

Safety and Soundness

Capital
Adequacy
(C)

Asset
Quality
(A)

Management
(M)

Earnings
(E)

Liquidity
(L)

Sensitivity to
Market Risk
(S)

Other
Activities
(O)

Lease Financing

August 2014

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Introduction

The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* booklet, "Lease Financing," provides guidance for bankers on how to legally and prudently engage in lease financing transactions for both commercial and consumer purposes. This booklet also provides bank examiners with examination procedures and tools that can be used in examinations targeting this type of lending. Throughout this booklet, national banks and federal savings associations (FSA) are referred to collectively as banks, except when it is necessary to distinguish between the two.

This booklet is not a guide to compliance with applicable consumer protection laws and regulations related to consumer leases, which are covered by the Consumer Leasing Act of 1976, as amended (15 USC 1667), and the Consumer Financial Protection Bureau's Regulation M (12 CFR 1013). To obtain such guidance, consult the "Other Consumer Protection Laws and Regulations" booklet of the *Comptroller's Handbook*.

The appendixes provide a table comparing the leasing authorities for national banks and FSAs, lease accounting examples, a glossary of leasing terms, a list of abbreviations, and matrices for assessing quantity of credit risk and quality of credit risk management, followed by a list of reference materials.

Overview

Background

A lease is an agreement that allows one party to use another's property for a stated period of time in exchange for consideration. Leases are an alternative method used by businesses and consumers to finance the acquisition of fixed assets. A lease agreement involves at least two parties: a lessor (such as a bank), who owns the property, and a lessee, who uses the property. The lessor, essentially a creditor in the transaction, is repaid from a combination of lease or rental payments, tax benefits, and proceeds from the sale or re-lease of the property at the end of the lease term.

Leasing is the most widely used method of personal property financing in the United States, and banks are permitted under various laws and regulations to provide this type of service. For the bank lessors, leasing is another competitive product that can satisfy the needs of bank customers. Leases may be safer than other bank products because the transactions are secured, and leases can be more profitable than loans because of certain advantages inherent in their structure, such as potential tax benefits.¹

¹ Under some circumstances, bank lessors may structure lease transactions so that available tax credits, such as the federal energy investment tax credit (26 USC 48), will flow to them. These transactions can be complex, however, and the bank must engage in appropriate due diligence and have an adequate risk management framework before entering into the transaction.

Leasing is a way for lessees to conserve capital because, in effect, they obtain 100 percent financing. Depending on the structure of the lease, the risks of ownership (such as the possibility that the product will become obsolete) can be transferred to the lessor. Tax benefits can also be transferred to a lessor, resulting in a lower lease payment requirement for the lessee. Leases that qualify as operating leases² under generally accepted accounting principles (GAAP) are not reported as a liability on the balance sheet of the lessee, which may improve certain of the lessee's key financial ratios.

Although leasing is often regarded as a modern-day financing technique, there are indications that leasing transactions took place as far back as 2000 BC. The basics of leasing have changed little since that time. Over the years, the strength of the leasing industry has been its resiliency and its ability to make the most of the changing business environment.

Statutory and Regulatory Framework for Leasing

Leases Equivalent to Loans: 12 USC 24(Seventh)

Since 1977, national banks have been allowed to provide personal property leases that are the functional equivalent of loans. Such activity is permitted under 12 USC 24(Seventh) as being incidental to the business of banking.

The Comptroller's interpretation permitting national banks to execute leases was upheld in the court decision *M&M Leasing Corp. v. Seattle First National Bank*.³ In that case, the court held that leasing is permissible provided the lease is the functional equivalent of a loan. Following that decision, the OCC issued an interpretive ruling (former IR 7.3400, effective June 12, 1979) that gave national banks the authority to enter into net leases that are the functional equivalent of loans.⁴

A lease under this section must be a full-payout lease.⁵ Any unguaranteed portion of the estimated residual value of the leased property that a national bank relies on to yield a full return must not exceed 25 percent of the original cost of the property to the bank. There is no regulatory limit on the aggregate amount of such leases a national bank can carry on its books, as long as these leases do not exceed the legal lending limits set forth for one borrower, transactions with affiliates, and insider lending.

² See the "Accounting Categorization of Leases by Lessors" section of this booklet for a description of operating leases.

³ 563 F.2d 1377 (9th Cir. 1977), *cert denied* 436 U.S. 956 (1978).

⁴ See glossary in appendix E for the definition of "net lease."

⁵ See glossary in appendix E for the definition of "full-payout lease."

CEBA Leases: 12 USC 24(Tenth)

The Competitive Equality Banking Act of 1987 (CEBA) was the first statute to specifically allow national banks to engage in leasing. Section 108 of CEBA amended 12 USC 24 by adding a 10th part that allows a national bank to invest in tangible personal property for lease financing transactions on a net lease basis.

A lease under this section, similar to a 12 USC 24(Seventh) lease, must be a full-payout lease. There is no limit, however, on the amount of estimated residual value a national bank may rely on to satisfy the full-payout requirement. In addition, investment in leases under this part cannot exceed 10 percent of a national bank's consolidated total assets. National banks also need to maintain documentation identifying these CEBA leases.

OCC Lease Regulation: 12 CFR 23

In 1991, the OCC issued 12 CFR 23, which allows lease financing of personal property by national banks under 12 USC 24(Seventh) and 12 USC 24(Tenth). Effective January 17, 1997, the OCC revised 12 CFR 23, which contains three subparts:

- Subpart A applies to all lease financing transactions.
- Subpart B addresses additional requirements applicable to CEBA leases.
- Subpart C addresses a bank's authority to enter into net leases that are the functional equivalent of loans.

Subpart A: General Provisions

All lease financing transactions in national banks must follow the general provisions contained in subpart A (12 CFR 23.1 through 23.6). Under these provisions, the lease must be a full-payout lease on a net-lease basis. This subpart defines a full-payout lease as one in which the national bank reasonably expects to realize its full investment in the leased property (and financing costs) from rentals, the estimated tax benefits, and the estimated residual value of the property at the expiration of the lease term. A net lease is defined as one that does not, directly or indirectly, obligate the bank to provide maintenance, insurance, parts, or accessories for the asset.⁶

This subpart sets out the general rule that a national bank can acquire specific property to be leased only after it has entered into a conforming lease, obtained a legally binding agreement indemnifying the bank against loss in connection with the acquisition, or entered into a legally binding commitment to lease. The regulation contains one exception to this general rule. A national bank may acquire property to be leased if the acquisition is consistent with the national bank's current leasing business or with a business plan to enter the leasing business or expand the national bank's existing leasing business. The national bank's

⁶ According to this subpart, national banks are not prohibited from arranging for an independent third-party provider to perform these services at the expense of the lessee.

aggregate investment in property held pursuant to this exception cannot exceed 15 percent of the bank's capital and surplus.

Upon the expiration of the lease (or the default of the lessee), this subpart requires the national bank to dispose of or re-lease the property as soon as practicable. Generally, the national bank must do so within five years of the date when the bank acquires the legal right to possess or control the property. The OCC may extend the holding period for as many as five additional years if the national bank can demonstrate that an additional holding period is clearly necessary.

This subpart also requires banks to maintain separate records to distinguish the 12 USC 24(Tenth) CEBA leases from the 12 USC 24(Seventh) leases and subjects all leases to the 12 USC 84 legal lending limits and restrictions on transactions with affiliates.

