potential residual risk of approximately 19% of the balloon payment.

The SPE funds the new construction or real estate purchase, then acts as a landlord and leases back to the company. Funds for the financing come from a minor equity investment (at least 3%, usually put up by a related party) and notes issued in the financial markets by the SPE. The SPE then leases the property back to the lessee company, usually for an initial term of 5 to 7 years. The lease payments are generally not fixed, but variable, usually at LIBOR plus some margin (LIBOR is the London Interbank Offering Rate).²

Common synthetic lease arrangements allow the lessee to purchase the property at any time under the lease, or to terminate the lease by making a termination payment devised by some predetermined rules. At the end of the initial term the lessee usually has three options: (1) re-lease

¹ "FASB Change May Add \$100 Billion Debt to Books," Bloomberg.com, 02/27/2002.

² www.ssectech.com/e-news/astmgt/2002/02.15/enevslms.html

Synthetic Leases (Continued)

the asset for 1 year, (2) buy the asset for the remaining balance, or (3) instruct the lessor (SPE) to sell the asset.

Figure 1 on page 7 provides one example of the many variations of a synthetic lease. In this example, rather than an SPE the lessee is using a bank as the lease agent under a time charter intended as security to finance railcars. The bank issues \$18.5 billion of securities to finance the acquisition. The lease has a fifteen-year term, with an initial five-year base term followed by one-year renewal options. At the end of the base or any renewal term, the lessee has the option to renew for 1 year, purchase the railcars for the outstanding lease balance or notify the lessor (the bank) to sell the equipment.

■ Analysis of Companies Using Synthetic Leases

Under recent accounting policies, the property secured by the synthetic lease does not appear on the balance sheet other than as a footnote. Most companies that use these leases describe the arrangements, albeit in varying levels of detail, in these footnotes.

The major credit rating agencies take the leases into account in assessing companies credit worthiness, so for the lessee companies, the impact of any synthetic lease financing is incorporated into their ratings.

■ Analysis of the Notes used in Synthetic Leasing

U.S. insurance companies, as a vital component of the institutional investment market, purchase the notes created by the SPEs in these synthetic lease mechanisms. As such, these securities are filed with the Securities Valuation Office (SVO) for designation purposes. These leases flow to the analysts at the SVO based on the underlying industry SIC codes; synthetic leases are not considered a separate asset class. This workflow, coupled with the fact that a number of these are private placement securities, make it difficult to estimate the extent of the insurance industry's investment in synthetic leases.

As the appropriate SVO credit analyst analyzes these securities, these notes are reviewed not only for credit quality but also for their "fit" with the regulatory guidelines for debt and equity as provided by the SVO *Purposes and Procedures Manual*. Each note filed is considered on its own merits and based on the unique features of the particular note and lease structure.

Some synthetic leases filed for designation with the SVO have been classified as common equity. This classification

arises because, as in the above example, the lessee could choose the asset sales option. If this option is chosen and the proceeds are insufficient to cover the outstanding lease balance, the note holders are exposed to a residual risk at the end of the lease. Part 7, Section (3)(d) of the SVO *Purposes and Procedures Manual* provides guidance that any investments that are not protected as to return of principal are to be considered equity.

Other synthetic leases have received debt treatment as a result of a credit enhancement, such as a Letter of Credit or Residual Value Insurance, that mitigates this residual risk. Other transactions have separated the notes into two tranches, to isolate this residual risk. The senior tranche without the residual risk should receive debt treatment and a designation commensurate with its level of credit risk.

■ Current Activity

As the events surrounding the Enron debacle began to unfold, the public spotlight focused on Enron's use of SPEs and other types of arrangements to keep debt obligations off of their balance sheet. As the criticisms mounted, a number of firms using synthetic leases rethought their strategies in order to avoid being improperly painted with the Enron brush. Krispy Kreme, for example, cancelled a planned \$35 million dollar lease for a new factory and instead placed the financing on its books.

The FASB began to review the accounting guidance surrounding synthetic leases as well. Some changes were made and others are being considered. According to FASB Chairman Edmund Jenkins, "The large majority of synthetic leases" will have to be reported on the company's balance sheets.³ The new rules focus on whether the company that establishes the SPE controls and benefits from it. Not yet determined is how to account for SPEs set up by a third-party, such as a bank, that may serve multiple companies. Some observers feel that it is likely that each arrangement will be considered and accounted for as a single entity.

Proposed rules have been put forward for public comment, and should be implemented by August. The new rules will apply immediately to new SPEs; existing SPEs will have to meet the new rules by the beginning of a company's next fiscal year after December 15, 2002.⁴ Until this uncertainty is resolved, market activity in new synthetic leasing programs is minimal.

³ "FASB Change May Add \$100 Billion Debt to Books," Bloomberg.com, 02/27/2002.

