Positioning Now for Business in the Future

2003 INDUSTRY FUTURE COUNCIL REPORT

EQUIPMENT LEASING AND FINANCE FOUNDATION
The Equipment Leasing and Finance Foundation

Established in 1989 by the Equipment Leasing Association (ELA), the Foundation is a not-for-profit organization that strengthens and supports the equipment lease financing industry by providing high-quality research studies and working to increase academic and media awareness of this industry.

Our Mission:

To promote the growth and effectiveness of the equipment leasing and finance industry, through programs that:

• Identify, study, and report on critical issues affecting equipment leasing and finance, and;

• Develop the body of knowledge of equipment leasing and finance for use by the equipment leasing and finance business, academic, investors, and public policy communities.
The Equipment Leasing and Finance Foundation wishes to express appreciation to the following company for providing sponsorship funds to support this year's Industry Future Council Report:

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Introduction

The 2003 Industry Future Council (IFC) met at the J.W. Marriott in Washington, D.C. January 21 – 22, 2003. The Equipment Leasing and Finance Foundation (The Foundation) hosted the 22nd annual meeting that was sponsored by American Lease Insurance. Sixteen senior equipment leasing executives, including the Chairs of the five ELA Business Council Steering Committees (small ticket, middle market, large ticket, vendor finance companies, and service providers) attended the meeting. Financial Institutions Consulting, Inc. (FIC), a leading strategy consulting firm to the financial services industry, facilitated the meeting.

The IFC meeting serves as an opportunity for industry leaders to meet and discuss the current state of the leasing industry, the forces driving the industry, the future of the industry, and the actions the industry and individual firms must take to meet the future. This report is the result of those discussions.

Following the approach used in prior years, The Foundation distributed a survey to members of the Business Council Steering Committees and a number of individual members. As a group, respondents covered all elements of the leasing industry. This survey prompted respondents to identify key issues and trends facing the industry. In most cases, FIC followed up with a telephone discussion to further clarify the issues. The results of this “homework” assignment formed the basis of the meeting agenda.

Key Messages

Seven key messages emerged from the IFC meeting:

1. While the short-term outlook for the industry may be negative, leasing is a highly viable industry that will rebound in the next economic up-cycle.

The industry’s short-term outlook appears to differ based upon ticket segment and funding source. Generally, small ticket and middle market players are more optimistic about current and near-term performance than are large ticket players (See Appendix A). Some small ticket players believe they are seeing signs of an upswing. However, other industry sectors such as transportation, particularly aircraft, continues to drag down large ticket lessors.

“I have never seen a down cycle as severe as this”
Overall, players believe that leasing will remain an important method of equipment finance and that the industry will rebound when investment in new equipment picks up.

2. Even in this difficult environment, opportunities exist.

Many see business investment levels at their lowest point in years. Still, some leasing companies are not just surviving, but thriving. Members agreed that firms with a specific industry niche and/or a targeted market focus will continue to earn respectable margins:

♣ Players in the medical equipment market project substantial growth over the next 12 months. However, because it is one of the few growing sectors, more players are entering the market, increasing competitive pressure.

♣ Some firms have adopted a targeted marketing approach, for example, using direct telephone marketing to increase sales and reduce cost.

♣ Bank-owned firms are increasingly concentrating on cross-selling existing bank customers. In addition, they are able to leverage a lower cost of funds.

“Some of our competitors would say that direct telephone marketing doesn’t work, but it does”

3. Opportunities will increase as competitors exit the market.

Many players who priced irrationally or failed to institute prudent risk management procedures have been forced to exit the market.

“The industry has been strengthened by the exit of poorly managed companies that did not have a sustainable business model”

Some players have taken advantage of industry consolidation to increase their penetration into existing markets or to enter new ones. As one executive put it, “agile lessors are now able to grab a larger slice of a [temporarily] shrinking pie.”