Subpart B: CEBA Leases

This subpart (12 CFR 23.10 through 23.12) governs the additional requirements for CEBA leases. Under 12 USC 24(Tenth), national banks may, on a net-lease basis, invest in tangible personal property, including vehicles, manufactured homes, machinery, equipment, furniture, and other types of tangible personal property. The aggregate book value of CEBA leases cannot exceed 10 percent of consolidated total bank assets. This subpart also establishes a minimum lease term of 90 days.

Subpart C: 12 USC 24(Seventh) Leases

This subpart (12 CFR 23.20 through 23.22) governs leases entered into under 12 USC 24(Seventh) and incorporates, with changes, the provisions previously contained in an interpretive ruling. Under this subpart, a national bank may be the lessor of tangible or intangible personal property on net leases that are the functional equivalent of loans. The bank's recovery of its investment plus financing costs must depend on the creditworthiness of the lessee and any guarantor of the residual value. The unguaranteed portion of the estimated residual value relied on by the bank to yield a full return must not exceed 25 percent of the property cost. Calculations of estimated residual values for leases with governmental entities, however, may be based on a reasonable expectation that transactions will be renewed.

Leases for Public Facilities: 12 CFR 7.1000(d)

This OCC interpretive ruling allows national banks to enter into leases for public facilities with municipalities or other public authorities. A national bank may purchase or construct a municipal building, e.g., a school or other similar public facility, and, as holder of legal title, may lease the facility to a municipality or other public authority. The only limit is that the municipality or authority must have sufficient resources to pay all rentals as they become due. Leases under this interpretation must provide that, upon expiration of the lease, the lessee will become the owner of the building or facility.

Law and Regulation for FSAs: 12 USC 1464(c) and 12 CFR 160.41

FSAs may engage in leasing activities under their lending and investing authority pursuant to section 5(c) of the 1933 Home Owners' Loan Act (HOLA) (12 USC 1464(c)) and OCC regulation 12 CFR 160.41. The types of leasing authorized under these powers are referred to as “finance leasing” and “general leasing” in their respective regulations.⁷

Finance Leasing

The authorization for finance leases comes from HOLA's lending authority. Similar to the national banks' 12 USC 24(Seventh) leases, FSAs that wish to make finance leases under such authority must structure them as the functional equivalent of loans. OCC regulation 12 CFR 160.41(c) specifies several requirements that must be met for a lease to qualify as a finance lease. To consider a lease the functional equivalent of a loan, the FSA must structure it on a net-lease and full-payout basis. The full-payout requirement cannot depend on the sale of the property at the end of the lease term for more than 25 percent of the original cost of the property.⁸

FSAs may make finance leases for tangible personal property, such as vehicles, airplanes, manufactured homes, machinery, equipment, and furniture, and for both consumer and commercial purposes.⁹ FSAs must aggregate finance leases with loans for purposes of determining compliance with HOLA's investment limits, as well as the current legal lending limits related to one borrower, transactions with affiliates, and insider lending rules. Finance leases, however, are not aggregated with general leases for the purpose of determining the limit of 10 percent of assets, as set forth in the next section.

General Leasing

Section 5(c)(2)(C) of the HOLA (12 USC 1464(c)(2)(C)) authorizes FSAs to invest up to 10 percent of their assets in tangible personal property acquired for the purpose of rental or sale. Personal property includes items such as vehicles, manufactured homes, machinery, equipment, and furniture. Section 160.41(d) of the OCC regulations specifically allows general leasing activities within this investment authority, similar to 12 USC 24(Tenth) leases (CEBA leases) for national banks.

⁷ Appendix A, “Comparison of the Leasing Authority for National Banks and FSAs,” summarizes some of the key features and differences between the various lease types offered by national banks and FSAs.

⁸ Please see OCC regulation 12 CFR 160.41(c) for a detailed listing of the requirements.

⁹ Unlike 12 USC 24(Seventh) leases, FSAs also can make finance leases of real property, which is generally prohibited for national banks. The leases, however, must be equivalent to secured real estate loans as authorized by HOLA unless they are conducted through a service corporation. National banks are permitted to engage in the leasing of real property only in very limited circumstances. These include (1) when a lease of real property is incidental to a permissible lease of personal property (see Interpretive Letter No. 770, 1997); (2) when it is equivalent to a secured real estate loan (see Interpretive Letter No. 806, 1997); and (3) when the lease is for financing of public facilities (see the “12 CFR 7.1000(d)” section of this booklet).

FSAs' general leasing authority, however, has a broader scope and capacity than the authority to enter into CEBA leases. Within their general leasing authority, FSAs can make several different types of leases with different purposes and duration without the net-lease and full-payout requirements. Service leases (or operating leases) are a type of general lease. These leases typically provide for financing and maintenance services, include an option to cancel, and often are relatively short-term. FSAs commonly make service leases for computer systems and other equipment.

Under the general leasing authority, FSAs may grant leases for consumer or business purposes but do not have to aggregate such leases with other commercial or consumer loans to determine the institution's compliance with investment limits. Instead, general leases are grouped together and limited to 10 percent of assets.

Limits and Restrictions on Banks' Leasing Activities

In addition to the lease-specific limitations discussed previously, leases entered into by national banks and FSAs are subject to the following limits, similar to other loans and investments:

- 12 USC 84 and 12 CFR 32,¹⁰ legal lending limits to one borrower
- 12 USC 371c and 371c-1 and 12 CFR 223 (Regulation W), restrictions on transactions with affiliates
- 12 USC 375a and 375b and 12 CFR 215 (Regulation O), restrictions on insider lending

Any bank engaging in a leasing program must be able to document how and why the lease financing conforms to the lending limitation regulations. The outstanding obligation of the lessee under 12 USC 84 is the sum of the present value of both the lease payments and the residual value of the property. The rate used in the present value equation for legal lending limit purposes is the "rate implicit in the lease" as defined in ASC 840.

The outstanding obligation of the lessee under a leveraged lease is calculated in much the same way.¹¹ In a leveraged lease, the unamortized balance of the nonrecourse debt is deducted from the present value elements. This deduction recognizes that nonrecourse debt is not an obligation of the lessee to the bank lessor.

¹⁰ In addition to 12 USC 84 and 12 CFR 32, FSAs are also subject to the special rules set forth under section 4(u) of HOLA (12 USC 1464(u)).

¹¹ See "Accounting Categorization of Leases by Lessors" in this booklet for more information on leveraged leases.

Similarly, when calculating the total volume of CEBA leases to apply the 12 USC 24(Tenth) limit of 10 percent, one subtracts the nonrecourse debt that the national bank has incurred to finance the acquisition of the leased property.¹² This treatment more accurately reflects the bank's exposure and is consistent with the lending limit treatment.

If the bank violates the lending limit with an advance of funds from a lease, it may correct the violation by selling a participation that covers the amount exceeding the legal lending limit at the time of its origination. In addition, the bank lessor must be careful not to sell an ownership interest in the leased property in such a way as to create a general partnership in which the national bank, by law, may not participate.¹³

Loan to a Leasing Company as Loans to the Underlying Lessees

Loans to third-party lessors to finance their origination of leases, especially lease pools, can result in a violation of the regulatory limitations for loans to one borrower if these loans exhibit characteristics that result in the credits being considered as loans to the originating or brokering company rather than the individual lessees. A loan to a leasing company, however, may be treated as separate loans to the underlying lessees if the bank can meet certain criteria set forth under 12 CFR 32.3(c)(10). These criteria include

- the bank evaluates the creditworthiness of the lessee on a lease-by-lease-basis.
- the loan is without recourse to the leasing company.
- the bank has a valid security interest in the leased equipment.
- the leasing company assigns all its rights under the lease to the bank.
- lease payments are assigned and paid to the bank.
- the lease terms are subject to the same limitations applicable to a bank lessor.