⁴ *ibid.*

Insurance Industry Exposure to Tyco International Ltd.

By Julius Vizner, SVO Associate Research Analyst

Tyco International Ltd., in the headlines recently for the indictment of its CEO, is reeling from accusations of poor corporate governance and subsequent downgrades of its credit rating. Unlike previous corporate implosions, however, a planned sale of its financing unit is expected to avert a crisis in the short-term.

While it is impossible to estimate whether restructuring will relieve the pressure of the market's credibility concerns, the regulatory community can be proactively informed of the fact that, in aggregate, property-casualty and life insurers held over \$6.1 billion in bonds (Figure 1) issued by Tyco and its subsidiaries and almost \$800 million in common stock at the end of last year. Six smaller firms (those holding less than \$100 million in bonds) had fixed-income investments in Tyco and its subsidiaries that totaled over 10% of their total bond portfolios. There were 34 companies, mostly smaller property-casualty insurers, that invested greater than 5% of their total bond portfolios in Tyco and its subsidiaries.

Figure 1. Insurance Industry Exposure to Tyco Debt (Year-End 2001)

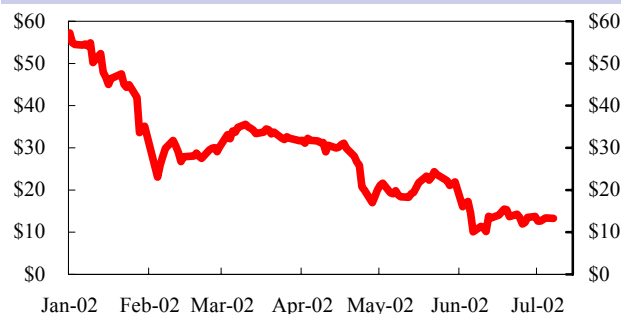
Fair Value (\$000's)	Life	P/C	TOTAL
Tyco	2,321,786	606,792	2,928,578
Cit Group	1,658,335	605,343	2,263,678
New Court	572,706	174,760	747,466
Capita Corp.	146,841	39,471	186,313
TOTAL	4,699,668	1,426,367	6,126,035

Source: National Association of Insurance Commissioners.

That property-casualty insurers tend to have higher percentage-wise exposures to Tyco than their life counterparts can be attributed to their generally smaller capitalization. The thirty largest Tyco investors, by absolute dollar value, account for almost half of all investment in Tyco debt. Individually, however, these large insurers each hold less than 1% of their bond portfolios in the form of Tyco debt.

The exposure of the property-casualty industry's aggregate equity position to Tyco is high compared to the life side; of the \$796 million in fair value of Tyco common stock (NYSE:TYC) life and property/casualty insurers reported on their 2001 annual statements, \$659 million was owned by P/C insurers. Damaged by the loss of investor confidence, shares in Tyco's common stock tumbled 50%

Figure 2. Tyco Common Stock Price



Source: Yahoo! Finance (<http://finance.yahoo.com>).

in the first week of June, dropping to a recent low of \$10; shares were priced at \$59 at the beginning of the year (Figure 2). In order to bring in cash to reduce its debt position, Tyco plans to sell its subsidiary, The CIT Group.

Tyco acquired CIT for approximately \$9.5 billion on June 1, 2001, issuing Tyco common stock valued at \$6.65 billion in exchange for 73% of the CIT stock outstanding and paying The Dai-Ichi Kangyo Bank \$2.5 billion for the other 27%. Additionally, Tyco made capital contributions totaling \$898 million in the third quarter of 2001.¹ Tyco plans to realize the proceeds of selling this diversified finance company through an IPO which was recently approved by the Securities and Exchange Commission. Moody's has decided to keep both parent and subsidiary on Ratings Watch Negative, noting that, "even with the anticipated debt reduction from the CIT transaction, the potential risks attendant to the widening array of management and corporate governance issues at Tyco render the company's credit profile inconsistent with an investment grade rating."² The agency rates CIT investment grade.

Newcourt Credit Group was acquired by CIT in November of 1999 to create one of the world's largest secured lenders with \$50 billion in managed assets. Capita Corporation, formerly known as AT&T Capital, is a wholly-owned subsidiary; its debt is fully guaranteed by CIT. Newcourt and Capita will be part of the CIT spin-off, according to 10-Q statements filed with the SEC.

If the IPO goes according to plan, insurers' aggregate bond exposure to Tyco will be halved and the associated systemic risk will be further reduced. While the situation is fluid, the diverse nature, high quality, and sheer size of insurer investment dilutes the effect that any single issuer can have on the industry portfolio.

¹ CIT Group Form 10-Q Filled with the SEC, May 15, 2002.

² "Moody's Downgrades Tyco's Debt..." Moody's Investors Services, June 12, 2002.



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