4. Operational discipline, excellence, and ethics are key to continued survival.

Last year’s Report noted, “Implementation not innovation is on the agenda for success in the foreseeable future.” This year, the members further refined that agenda to focus specifically on implementation of operational discipline and excellence.

Operational excellence focuses on creating processes and procedures that effectively manage key cost components, including credit decisions, tax accounting and back office processing. As one manager put it, “operational excellence means having no crumbs left on the table.”

“In order to succeed, you have to be good at everything; you have to get it all right”
As a complement to operational excellence, operational discipline focuses on consistently adhering to those processes and procedures. Successful companies will no longer make “exceptions” to their pricing and risk management policies to gain market share or please a good customer.

Recent business events have focused investor, government, and public attention on business ethics. In light of those events, leasing executives believe there must be an increased emphasis on fairness and transactional transparency.

5. In the near term, regulatory and accounting changes will profoundly impact the industry, creating both challenges and opportunities.

Members unanimously agreed that significant accounting and regulatory changes for the leasing industry are on the horizon. Recent legislation designed to protect investors has made certain products and funding vehicles “off-limits.” Potential changes in the way companies account for leases may severely impact one of the major benefits of leasing: the ability to leverage the lessor’s balance sheet to finance equipment.

In addition, the adoption of the Basel II Accord will have a profound impact on segments of the industry. Basel II will force increased focus on pricing and risk management, probably limiting transactions with higher risk lessees.

Many of the pending regulations are a reaction to the accounting frauds that contributed to the failure of Enron and WorldCom. They are intended as much to restore investor confidence as to address real business issues. As such, many will likely have unintended, negative consequences. However, many members noted that some of the regulatory changes will effectively “force” rational pricing on the industry to the benefit of all.

“Regulators often work with blinders on, focusing on political expectations, not on business reality”

6. Players have a limited ability to differentiate themselves based solely on their product offering.

The expected accounting and regulatory changes will reduce the lessors’ ability to make use of “financial engineering” in its product offerings. Consequently, the leasing product may increasingly become a commodity.

While in the past, product innovation created clear advantages, today competitors are able to “reverse-engineer” new products in a matter of days, virtually eliminating any sustained competitive advantage.

In order to differentiate themselves, lessors need to focus on exploring opportunities to bundle the leasing product with other value-added services, such as asset management or equipment remarketing. At the same time, they must also focus on building and strengthening the customer relationship.
While leasing will remain a viable industry, members expressed differing views concerning the future organizational structure for leasing companies. Some members expressed the view that the leasing company of the future will be part of a broad-based financial solutions provider. They based this observation on the increasing commoditization of the leasing product and the trend toward “one-stop shopping” for financial services. They cited some national and regional banks as examples of this trend.

Other members see leasing companies remaining as stand-alone providers. The increasing demands of customers for specialized services means that only those firms focused specifically on leasing will develop the expertise necessary to succeed.

Current State of the Market

While the focus of this report centers on future expectations, it is important to briefly assess IFC members’ view of the current state of the leasing industry.

All participants agree that the industry is currently suffering intense pressure related to growth and profitability. Three major factors have combined to make this a particularly challenging period for the industry:

♣ Business Equipment Investment
♣ Interest Rates
♣ Regulatory Environment

Business Equipment Investment

According to the U.S. Bureau of Economic Analysis, in 2001 investment in business equipment and software declined by 6.4 percent from the previous year. In 2002, investment in new equipment and software declined nearly 2 percent over 2001 levels. This modest decline, however, is distorted by a 5 percent increase in software investment. Removing software, which is less likely to be leased, investment in new equipment declined by more than 3 percent in 2002.

Interest Rates

Lower interest rates eliminate some of the benefits of a lease versus a loan. In addition, banks have been aggressively selling low-priced loans and lines of credit to the best customers, reducing customer desire to lease.

Regulatory Environment

In anticipation of broad regulatory changes, the leasing industry has adopted a “wait and see” attitude. Expected legislative and accounting changes will affect nearly all areas of leasing from product development to risk management to funding. Some changes, such as the adoption of Basel II, are seen as virtual certainties; the best players are planning now for the impact.