The above provision of lease financing to a leasing company in no way lessens the need to secure, understand, and retain information and analyses on the underlying lessees.

Binding Commitment and Legal Agreement

According to 12 CFR 23, subpart A, a national bank should have a legally binding agreement or a lease contract before purchasing the leased property.¹⁴ When a customer asks the national bank to purchase property for a lease, the bank issues a commitment letter that describes the property, the cost, and the lease terms. After the lease terms are agreed to in

¹² See 12 CFR 23.10.

¹³ A national bank is prohibited from being a general partner in a commercial endeavor. This rule was established by the Supreme Court in *Merchants National Bank v. Wehrmann*, 202 U.S. 295 (1906). Therefore, when a national bank sells participations in a lease, it must avoid becoming a general partner, generally by entering into a trust arrangement or forming a limited partnership.

¹⁴ FSAs do not have this legal requirement, but they are encouraged to practice the same standard from a safety and soundness standpoint.

negotiations between the national bank and its customer, the customer writes an order asking the bank to purchase the property. After purchasing the property, the bank arranges for any necessary delivery and installation.

The legally binding agreement to lease or the lease contract should incorporate all the points in the commitment letter. The lease contract also should outline the rights of all parties in the event of default. The lease contract usually is signed at the same time as the order to purchase and the agreement to lease. Each lease is an individual contract written to fulfill the lessee's needs; consequently, there are many variations in lease terms and conditions. Every lease contract should convey a clear understanding of the lessee's positive right to use the property for a specific period, and every lease should make the payment plans irrevocable.

Accounting Categorization of Leases by Lessors

To determine the appropriate accounting treatment for a lease, the lease needs to be correctly categorized. Under GAAP, a lessor must categorize each lease into one of four types—operating, direct financing, leveraged, or sales-type.

To properly categorize a lease, the facts and circumstances surrounding the lease contract must be analyzed to determine whether substantially all of the benefits and risks of ownership are transferred to the lessee. A lease that transfers substantially all of the ownership benefits and risks should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor.

According to ASC 840, "Leases," (formerly FASB Statement No. 13, "Accounting for Leases," as amended and interpreted), substantially all of the risks and benefits of ownership are considered to be transferred to the lessee if, at inception, the lease meets at least one of the four following criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term equals at least 75 percent of the estimated economic life¹⁵ of the leased property.
- The present value of the minimum lease payments at the beginning of the lease term equals at least 90 percent of the fair market value less any investment tax credit retained by the lessor.¹⁶

¹⁵ Economic life is defined as the period during which the property can be used economically by one or more users for the purpose that was intended at the inception of the lease. Estimated economic life and estimated useful life (for depreciation purposes) are not necessarily the same. For example, a bank may use a shorter useful life and higher salvage value for depreciation purposes if its policy is to dispose of assets before the end of the assets' economic lives.

¹⁶ Under GAAP, a lessor should compute the present value using the interest rate implicit in the lease. A lessee should compute the present value using the lessee's incremental borrowing rate unless the implicit rate is available and lower.

Operating Lease

For the lessor, a lease is accounted as an operating lease if the lease meets none of the four ownership risks and benefits transfer criteria listed above. In addition, the lease should also be accounted as an operating lease if it meets one or more of the four criteria but fails to meet any one of the following two additional requirements pertaining to the lessor:

- The collectibility of the minimum lease payments is reasonably predictable.
- The amount of non-reimbursable costs to be incurred by the lessor under the lease is substantially predictable.

As stated earlier, an operating lease does not transfer the risks and benefits of ownership to the lessee. The lessor, as owner of the property, retains legal title. In this transaction, the lessor is entitled to any tax benefits of ownership (such as accelerated depreciation). The lessor also retains the rights to the property's residual value at the end of the term. In most operating leases, the term of the initial lease agreement is significantly shorter than the economic life of the property.¹⁷

For a lease that does not qualify as an operating lease, the lessor must categorize it as one of the remaining three types—direct financing, leveraged, or sales-type.¹⁸

Direct Financing Lease

A direct financing lease is one in which the lessor's only source of revenue is interest. The lessor buys an asset and leases it to the lessee. This transaction is an alternative to the more customary lending arrangement in which a borrower uses the loan proceeds to purchase an asset. A direct financing lease is the functional equivalent of a loan.

Leveraged Lease

A leveraged lease is a specialized form of direct financing lease that involves at least three parties: a lessee, a long-term creditor (the debt participant), and a lessor (the equity participant). This type of lease transaction is complex because it usually involves a large transaction, a significant number of parties, complex legal issues, and the unique advantages to all parties. Because of the legal expenses and administrative costs involved, leveraged leasing usually finances large property purchases for capital-intensive projects. Leveraged

¹⁷ Lessors also commonly refer to long-term operating leases as true leases or tax-driven leases because, as the tax owners of the property, the lessors can retain the tax benefits from property depreciations, which was one of the key motivations for entering a leasing arrangement historically. Because of the rapid growth of other leasing products, changes in the tax laws, and concerns over potential legal liabilities from property ownership, true leases and tax-driven leases have become less common in a bank lessor's leasing portfolio.

¹⁸ Under GAAP, a lease that does not qualify as an operating lease is categorized as a capital lease from the perspective of a lessee.

leases are generally used to take advantage of favorable tax benefits unique to this type of financing for the participants in the transaction.

In a leveraged lease, the lessor that purchases the property provides only a percentage (usually 20 percent to 40 percent) of the capital needed. The lessor takes out a nonrecourse loan for the balance of the purchase price from long-term lenders (the debt participants). That loan is secured by a first lien on the property, an assignment of the lease, and an assignment of the rental payments. Under this arrangement, the lessor, as the owner, is able to take accelerated depreciation and to claim any available investment tax credit based on the total cost of the property. The lessor also retains the residual value rights to the property at the end of the lease period. Under this arrangement, the lessee has use of the property at a lower cost in exchange for leaving the tax benefits with the lessor. This trade-off ideally produces an attractive rate of return for the lessor and financing for the lessee at a cost below the lessee's normal borrowing rate.

When the purchase price of the property is large, a leveraged lease may involve several lessors and debt participants. In such cases, an owner trustee generally holds title to the property and represents the lessors, or an indenture trustee may hold the mortgage on the property on behalf of the debt participants.

Sales-Type Lease

A sales-type lease is structured so that the lessor (generally a manufacturer or dealer of property) not only obtains interest income but also recognizes a profit or loss on the transaction. Such recognition can occur only if the value of the property is different from the cost when the lease expires. It may be useful to see this type of transaction as tantamount to a sale. A common sales-type lease is the agreement between an automobile dealership and a customer. In that circumstance, the lessor (dealership) is leasing the automobile in lieu of selling it. Bank lessors normally do not offer sales-type leases.

Accounting for Leases by Lessors

Standards for lease accounting are set forth in ASC Topic 840, "Leases." For non-operating leases, such as direct financing leases, bank lessors record the lease in loans and lease financing receivables in an amount equal to the sum of the aggregate minimum lease payments (including any guaranteed residual value), the unguaranteed residual value, and any available investment tax credit. Any excess of those items over the actual cost of the property leased is recorded as unearned income, which is recorded as a liability. Lease payments made are applied to reduce the asset account. Unearned income is accrued over the life of the lease using the effective income method (a constant periodic rate of return). Initial direct costs also are amortized over the lease term. Banks may use other methods of recognizing income if the results are not materially different.

