Cassels

High Interest Rates? Think Residual Leasing

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Over the past several years, interest rates have remained relatively low and borrowers were often ambivalent as to whether they should fund their capital expenditures through a lease or a loan. Rising interest rates may change that analysis for borrowers, particularly if cash flow is a concern.

Most capital expenditures when funded through a loan or finance lease amortize the purchase price of the capital equipment over a term which is generally for a period of three to five years. In a low interest rate environment, the interest component over the term is relatively manageable. As interest rates rise, the payments will increase reducing cash flow. This reduction to cash flow could have the impact of making the acquisition of capital equipment too expensive. A high residual lease may change that equation.

What is a High Residual Lease?

A high residual lease, or a “true” lease as it is often known, is a lease where at the end of the term, the lessee has the option to either (i) acquire the assets either at a pre-determined percentage of the original equipment cost or its fair market value (known as the residual), or (ii) return the equipment. The classic example of a high residual lease is a consumer vehicle lease where the consumer has the option but not the obligation at the end of the lease term to purchase the vehicle for somewhere between 20% to 50% of the original cost (the percent being determined based on a number of factors including the term of the lease and the type of vehicle being financed). The advantage to the consumer is they can lease a relatively expensive vehicle for monthly payments which are much lower than had they purchased the vehicle even with very low interest rates. As interest rates increase, the difference in the payment between a loan and a lease expands, as while the monthly lease payment will increase somewhat, the loan payment is likely to have a more significant change. The impact will be higher monthly payments and reduced cash flow.

High residual leases pose risk to the lessor and, as such, are not available from all institutions. Simply stated, the risk that the asset will not hold its value during the term of the lease is borne by the lessor. Further, the Bank Act restricts the size of the residual that can be provided for regulated financial institutions. A regulated financial institution cannot provide a residual of greater than 25% of the original equipment cost on any single transaction and its portfolio taken as a whole should not have a residual greater than 10%. Financial companies who are not subject to the Bank Act, such as commercial finance companies, are not restricted as to the residual they can hold but are cautious as to the size of the residual, as if the asset has a lower value than anticipated the lessor will accrue a loss. Automobiles again are the classic example. If a lessor were to hold a residual of 50% on a vehicle with an original purchase price of

$50,000, and the lessor structured the lease payments on the basis of this residual, but the vehicle when returned had a fair market value of only $10,000, the lessor would suffer a loss of $15,000 ($25,000 - $10,000). Lessors must reduce and manage this risk by properly evaluating the residual.

The restriction on holding a high residual leases can be managed by regulated financial institutions. First, the purchase return option can be structured to ensure that the regulated financial institution only is liable for a portion of the risk. Alternatively, regulated financial institutions can have the residual risk insured by a third party or obtain a guarantee from a third party to purchase the asset at a particular value at the end of the term (for example, through a vendor relationship). The nature and scope of these relationships are complex but common among certain large multinational banks.

As interest rates rise, it is anticipated that residual leasing will increase. Both borrowers and lenders should be mindful of both the advantages and risks associated with this form of financial structure.