Despite the challenges facing the industry today, most members feel as though their companies are effectively managing through these turbulent times.
Market Drivers

In the “homework” assignment and during the course of the meeting, members identified key factors affecting the industry both today and going forward: the economy, accounting and regulatory changes, increasing customer sophistication, and the changing competitive environment. Members discussed each of these issues and how they might impact the industry.

The Economy

The health of the leasing industry is directly related to investment in business equipment. As discussed earlier, the past two years have seen a nearly 10 percent decline in purchases of new equipment. Over-investment in the late 1990s, a global economic slowdown, and migration of manufacturing to developing countries are some of the reasons for this steep decline.

Members agree that economic conditions will improve, as they have during past downturns. They disagree, however, on when conditions will begin to improve.

As noted earlier, outlook differs by ticket segment. The chair of the Small Ticket Business Council reported that his members have already noticed an increase in small ticket volume. Small ticket customers tend to be small businesses that, because of their organizational structure, are able to react quickly to business trends. Members see this as an indication that the “grass roots” of the American economy is seeing an upturn in economic conditions. Many in the middle market also share this positive outlook.

In contrast, large ticket lessors believe they will continue to be battered by weakness in aircraft and rail and marine transportation. Of particular concern is the potential bankruptcy of more airlines as well as the devaluation of collateral, as airlines continue to retire aircraft in an effort to trim system-wide capacity. Lessors are also concerned that that could begin to see similar trends in other areas, such as railcars and marine.

Of course, macro-economic conditions are a major driver of the leasing industry. While there is little lessors can do to change conditions, best players are able to anticipate changes in the economic environment by continually analyzing the market. Collecting and interpreting data on delinquencies, customer credit quality, and pipeline volume can help managers plan for effective allocation of resources. In addition, maintaining operational excellence and discipline even during “the good times” will help companies survive the bad times.

Accounting and Regulatory Change

The trend in the regulatory environment may be having an even greater impact on the industry than the economy. Recently adopted changes include:

1. FASB (Financial Accounting Standards Board) rules on consolidation of Variable Interest Entities (VIE), also known as Special Purpose Entities (SPE)
2. FASB rules on reporting and accounting for certain loan guarantees
3. FASB adoption of a “principles-based” approach to standard setting
4. SEC requirements for reporting exposure to VIEs

Pending changes that will impact the industry include:
5. FASB conformity to international accounting standards

6. Adoption of Basel II

We will discuss each change and its potential impact on the leasing industry:

1. On January 16, 2003, FASB finalized Interpretation No. 46, *Consolidation of Variable Interest Entities*. FASB intends its rules to clarify the definition of a VIE and to prevent the abuse of structured-finance vehicles to move assets and debt off a company’s balance sheet.

   Under the old rules, a company was required to include the VIE on its balance sheet if it owned more than 3 percent equity. Under the new rules, a company must consolidate the VIE onto its balance sheet if that company is exposed to a majority of the entity’s losses, should losses occur. Interpretation No. 46 outlines the calculations for determining the entity’s expected gains and losses and the company’s exposure.

   Potential industry impact includes:
   - **Increased cost of capital.** Commercial Paper conduits (funding entities) will be reported either by the sponsoring bank or by a third-party first loss provider making them a less attractive financing source. In addition, use of VIEs for funding purposes will likely slow until the new rules are fully tested.
   - **Reduced demand for synthetic leases.** Synthetic lease SPEs will be reported on the lessee’s balance sheet, reducing the attractiveness of this product.

2. Passed on November 25, 2002, Interpretation No. 45 tightens disclosure rules for loan guarantees and requires companies to recognize those guarantees at their market value when they are issued. Previously, loan guarantees were only recognized on the books when/if the company was required to honor them.