When accounting for leveraged leases, the lessor's net investment (gross investment less unearned income and deferred taxes) is recorded as it would be in a direct financing lease, but principal and interest on the nonrecourse debt is netted out. Based on an analysis of

projected cash flow for the lease term, unearned and deferred income is recognized as income at a constant rate only when the net investment is positive. In years when the net investment is zero or negative, no income is to be recognized. As a result of the timing of the tax benefits, the lessor's net investment declines during the early years of the lease and rises in the later years.

Bank lessors account for operating leases by recording the cost of the property leased as an "other asset." That asset, less the residual value at the end of the lease, is depreciated over the estimated economic life of the property, following the bank's normal depreciation policy or practice. Lease rental payments are taken directly into income over the life of the lease as they become due and receivable (accrual accounting). Any initial direct costs generally are amortized over the lease term as revenue is recognized. If such costs are immaterial, they may be expensed as incurred.

Banks should record assets acquired and held for future leasing activities¹⁹ at cost. If the property is not leased or otherwise disposed of within a reasonable time, it should be reviewed for impairment.

Appendix B contains examples that demonstrate a lessor's accounting treatment of an operating lease, a direct financing lease, and a leveraged lease.

Renewals, Extensions, and Treatments for Off-Lease Property

Lease renewals and extensions are accounted for differently depending on the type of renewal or extension. Any adjustments must be reflected in the current period's income.

When a lease is terminated, the previously leased property becomes "off-lease property."²⁰ The remaining net lease receivable, if any, should be removed, and the property recorded as an "other asset" at the lower of cost, present fair value, or current carrying value.²¹ Adjustments should be reflected in the current period's operating results. If the leased property is sold at the end of the lease, the gain or loss is calculated by comparing the net proceeds from the sale to the residual value account balance. Again, any gain or loss should be reflected in income during the current period. The maximum holding period for off-lease property is five years for national banks, unless the OCC specifically approves a longer

¹⁹ According to 12 CFR 23.4, national banks cannot customarily acquire personal property for future leasing, except when the acquisition is consistent with the national bank's current leasing business, a business plan for expansion of the national bank's existing leasing business, or a business plan for entry into the leasing business. The national bank's aggregate investment in property held pursuant to this exception cannot exceed 15 percent of the bank's capital and surplus. FSAs are not subject to the limitations of 12 CFR 23.

²⁰ Off-lease property refers to leased property that has been terminated because of the expiration of a lease term or the default or other nonperformance of contractual obligations by the lessee and is now reverted to a bank's possession and control before being re-leased, sold, or otherwise disposed of. See 12 CFR 23.2(g).

²¹ See Federal Financial Institutions Examination Council (FFIEC) call report instructions for "Other Assets" (Schedule RC-F) for guidance on how to record off-lease property.

one.²² If the property is not re-leased or sold during the holding period, it should be disposed of at the expiration of the period. For the FSAs, current regulation does not mandate a numerical limit but requires the FSAs to liquidate or re-lease off-lease property resulting from finance leases as soon as is practical.²³

Other Lease Financing Products and Alternatives

Lease financing products have evolved as a result of changes in the tax laws, business environments, macroeconomic conditions, markets, and competitions. For example, the traditional tax-driven operating leases have lost some prominence in recent years, while leases that are structured as loans or the functional equivalent of loans have become the main business for many banks' lease financing operations. This section describes a few popular products offered or other terms used by banks' leasing operations.

Equipment Finance Agreement

An alternative to the traditional direct financing lease, an equipment finance agreement (EFA) is a single loan document to finance the purchase of equipment with a security interest on the equipment under the Uniform Commercial Code (UCC). A bank's leasing department can use EFAs to make secured financing loans with certain lease characteristics, even if the bank is prohibited by internal policies or system limitation from underwriting traditional loans. Unlike the traditional direct financing lease in which the lessor retains the property title and the right of ownership, the borrower in an EFA is considered the owner of the equipment for both financial reporting and tax purposes and can retain the equipment at the end of term without having to pay a purchase option price.²⁴ For these and other reasons, EFAs are used instead of leases to reduce a bank's exposure or liability as a lessor of certain types of property or equipment. Banks also prefer to use EFAs over traditional leases because some state and local tax authorities routinely tax leases based on ownership.

EFAs are more flexible than leases because they do not typically require down payments. In an EFA, the bank typically finances 100 percent of the collateral value at the inception of the term. To book an EFA as a loan, the bank should apply regular loan accounting policies and procedures, while the borrower should generally account for the transaction by recording an asset and a liability on its balance sheet.

²² See OCC regulation 12 CFR 23.4(c) for national banks.

²³ See OCC regulation 12 CFR 160.41(c) for FSAs.

²⁴ There is another variation of the zero purchase option in which the lessee has the option to pay the lessor a nominal price such as \$1 at the end of the lease to retain the full ownership of the property, hence the term "dollar-out" lease. A dollar-out lease is a direct financing lease and the functional equivalent of a loan.

Sale-Leaseback

A sale-leaseback is a special type of lease that allows the owner of a piece of property to raise funds while retaining use of the property. In such a lease (actually two separate transactions), the owner of the property sells the property and immediately leases it back. There is no physical transfer of the property. From a safety and soundness perspective, leases that result from sale-leaseback transactions should be reviewed in essentially the same manner as other leases.

Tax-Exempt Municipal Lease

A tax-exempt municipal lease is a financing transaction for an installment purchase in which the lessee is a state or local government entity. It is a full-payout lease, with the payments consisting of principal and interest. The municipal lessee is the tax owner of the property, which becomes unencumbered at the end of the financing term with a nominal purchase option or no purchase option.²⁵ The interest portion of the payments due under a properly structured municipal lease is exempt from federal income taxes in the same way as the interest on a municipal bond.

There are three primary categories of tax-exempt municipal leases: bank qualified (BQ), non-bank qualified (NBQ), and tax-exempt conduits for 501(c)(3) corporations.

Bank Qualified

The Tax Reform Act of 1986 created the concept of BQ. A tax-exempt lease financing transaction is considered BQ if the lessee, or borrower, does not intend to issue \$10 million or more in new tax-exempt obligations (including leases, loans, and bonds) in the calendar year that the lessee enters into the transaction. The tax laws allow tax exemption on the interest income but limit the interest deduction to 80 percent of the cost to fund these assets.²⁶

Non-Bank Qualified

NBQ leases are defined as the debt obligations of tax-exempt entities that issue more than \$10 million in tax-exempt debt in that calendar year. If a bank were to acquire an NBQ transaction, it would lose the entire deductibility of the interest expense. The interest income, however, would still be tax-exempt.

²⁵ In addition to personal property leasing to municipalities, national banks may lease public facilities (i.e., real estate) to municipalities. See 12 CFR 7.1000(d).

²⁶ IRS laws, regulations, and rulings can change frequently. Bank lessors should seek guidance from the IRS directly, frequently monitor tax law changes, and adjust their business strategies accordingly in a timely fashion.

The American Recovery and Reinvestment Act of 2009 (ARRA) introduced several incentives for municipal financing, including a de minimis exception to the disallowance of interest deductibility for new non-bank qualified municipal bonds sold in 2009 and 2010, if the bank's total holding of these bonds does not exceed 2 percent of the bank's total assets. For this de minimis amount, the bank can deduct interest expense up to the 80 percent limit.²⁷

Conduits for 501(c)(3) Corporations

A bank can also provide tax-exempt lease financing to a nonprofit corporation with IRS 501(c)(3) status, such as a university or a hospital, through a local municipal entity that serves as the conduit. The bank lessor enters into a tax-exempt lease-sublease agreement with the municipal conduit (the lessee or sub-lessor), which assigns its lease with the nonprofit corporation (the sub-lessee) to the bank lessor. The assignment is on a nonrecourse basis to the conduit. Because of its tax-exempt status, the conduit can obtain tax-exempt financing for the nonprofit corporation.

TRAC Lease

A terminal rental adjustment clause (TRAC) lease generally is used for "over-the-road" vehicles such as trucks, tractors, and trailers. It contains a stated value of the equipment at maturity. A TRAC lease provides the lessee with a predetermined purchase provision and the lessor with a residual value guaranteed by the lessee at the end of the lease.²⁸

The monthly payments on a TRAC lease are determined by the residual price established at the start of the lease. Depending on the lessee's cash-flow needs, the lessee can select a higher residual amount for lower monthly payments or keep the residual price lower by making higher monthly payments. This flexibility of payment options makes the TRAC lease attractive to businesses trying to improve and better manage their cash flow.

A modified version of the TRAC lease allows the bank lessor to assume part of the estimated residual risk, sufficient to cause the transaction to be classified as an operating lease. The IRS allows the lessee of the modified TRAC lease to maintain the "full deductibility" of an operating lease even though there is a predetermined residual value, while the lessor would retain the benefits of depreciation.

Risks Associated With Lease Financing

From a supervisory perspective, risk is the potential that events, expected or unexpected, will have an adverse effect on a bank's earnings, capital, or franchise or enterprise value. The

²⁷ See Section 265 of the Internal Revenue Code (26 USC 265).

²⁸ At the end of the lease term, the lessee must make a lump-sum payment to the lessor for the predetermined residual value of the leased equipment, regardless of the fair market value of the equipment at that time. If the lessee fails to make such a payment, the lessor can sell the equipment at the market price and bill the lessee for any shortage below the predetermined residual value, while any excess amount would be returned to the lessee.

OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive. Any product or service may expose a bank to multiple risks. Risks also may be interdependent and may be positively or negatively correlated. Examiners should be aware of this interdependence and assess the effect in a consistent and inclusive manner. Refer to the “Bank Supervision Process” booklet of the *Comptroller’s Handbook* for an expanded discussion of banking risks and their definitions.

The risks associated with lease financing are credit, interest rate, liquidity, operational, price, compliance, strategic, and reputation. These risks are discussed more fully in the following paragraphs.

Credit Risk

The primary risk to a financial institution engaged in leasing activities is credit risk. Leases create credit risk in ways similar to other types of secured lending products. A lessee may not fulfill its contractual obligations on the lease due to business or financial problems. A bank may end up receiving the property and be unable to re-lease the property within a reasonable time frame.²⁹ The quantity of credit risk from leasing activities should be assessed using similar risk rating criteria, loan loss estimation processes, and interest accrual status as used for other types of loans.

Interest Rate Risk

Like loans, leases are subject to interest rate risk (IRR). Loans have an explicit interest rate, whereas a lease transaction is negotiated and underwritten based on an implicit interest rate. This implicit rate is derived from a fixed rate of interest for most leases in the banking industry. Typically, the IRR to a bank is the same as if the bank were making a loan with an explicit fixed interest rate. Fixed interest rates expose the bank to IRR when interest rates change (which they do because of competitive or economic forces). In addition, prepayment or early termination of leases could undermine the full receipt of the recorded lease receivable and thus subject the bank to additional reinvestment risk in a falling interest rate environment.

Liquidity Risk

An asset’s liquidity can be viewed in terms of its expected life and the ease with which it can be converted into cash. A lease’s liquidity risk is no different. Leases can be sold, reassigned, or participated out to other parties, but they are not as liquid as corporate bonds. Similar to a loan, a lease’s liquidity profile largely depends on the underlying value of the asset, including the nature of the leased property and the underwriting parameters surrounding the leased

²⁹ Off-lease property also carries price risk in that the property value could have declined significantly from its original expected value, resulting in a loss to the bank if it has to dispose of the property to meet the leasing regulatory requirement.

asset. The lease will have high liquidity risk if the resale value of the leased property is low and lender protection in the transaction is weak. Leases may also entail an extended disposition period if the leased property comes back to the bank lessor for sale, liquidation, or re-lease. The disposition period can vary significantly depending on the liquidity of the underlying asset and the demand for the asset at lease termination.

Operational Risk

The processes for originating, administering, and collecting leases create operational risk for an institution engaging in this activity. Lease documentation processes, payment collections, regulatory compliance processes, and managing leased property residual values are key areas that affect the quantity of operational risk from leasing activities. Additionally, certain types of leases include complex structures, accounting rules, and reporting methods that add further operational risk to the leasing portfolio.

Operational risk in leases can stem from lease documentation failures and any lapses in lease administration. Each lease should be properly documented, including the unique documentation requirement for CEBA leases. Operational risk can also result from lack of effective processes to monitor and control the disbursement of funds for property purchases and the receipt of lease payments. Collection of lease obligations can be complicated if the property is not legally titled to the bank or liens are not properly perfected. Any failures in these documentation, inspection, control, and monitoring requirements could result in the bank lessor's inability to collect the lease payments and regain control of the leased property if repossession becomes necessary.

Third-party servicers of lease pools represent another source of operational risk. Lease pool servicers have been known to replace delinquent leases with performing leases, or to advance payments to cover delinquent leases. Both of these situations have led to complacency on the part of bank lessors investing in the lease pools and lack of attention to the quality and performance of leases accepted.

Price Risk

Lease financing exposes a bank to market price changes in the value of the leased property at the end of the lease, whether the property is re-leased immediately or held as an off-lease asset. Ineffective administration of the residual values of leased property (the estimate of a leased property's future value, or the amount that may be realized upon disposal or re-lease of the property at the end of the lease term) can result in losses from unexpected price changes in the property over the lease term or when held as an off-lease asset. Leases with significant residual values have higher price risk than many other types of lending because the economics of the lease also rely on the leased property's value in addition to the other sources of repayment from the lessee. A bank lessor that does not properly manage residual values may be unable to recover its investment. Failure to perform financial due diligence on the leased property, making unreasonable assumptions in the residual value estimates, and the lack of an effective system of monitoring and inspection of the leased property further exacerbate the exposure to price risk related to residual values.

Compliance Risk

Compliance risk in the form of litigation, settlements, or judgments affects leasing. Failure to comply with the statutory and regulatory requirements discussed previously in this booklet can expose the bank to regulatory actions and civil money penalties. If there are problems with documentation, the bank could lose its contractual rights under the lease. The bank could also lose its ability to realize tax benefits or take advantage of the rights of property ownership, including repossession and sale.

Strategic Risk

Lease financing should be fully integrated with a bank's strategic goals and direction, including a strong risk management system and a highly specialized and knowledgeable leasing staff to recognize, assess, mitigate, and monitor the risks unique to leases. Leasing transactions conducted without a continuing investment in the personnel and infrastructure necessary to maintain a sound and profitable operation could run counter to the bank's strategic goals. Any decision by the bank to engage in lease financing activities without a well-developed understanding of the inherent risks and a robust operational system poses significant strategic risk to the bank.