   The new rules apply to standby letters of credit and manufacturers recourse loans. It does not apply to guarantees issued by insurance companies, guarantees accounted for as derivatives, product warranties, or to lessees’ embedded residual protection in capital leases.

   Potential industry impact includes:
   - **Increased cost of capital.** In certain funding vehicles (such as certain CP conduits) where a third party issues a loan loss guarantee, the third party issuer is required to record the total potential loss as a liability at the time of issue.
   - **Increased competition.** Insurance companies that are exempt from this rule may enter the market.
   - **Elimination of residual guarantees.** Residual guarantees in products other than capital leases must be carried as a liability to the issuing company, weakening their balance sheet.

3. In creating the two interpretations discussed above, FASB has signaled its intent to adopt a principles-based approach to standard setting. While not yet officially adopted (it is at the end of the proposal phase), FASB is writing its rules with adoption in mind.

   Until now, FASB has used a rules-based approach to standard setting. Under the
rules-based approach, CFOs, accountants, and auditors interpreted accounting standards based on the “letter of the law” rather than the “spirit of the law.”

Using a principles-based approach, companies are required to report based on the overall intent of the ruling, typically financial transparency. This is the approach generally used outside the U.S. and brings FASB one step closer to conformity with the International Accounting Standards Board (IASB).

This change in concept requires a change in mindset for the accounting and legal community. At least in the short-term, it will cause auditors to become more conservative as they attempt to interpret the “spirit” of the law.

Potential industry impact includes:

♣ Reduced demand for synthetic and structured leases. Companies will be less willing to use these financing products as accountants and auditors become more conservative.

♣ Reduced product differentiation. Lessors will be unable to develop specialized structured products that conform to the rules but not necessarily the principles of FASB.

4. On January 21, 2003, the SEC adopted rules on the disclosure of VIEs. These rules apply to the “management’s discussion and analysis” section of quarterly and annual SEC filings.

Under the new rules, companies are required to explain in a separately captioned subsection any off balance sheet arrangement that is “reasonably likely” to materially impact the companies financial position.

Potential industry impact:

♣ Reduced near term demand for synthetic leases and other structured finance products. Investor’s skittishness over off balance sheet items will make companies unwilling to use these products.

Pending changes:

5. In October 2002, FASB and IASB issued a Memorandum of Understanding representing their commitment to adopt consistent and compatible accounting rules. An Exposure Draft identifying and addressing certain specifically identified differences between U.S. and international approaches is expected by late this year.

The intent is to improve comparability of financial statements across national jurisdictions. In addition to providing uniformity for investors, it will eliminate any “accounting advantages” gained by companies operating under different accounting rules than domestic competitors.

Potential industry impact includes:

♣ Increasing pressure on operating leases. Currently, the UK Accounting Standards Board is working on rules requiring the capitalization of all material leases. If adopted as part of an effort to conform to international standards, one of the main advantages of leasing over direct purchase would disappear.
6. The Basel II Capital Accord, widely expected to take effect in the next several years, creates additional borrower categories, based on the external rating of the borrower. Under the existing Accord, assets are classified into four buckets (0%, 20%, 80%, 100%) according to the borrower category. The capital requirement of the bank is 8 percent of the subject amount of the asset. For example, most corporations are in the 100 percent category. The capital requirement for a $100,000 claim against a corporation would be $8,000 (8 percent of 100 percent of the loan).

7. Basel II creates subcategories based on external ratings. (See Appendix B) This will require institutions subject to the Accord to categorize each asset separately, rather than as a portfolio.

Under the new accord, bank-owned lessors lending to highly rated credits will have reduced capital requirements. This will allow them to price those leases more competitively and to deploy more capital. However, this pricing advantage will be offset by the new requirement to calculate and reserve for operational risk as well as the additional cost to track and maintain multiple asset categories.

In the U.S., only banks, bank holding companies, and thrifts are subject to the capital requirements outlined in the Basel Accord. The Federal Reserve has no plans, at this time, to extend the capital requirements to other types of financial services firms.