In addition, failure to provide effective oversight of lease financing activities can increase the bank's strategic risk in addition to other correlated risks, such as credit, operational, and reputation.

Reputation Risk

Actions taken by a bank to protect its interests, such as the termination or modification of a lease or repossession and liquidation of the leased property, may diminish the bank's reputation. Material credit losses also may have a negative effect on the bank's reputation. Failure to meet the needs of the community, inefficient operation and property delivery systems, lender liability lawsuits, and owner liability lawsuits, in the case of an operating lease in which the lessor is considered the owner of the property, are all examples of factors that may tarnish the bank's reputation.

A lease may be leveraged as discussed previously in this booklet. A leveraged lease may be syndicated among the lessor and several debt participants because of the transaction size and risk characteristics. If the bank, especially if it is acting as the originating lessor, fails to meet its legal or fiduciary responsibilities in conducting these activities, the bank can damage its reputation and impair its ability to compete successfully in this line of business.

A lease may also be part of a complex structured leasing transaction, which typically involves structuring cash flows, distributing tax benefits, and allocating risk among the lessee, the lessor, and the debt investors, if applicable, to meet specific customer objectives

more efficiently.³⁰ These transactions often involve professionals with specialized expertise and may involve creation of special purpose entities and nonbank subsidiaries. Although the majority of transactions serve legitimate business purposes, the bank may be exposed to significant reputation and legal (compliance) risks if the bank enters into transactions without sufficient due diligence, oversight, and internal controls.

Risk Management

The OCC expects each bank to identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for its size and the complexity of its operations. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems. Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

Policies and Procedures, and Control Functions

A bank should adopt prudent policies and procedures in accordance with the existing regulations and policy guidance, and should closely monitor its compliance with such policies. The bank's board of directors should review and approve such policies and procedures on a timely basis. The policies, processes, and control systems used by management and the board of directors to engage in leasing activities should be similar to those used to manage other types of lending products.

Leasing activities should be included in a bank's audit program as part of the institution's system of internal control and risk management. In addition, a bank's loan review and compliance functions should include reviews of leasing in their scope of activities.

Leasing activities should have accurate and complete management information systems (MIS) and reporting frameworks to help identify, measure, monitor, and control risk. MIS should enable management to monitor lease payment status, collections, lease runoffs, residual positions, and concentrations of credit within the leasing portfolio.

Personnel and Organization

Capable management and appropriate staffing are essential to effective risk management. Retaining and recruiting competent leasing executives, line managers, risk management personnel, and back-office staff are essential. The skills and expertise of leasing management and staff must be commensurate with the complexity of the institution's leasing products and services. The skills required for larger institutions (and what a bank must pay the personnel

³⁰ See the "Other Lease Financing Products and Categories" section of this booklet for some examples of complex and specially designed products and OCC Bulletin 2007-1, "Complex Structured Finance Transactions: Notice of Final Interagency Statement," for a general discussion of complex products and the risk management expectations for them.

who have these skills) are generally greater and more varied than those required in less diversified and complex institutions. Mergers and consolidation may also present complicated personnel challenges. Merger plans should lay out strategies for retaining the staff members essential to effective risk management.

Leasing personnel must understand the statutory and regulatory requirements for leasing activities, the institution's risk appetite, risks associated with leasing, the different types of leases, and the proper accounting and reporting requirements for leasing. Personnel must stay current with changes in tax law, accounting standards, customer demand, and other economic factors that may affect the bank's leasing program.

Because of their complexity, leveraged leases should be offered only by banks with appropriate expertise. Examiners should determine whether the personnel who structure and administer leases are qualified in that area and have a working knowledge of applicable tax laws and regulations.

To ensure a safe and sound leasing business, a strong leasing department should exhibit the following key characteristics:

- Expert knowledge of the assets acquired for leasing (specifically in the areas of market demand, purchasing, disposition, market value depreciation over time, and appraisal techniques).
- Expertise and experience with structuring lease contracts and perfecting security interests in the leased property.
- Procedures for the periodic reviews of policies to determine consistency with changes in the tax laws, accounting requirements, and market conditions.

Underwriting Standards

The underwriting considerations the bank should apply in leasing are basic to credit risk management and are no less important than for other types of lending. Before entering into a lease, the bank must reasonably expect to realize the return of its full investment in the leased property and the estimated cost of financing the property over the lease term from a combination of rental payments, estimated tax benefits, and the estimated residual value of the property when the lease term expires. Bank lessors should develop specific underwriting guidelines or loan policies that set forth clear and measurable lease underwriting standards, such as a minimum fixed charge coverage ratio, to guide the leasing staff's transaction structuring and risk evaluations. These standards should include credit analysis expectations, lease structures, repayment terms, property and residual controls, covenants, documentation standards, and borrower equity and credit enhancement requirements.

New leasing products such as lease pools offered by brokers/servicers and short-term consumer operating leases such as auto leases tend to have more structural weaknesses than the traditional direct financing leases. Therefore, it is important that bank lessors underwrite these leases as prudently as the traditional direct financing leases and place a stronger

emphasis on these leases' residual valuations and controls, due to the particular structural characteristic of these leases.

When structuring leveraged leases, the bank lessor should consider all relevant aspects of the leasing activities that could affect the bank, including capital requirements, estimated future cost of funds, cash flows, and legal and administrative expenses, due to the size impact and the multiple parties involved. The return on the bank's investment in leveraged leases depends largely on these factors, and even a slight change in the variables can affect profitability.

Financial and Payment Capacity Analysis

Accurately estimating cash flows from the lease, such as tax advantages or the residual value of the property at the lease's end, is key to measuring risk in lease financing transactions. With each lease transaction, a bank should compute the internal rate of return, considering lease payments, estimated tax benefits, the estimated residual value at expiration of the lease, and the cost of funds. Any change in variables during the lease term will affect the rate of return.

For each lease, the bank should review the risks affecting collectibility by ensuring that the bank has established the creditworthiness of the borrower (lessee), has considered potential changes in tax benefits, and has periodically assessed the value of the leased property. This includes evaluating the lessee's character and credit history as evidence of the lessee's willingness to repay the lease obligation as agreed. The bank should evaluate the lessee's income and financial resources to demonstrate its ability to meet the lease obligation according to the terms established.

In a leveraged lease transaction, the bank lessor should carefully scrutinize the financial capacity of all parties involved in the lease. If the lessee defaults, the lessor would have to repay the loan if it wants to recapture at least a part of its investment. Thus, the bank should not enter into a leveraged lease as the lessor, i.e., the equity participant, unless the bank has the capacity to maintain the lease for a time in the event the lessee defaults.

When reviewing lease pools serviced by a third-party servicer, the bank lessor must be aware of the composition and performance of the lease portfolio, regardless of any take-out arrangements that may exist. This is crucial if the servicer fails and the bank lessor must assume control of the pools.³¹

When underwriting leases for municipalities, the bank should determine the likelihood of non-appropriation, an assessment that should be based on the type of property leased. Municipalities may cancel property leases if funds are not appropriated. All municipal leases should include a provision that prohibits the municipality from re-leasing or purchasing

³¹ For further guidance pertaining to the use of third-party services, please refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," October 30, 2013.

similar property if the lease is canceled.³² In general, the agreement also should include evidence of appropriation for the first fiscal period.