Potential industry impact includes:

♣ Increased costs for bank-owned lessors. The additional asset categories described in the Accord will require bank-owned lessors to track each individual lease. In addition, for those bank-owned lessors with higher risk customers, capital requirements will increase. Many bank parents may also allocate the costs associated with operational risk capital requirements.

♣ Decreased competition. Banks may withdraw from the leasing industry if the additional costs reduce profits significantly. New bank-owned entrants may decline as well.

IFC members believe that the industry does not need additional regulation. However, there is also a view among some members that recent and pending regulations, particularly those that will increase financial transparency, will help the industry by alleviating investor worries concerning off balance sheet items. Ultimately, this will increase capital investment into the leasing industry.

Customer Sophistication

Members discussed increasing customer sophistication as an important market driver. The desire to maximize value received and the abundance of price information available
through the Internet contribute to customer’s rising demands. Typically, they require more services at lower prices.

As companies refocus on their core competencies, they are increasingly looking to leasing companies as not just a financing source but also as a vehicle for outsourcing asset management. They often require additional services, such as asset tracking and equipment remarketing, included in the lease agreement.

Many members agreed that as the lease product becomes more homogenous, these types of “value-added” services are necessary to differentiate the lessor and create customer loyalty. However, some expressed their view that little willingness exists among customers to pay for these additional services. Lessors need to determine whether and how to charge for the additional services provided.

The availability of information through the Internet makes it particularly easy for customers to shop and compare. In light of current interest rates, many lessees, particularly “blue chip” customers, are demanding lower pricing.

“Lessees don’t understand that today’s low interest rate environment does not necessarily impact our ability to price. They compare our rates to bank lending rates and often, bank loans are the less expensive option”

In order to compete with bank loan pricing and to meet customer expectations, lessors must create value for the customer beyond simple financing. Most non-bank leasing companies will be unable to compete with banks on price. Instead, they will need to offer services that will create a financing package with more value to the customer than a straight bank loan. To the extent possible, those services must be technology based and cost little to provide. Most important, lessors must be able to charge the customer for these additional services.

Potential impact for the industry includes:

♣ *Increased pricing pressure.* While interest rates remain low, better customers will demand lower pricing.

♣ *Reduced margins.* In order to meet customer demand for additional services, lessors must purchase technology and/or hire people. The market is unlikely to bear these additional costs.

*The Competitive Environment*

The changing competitive environment is a subject for discussion at nearly every IFC meeting. Past discussions have focused on industry consolidation and the shift to the Whale and Minnow concept. This year, participants noted that there are fewer competitors than previously but they have become more aggressive. They have also seen many lessors reaching outside of their traditional markets.

Members in every ticket segment have seen a reduction in the number of competitors in the market. The economic slowdown and funding difficulties have caused many to exit the market. In addition, risk management issues have caused other players to reduce their activity in certain markets.

Although there are fewer players in the market, competition has intensified, particularly for the best customers. Members indicated that they are seeing less
price/rate driven competition. Instead, lessors are aggressively competing on deal structure and service.

“Although there are fewer competitors, the players remaining are usually larger and better financed, like the banks. The other survivors are the smaller, smarter niche players that win business on the basis of service or better transaction structure”

With fewer deals, the remaining competitors are looking outside their traditional markets to meet volume targets. Large ticket lessors, particularly hard hit by economic conditions, are beginning to expand even further into the middle market. Some niche industries, such as health care equipment, are seeing increased competition as lessors move to “cast a wider net” for deals.

The current competitive environment can offer opportunities for some players. Smaller more agile niche players are able to increase market share by filling the void left as competitors exit the market. Larger well-funded lessors can “force” their way into new markets to increase share.

Potential industry impact:

♣ Return to rational pricing. Rate based competition appears to be decreasing. This will allow the industry to implement risk-based pricing without sacrificing market share.

♣ Increased competition. The surviving players are generally strong. In response to a decline in overall leasing volume, they are expanding into what is for them new segments.

♣ Increased risk management issues. As lessors expand into unfamiliar markets, risk management and portfolio quality issues may arise.

The Role of Technology

While technology remains important, it was less of a focus than in prior years. Technology is allowing lessors to reduce costs and communicate more effectively with customers. However, not all technology investments have paid off, particularly investments in “e-commerce.”

Lessors have been successful using technology to streamline operations, increase productivity, and reduce costs. However, members noted that, for technology to be effective, the process it is automating must be effective.

“Without effective processes, technology will only emphasize the problems”

Lessors are also using technology to increase customer touch and service. Through email, account managers are able to communicate more effectively with their customers. Many lessors are implementing web-based customer service so that customers can manage their accounts at any time.

Over the past five years, companies have invested heavily in “e-commerce” applications with the hopes of driving new business volume through the Web. Most members expressed disappointment with this effort. New business volume has been
significantly less than hoped for and much of the business generated on the Web is low credit quality.

"Internet applications and e-commerce are not the home-run we had hoped for. Many of the applications coming in over the Web are of lower quality than we can accept”

Going forward, lessors will focus their resources on technology that will continue to reduce costs and increase customer service. However, given the current business conditions, many lessors have significantly reduced their IT budgets by eliminating capital expenditures to update equipment.

"Systems require huge investments that few can afford or are willing to make”

The slowdown in technology investment has hit vendors hard. Some IT vendors have seen a 60-80 percent decline in larger scale new projects during the past two years, causing them to rely more heavily on add-on projects from within their existing client base.

The Future of the Leasing Industry

As a way to gauge the participant’s view of leasing’s future, The Foundation asked them to write the title and lead paragraph of an imaginary 2008 Fortune Magazine article about the industry.

Members were uniformly positive that the industry would remain an important source of capital and financing for new equipment purchases. Some members expressed the belief that leasing companies will evolve into integrated financial services companies rather than remain as stand-alone leasing companies.

Members agreed that several key trends will define the industry:

1. Focus on value added services - The leasing product will focus on value-added services to differentiate a commoditized lease product
2. Slowing consolidation - Industry consolidation will continue but at a slower pace
3. Thriving independents - Independent lessors will grow strong again
4. Operational excellence and discipline – “Getting it all right” will be essential for survival

Overall, members agreed that the industry would grow with the economy and that its future depends on creativity and flexibility.

1. Focus on Value Added Services

Because product differentiation is difficult, companies may need to distinguish themselves in the market through bundled services. In general, members expressed the belief that, increasingly, customers will lease to take advantage of the leasing companies:

♣ Balance Sheet – To the extent allowable by regulation, some customers will want to shift liabilities to the lessor’s balance sheet.

♣ Asset Management Ability – As customers continue to focus on their core competencies, they will look to the leasing companies as outsourced
asset managers. They will take advantage of the lessor’s ability to track and manage the lease assets, including location, service contracts, and maintenance schedules.

♣ Tax Appetite – Tax implications will continue to be a factor in the lease versus buy decision. Companies unable to take full advantage of depreciation or wishing to accelerate deductions on new equipment acquisitions will continue to look to leasing.

♣ Treasury Function – Companies are becoming more focused on deploying assets in the most efficient manner. They will continue to lease equipment and other assets in order to conserve cash and avoid down-payments on new equipment.

♣ Structuring Ability – Customers will lease to take advantage lessor’s flexibility in structuring terms and conditions.

In order to survive, lessors will not only have to provide the types of value added services that customers demand, but do so in a very cost effective manner.

2. Slowing Consolidation

Members predict that industry consolidation will continue, but at a much slower pace. The market will continue to shake out unsustainable competitors and the survivors will be those with sound internal processes and disciplined pricing.

Members discussed several reasons why they believe industry consolidation will slow in the coming years:

♣ Economic conditions and investor and regulatory scrutiny will force many “insane” competitors out of the market.