Valuation and Residual Analysis

Ownership of the leased property is an additional consideration in evaluating a lease transaction. If the lessee defaults, a bank, as owner, usually can recover the property more expeditiously than other secured lending. Therefore, the bank lessor should carefully review the underlying property and workout covenants (which are often unique) to ensure the contracts are written to reduce the bank's risks.

Leased property may be valued by appraisal, engineering estimates, brokers'/dealers' prices for similar used assets, and past recoveries on similar assets. In the automobile leasing business, for example, staff may obtain estimates from the various industry pricing guides, such as the National Automobile Dealers Association guides, which look at trends in used car prices and project future retail and wholesale prices for various vehicle makes and models. In the equipment financing business, Equipment Watch is a major price discovery source. It is important that the bank lessor use conservative estimates based on wholesale value, rather than retail value, as the bank will likely sell the leased property at wholesale at lease end.

The bank lessor should evaluate the residuals on individual leases as part of the overall assessment of risk in the bank's portfolio. The bank must carefully review how the property is valued initially and periodically throughout the lease to determine whether the residual value is reasonable. If the bank uses a model to derive residual values, it must determine whether assumptions used in the model are reasonable. Incorrect assumptions or changes in market conditions affecting the property could make it difficult for the bank to recover its investment. If the bank manipulates income by projecting unreasonably high residuals, it exposes itself to unwarranted risk during the lease term.

The leasing staff's ability to realistically estimate the value of the leased property at the end of the lease and the ability to apply an effective control over the property is key to the success of any leasing program. A good way for the bank to exert such a control is to periodically inspect properties for condition and possible misuse to prevent rapid deterioration of the value of the property before the lease term expires. The bank lessor also should monitor properties for obsolescence or market value decline, which could assist in structuring profitable lease programs in the future.

Lease Documentation Standards

Banks must be thoroughly familiar with the documentation for lease financing and its operation. Lease financing documentation is similar to the documentation for any secured financing and includes the following:

³² This also is referred to as the non-substitution clause.

- A lease financing agreement that details the lease obligation, including payment amounts and the lease term.
- A security agreement that establishes the lessor's right to the leased property in event of default.
- A financing statement filed under the UCC that perfects the lessor's right in the personal property.
- An assignment from the original lessor, passing rights under the financing arrangement to the bank (only if it purchases the lease from a broker or invests in a pool of leases).

Bank management must understand the documentation regardless of the structure of the transaction. Legal counsel familiar with leasing and answerable to the bank should thoroughly review the documentation. Each lease agreement should clearly state the type of lease structure and identify the specific characteristics that qualify the lease for the designated tax and accounting classifications. Most importantly, the bank lessor should obtain a clear title to the leased property to enable its repossession and liquidation if the lessee defaults. There should be clear recourse to the collateral if the lessee defaults.

Regardless of whether it is originating the leases directly or purchasing them through a third party or in a pooled arrangement, the bank lessor should have control of the documentation. Not only can the bank readily monitor the documents, but, in certain situations, possessing the actual lease also can provide a distinct advantage in the perfection and recovery of collateral and the ability to take control of cash flow from leases.

Tax Considerations

Tax credit-driven leases often are complex transactions that require significant due diligence and an appropriate risk management framework. Lessors whose returns depend substantially on tax benefits risk losing them if the lessee defaults or tax laws change. Some lessors/owners may claim accelerated depreciation on the cost of the property, which can produce deferred tax benefits because of the difference between book and tax accounting. This action results in a tax deferral, not the elimination of tax liability. The deferred taxes must be paid when the property is either sold or taken out of service. Therefore, such benefits are more pronounced with long-term leases than with short-term leases.

Some leasing transactions offer investment tax credits to the lessors. In such circumstances, a bank should evaluate its present and anticipated future tax position and future money rates. If there is a default and leases depending on tax benefits are "unwound," the bank may be required to recapture tax benefits taken to date. That could significantly increase the bank's exposure to loss. Therefore, a bank lessor should periodically review its exposure to changes in its tax position. When the exposure is caused by changes in tax laws, the bank should determine whether the borrower indemnifies the lessor against that risk.

The tax authority decides whether the bank is eligible for a tax credit. It is therefore important that a lease contract be in a form acceptable to the IRS, the state and local tax departments, or both, as applicable. The IRS considers the inclusion of the following components to meet the requirements of a bona fide lease transaction:

- The term should be less than the useful life of the property; otherwise, the lease may be regarded as a form of sale.
- The rent should provide a reasonable return to the lessor.
- The renewal option should be bona fide. This requirement may be met by giving the lessee the first option to meet an equal bona fide outside offer.
- Any purchase option should not be less than fair market value.

IRS requirements may change periodically. Bank lessors should continually monitor tax law changes and structure lease contracts so the bank lessors' interests are protected if tax laws change.

Interest Rate and Liquidity Risk Considerations

When a bank funds a lease, management should consider the potential impact on earnings arising from IRR. Banks can use a variety of techniques to manage IRR, such as adjusting the maturity and payment frequency of the lease, basing the implicit interest rate on a floating rate, or hedging the fixed-rate exposure. Bank management should use the appropriate techniques to manage the risk associated with fixed-rate lease financing.

To the extent that the leasing portfolio affects a bank's liquidity, management should assess any expected needs to liquidate portions of the portfolio to meet other funding requirements or take advantage of other opportunities. Examiners must evaluate the terms of the leases and determine whether anything could affect the bank's expected yield on the leasing portfolio. Concentrations by obligor, industry, or property type should be carefully reviewed to evaluate the liquidity risk, as well as credit risk.

Risk Rating Leases

Regulatory Ratings

When evaluating lease receivables for possible adverse classification, examiners should apply the uniform classification definitions found in the "Rating Credit Risk" booklet of the *Comptroller's Handbook*. To determine the appropriate classification, examiners should consider all information relevant to evaluating the prospects that the expected return from the lease will be fulfilled. This evaluation includes information on the borrower's creditworthiness, the residual value, tax benefits provided by accelerated depreciation or tax credits, and any support provided by financially responsible guarantors.

As with other types of loans, leases that are adequately protected by the current sound worth and the paying capacity of the borrower (lessee), the presence of a strong guarantor, the underlying lease property value, or the tax benefits generally should not be classified. Similarly, leases to sound borrowers that are renewed in accordance with prudent underwriting standards should not be classified unless well-defined weaknesses exist that jeopardize the lease payments, the residual value, or the associated tax benefits. A bank should not be criticized for continuing to carry leases with weaknesses that resulted in

classification or special mention as long as the bank has a well-conceived and effective workout plan for such borrowers/lessees and effective internal controls to manage the level of risk from the leases.

The risk rating of off-lease property also should be consistent with the “Rating Credit Risk” booklet of the *Comptroller’s Handbook*. While it is not OCC policy to automatically classify off-lease property, the market value (or fair value less cost to sell) of such assets could have declined significantly from their book value. The fact that the property is off-lease usually indicates a significant decline in the value compared with its original estimate or a lack of current demand for the use of this property. A bank often suffers a loss when it has to dispose of this property due to regulatory requirements despite the apparent adequacy of appraised values. Off-lease property is a nonearning asset, and the bank will incur costs to hold the property, such as property taxes, insurance, utilities, repairs, and maintenance. The bank may also incur substantial liability for certain types of property from environmental issues.