♣ Regulatory changes will force more assets on the books, altering the financial picture of many firms that traditionally used acquisition as a means of growth. Their ability to fund acquisitions will be limited.

♣ Investor’s memory of recent leasing industry “train wrecks” will begin to fade. Capital will become more readily available to independent lessors with sound processes, pricing and risk management.

Market discipline, slower acquisition, and renewed investor confidence will combine to stabilize the competitive landscape.

Participants also predict that independents will become strong again and continue to lead industry innovation.

3. Thriving Independents

The lack of regulatory oversight can be an advantage for independent lessors. They will be able to pursue deals and set terms and conditions that regulated lessors cannot. The market, not regulators, will reward or punish them based on the merits of the deal. In addition, some of the cost of funds advantage currently enjoyed by bank-owned lessors will disappear as those lessors absorb the additional cost of capital imposed by Basel II.

Independents have historically led the industry in innovation. Their leaner structure and lack of “parental” oversight lends itself to rapid product development and swift adaptation to changing market conditions.
As regulation increases on bank-owned lessors and captives continue to focus inward, some participants believe that independents will leverage their entrepreneurial ability and once again lead the industry in terms of innovation and profitability.

4. **Operational Excellence and Discipline**

Operational excellence will continue to be a focus of the leasing industry. In addition, participants at this year’s meeting also discussed operational discipline as complementary to operational excellence.

Operations excellence is essential for driving out costs. To achieve it, players must focus on creating systems, processes, and a culture that allows them to “get it all right” in all areas of their business: pricing, risk management, operations, and customer service.

> “Operational excellence means that when a deal is done, we haven’t left any crumbs on the table”

In their discussion, members emphasized that “systems” does not necessarily mean technology. In the past, some companies invested in technology as a “magic bullet” to improve processes and reduce costs. Many did not receive the expected return on investment because they were simply automating broken processes. Going forward, lessors will emphasize creating efficient operations and the culture to support them and will use technology as a tool rather than a remedy.

Operational discipline means that once effective systems and processes are in place, lessors stick to them. Too often, lessors make exceptions, particularly in terms of pricing, to get a deal or to keep a “good” customer happy. Operational discipline can be the difference between making money on a deal and losing money.

> “If lessors went back and did a post-mortem on all the deals they have done, many would have a very unpleasant surprise. With all the exception pricing and special terms, probably half of those deals actually lost money”

With decreasing ability to differentiate based on product or price, operational excellence will become, in the words of one member, “a competitive advantage.” The best players will be those with cost-efficient operations and the discipline to adhere to their cost and risk management policies.

**Action Steps for Achieving the Future**

After discussing the current state of the industry and future trends, IFC members recommended specific steps that the industry should take to prepare for the future:

- **Continue to analyze the market for trends.** While the current environment has created many challenges for lessors, it has also created opportunities in specific market niches. Players must be able to
quickly identify and take advantage of these trends to be successful.

♣ **Focus on operational excellence and operational discipline.** In order to survive today’s market environment and to succeed in the future, lessors must create effective and cost efficient operations in all areas of the business, including: pricing, risk management, operations, and customer service. Just as important, lessors must build the discipline to resist allowing exceptions to policies and procedures that could reduce profitability and increase risk.

♣ **Link product benefits to additional customer metrics.** As new regulation reduces some of the traditional advantages of the leasing product, lessors must communicate the value of leasing to the customer. Lessors must show value in terms that are most meaningful to the customer. For example, creating a vehicle lease in terms of dollars per mile rather than dollars per month.

♣ **Focus on developing products/bundles for the post-regulatory change world.** While no one is certain about exact nature of the impending regulatory and accounting changes or when they will take affect, there is no doubt that change is on the horizon. Lessors must be proactive and begin developing products that comply with anticipated changes.

♣ **Build and expand customer relationships.** As differentiation based on product and prices becomes more difficult, lessors will need to rely on strong customer relationships to maintain and build volume. Members note that many lessors have traditionally been transaction driven. In the future, the relationship will be more important than an individual transaction.

♣ **Clarify/create value for the customer.** As market conditions and regulation have reduced the benefits of lease over a loan and the lease product is becoming more of a commodity, lessors must offer customers a reason to lease and, more importantly, a reason to lease with them. Service and expertise will soon become the differentiating factors in the leasing industry.

**Conclusion**

While leasing is currently facing challenges, IFC members are optimistic about the future of the industry. As one member put it, “It has been the end of the world before, and we have always survived.”

Business cycles are inevitable. The current downturn has caused problems for the leasing industry, but there is little doubt that conditions will eventually improve, although no one can know when a turnaround will occur. Small ticket lessors may already be seeing signs of an upturn, but that improvement has not yet extended to large ticket lessors.

Recent and impending regulatory and accounting changes will create challenges and opportunities for the industry. Restrictions on off balance sheet items will reduce the advantages of some lease products as well as increase the cost of capital raised through certain funding vehicles. At the same time, opportunity exists for innovative lessors to develop new products and the adoption of Basel II will help “level the playing field” with bank-owned companies.
Leasing has always been and continues to be a creative and innovative industry. Opportunities exist for those companies able to drive down costs, create value-added product bundles, and institutionalize pricing and risk management discipline.

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**About Financial Institutions Consulting, Inc.**

Financial Institutions Consulting, Inc. (FIC) focuses on providing advice and counsel on issues related to growth and profitability for financial services clients. We emphasize practical, bottom-line results based on quantitative and qualitative research and an in-depth understanding of industry dynamics.

In addition to completing prior projects for the ELA and The Foundation, our work in leasing has included process streamlining, segmentation strategy, and new business acquisition. Our activities include conducting formal engagements, leading brainstorming sessions, and providing ongoing retainer counseling to clients.

Please visit our website at: [www.ficinc.com](http://www.ficinc.com) for more information about our consulting and advisory services. We also e-mail a weekly newsletter on topics of critical importance to the industry and read by over 4,000 financial services executives worldwide. You can sign up for that email on our website.
Appendix A

Industry Performance

<table>
<thead>
<tr>
<th>Category</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Large Ticket</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business Council</td>
<td>4 (range)</td>
<td>5-8 (range)</td>
</tr>
<tr>
<td>Player A</td>
<td>4</td>
<td>5-7 (range)</td>
</tr>
<tr>
<td>Player B</td>
<td>3</td>
<td>3-4 (range)</td>
</tr>
<tr>
<td><strong>Middle Market</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Player A</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>Banks</td>
<td>4.3 (avg.)</td>
<td>6.4 (avg.)</td>
</tr>
<tr>
<td>Independents</td>
<td>2.4 (avg.)</td>
<td>5 (avg.)</td>
</tr>
<tr>
<td><strong>Small Ticket</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Player A</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Business Council</td>
<td>6.4 (avg.)</td>
<td>8.1 (avg.)</td>
</tr>
<tr>
<td>Player B</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td><strong>Service Providers</strong></td>
<td>4.4 (avg.)</td>
<td>5.5 (avg.)</td>
</tr>
</tbody>
</table>

* On a scale of 1-10 (1=about to exit the business, 10=best year ever)
## Appendix B

### Risk Weights by Borrower Category and External Rating

<table>
<thead>
<tr>
<th>Category</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BBB-</th>
<th>BB+ to BB-</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereigns</td>
<td>0%</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
<tr>
<td>Banks (1st option) rating of country</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
<tr>
<td>Banks (2nd option) rating of bank</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>50%</td>
</tr>
<tr>
<td>Banks (2nd option) rating of bank claims less than 3 months</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>50%</td>
<td>150%</td>
<td>20%</td>
</tr>
<tr>
<td>Corporate</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Mortgages (residential)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>50%</td>
</tr>
<tr>
<td>Mortgages (commercial)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>
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