Impairment Analysis and Allowance for Loan and Lease Losses

According to GAAP, the lessor is required to review the residual value at least once each year. If a decline in residual value is other than temporary, the resulting reduction in the net investment must be recognized as a loss in the period of the decline, through a charge to noninterest income instead of a provision to the allowance for loan and lease losses (ALLL). Estimated residual values should not be revised upward.

Loss experience for a well-structured and controlled lease financing transaction is often minimal compared with other types of lending. A bank should ensure that its ALLL methodology for financed lease receivables accurately reflects the bank’s historical loss experience and other relevant factors. The OCC encourages banks to segment their loan and lease portfolios into as many components as practical to provide a more thorough evaluation of estimated credit losses. Bank management should first separate the lease portfolio out from the loan portfolio. Further consideration should be given to segmentation of the lease portfolio based on industry concentrations or other characteristics, such as the categories of leases delineated in this booklet.

ASC 450-20, “Loss Contingencies,” and call report instructions provide guidance on the ALLL. For additional ALLL guidance, please see OCC Bulletin 2001-37, “Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions,” and OCC Bulletin 2006-47, “Allowance for Loan and Lease Losses (ALLL): Guidance and Frequently Asked Questions (FAQs) on the ALLL.”

Examination Procedures

This booklet contains expanded procedures for examining specialized activities or specific products or services that warrant extra attention beyond the core assessment contained in the “Community Bank Supervision,” “Large Bank Supervision,” and “Federal Branches and Agencies Supervision” booklets of the *Comptroller’s Handbook*. Examiners determine which expanded procedures to use, if any, during examination planning or after drawing preliminary conclusions during the core assessment.

Scope

These procedures are designed to help examiners tailor the examination to each bank and determine the scope of the lease financing examination. This determination should consider work performed by internal and external auditors and other independent risk control functions and by other examiners on related areas. Examiners need to perform only those objectives and steps that are relevant to the scope of the examination as determined by the following objective. Seldom will every objective or step of the expanded procedures be necessary.

Objective: To determine the scope of the examination of lease financing and identify examination objectives and activities necessary to meet the needs of the supervisory strategy for the bank.

1. Review the following sources of information and note any previously identified problems related to lease financing that require follow-up:
 - Supervisory strategy
 - Examiner-in-charge’s (EIC) scope memorandums
 - OCC’s information system
 - Previous reports of examination (ROE) and work papers
 - Internal and external audit reports³³ and previous audit work papers
 - Bank management’s responses to previous ROEs and audit reports
 - Customer complaints and litigation
2. Obtain the results of such reports as the Uniform Bank Performance Reports (UBPR) and Canary.
3. Obtain and review the policies, procedures, and reports that bank management uses to supervise lease financing. Consider
 - lease financing policies, risk management guidelines, and subsidiary control.

³³ If an examiner was assigned to review internal and external audits, a copy of any significant deficiencies for this area should be obtained from that examiner. If the internal and external audits were not part of the overall scope of examination, review the work performed by the internal and external auditors in this area and obtain a list of any deficiencies noted in their most recent review.

- portfolio strategies and leasing profitability reports.
 - general ledger, trial balance, and related call report entries.
 - internal risk assessments and risk-rating stratification and migration reports.
 - a list of all leases that are past-due, nonaccrual, and defaulted as of the examination date, including the date of lease, terms, book value, residual value, date of last payment, description, and location of property.
 - a list of restructured or modified leases.
 - a list of lowest-rated pass leases.
 - past-due and defaulted lease reports submitted to the board of directors or its loan or leasing committee.
 - latest appraisal report or other collateral evaluation for past-due and defaulted leases.
 - board or loan committee reports and minutes related to leasing activities.
 - a schedule of lease commitments, as of examination date, that gives the name of the prospective lessee, the date of commitment, expiration date, cost, and description of property to be leased.
 - a list of off-lease property, as of examination date, which discloses the book value, the date property came off lease, a description and location of property, the date of latest appraisal, and the appraised value.
 - a list of liability and other information on common borrowers available from other examiners assigned to review cash items, overdrafts, and other loan areas.
 - concentration and exception reports, measured in dollars and units and as a percentage of total capital and total loans/leases, respectively.
 - reports used to monitor lease compliance and off-lease property.
 - a list of lease participations purchased and sold as of examination date, indicating from whom purchased or to whom sold.
 - information about the composition of the leasing business unit, including the organizational chart, résumés of senior staff, and lending authorities.
 - a list of leases made to insiders of the bank or any affiliate of the bank.
 - a list of third-party servicers and vendors involved in the bank's leasing program, showing the descriptions of the services, terms, costs, and related risk assessments.
4. In discussions with bank management, determine if there have been any significant changes since the previous examination of lease financing. Consider
- how management supervises the lease financing area now and before.
 - any significant changes in policies, practices, personnel, control systems, products, volumes, markets, and geographies.
 - any internal or external factors that could affect the lease financing area.
5. Determine if the national bank or FSA is in compliance with the relevant sections of the laws and regulations.
6. Based on an analysis of information obtained in the previous steps, as well as input from the EIC, determine the scope and objectives of the lease financing examination.

Quantity of Risk

Conclusion: The quantity of each associated risk is
(low, moderate, or high).

Credit Risk

Objective: To determine the quantity of credit risk associated with lease financing.³⁴

1. Analyze the quantity of credit risk. Consider in your analysis the products, markets, geographies, technologies, volumes, size of the exposures, quality metrics, concentrations, etc.
2. Assess the effect of external factors, including economic, industry, competitive, and market conditions.
3. Assess the effect of potential legislative, regulatory, accounting, and technological changes.
4. Prepare for examination a sample of leases that in the examiner's judgment require in-depth review.
5. Using the list of liability and other information on common borrowers, decide who will review the borrowing relationship.
6. Using selected lessee liability records and document files, transcribe or download the following information onto line sheets:
 - Name of lessee
 - Type of business and other affiliations
 - Name(s) of guarantor(s)
 - Date lease was made
 - Terms including options
 - Expiration date of lease
 - Date of last lease payment
 - Aggregate unpaid rentals
 - Description and location of property
 - Cost of property
 - Book value
 - Residual value
 - Accumulated depreciation

³⁴ Appendix C, "Quantity of Credit Risk Indicators," provides a detailed matrix for assessing the quantity of credit risk.

- Insurance coverage
- Corporate resolution to lease or guarantee

For leveraged leases, transcribe or download the following additional information onto line sheets:

- Bank's original investment
- Name of indenture trustee (person holding security interest in leased property for the benefit of the lenders)
- Name(s) of lender(s)
- Original amount financed by lender(s)
- Current amount owed to lender(s)
- Terms of the debt
- Maturity of the debt
- Name of owner trustee (person holding title to the leased property for the benefit of the equity holders)
- Name of other equity participants and percentage of equity owned

7. Request credit folders on all selected leases and transcribe the following information to financial statement line sheets and comment line sheets:

- Balance sheet and profit and loss statements for the preceding three fiscal years
- The most recent interim balance sheets and profit and loss statements
- Projections of future operations, including cash flow debt servicing requirements, earnings, and lease commitments
- Current financial information on any guarantors
- Past and present borrowing records with the bank and outside credit inquiries
- Relevant information from the loan officer's credit memorandums

8. Determine whether the terms and conditions of selected leases are appropriate.

9. Determine that rentals, estimated tax benefits, and the estimated residual value of the property at the expiration of the term are such that the bank can reasonably expect to realize the return of its full investment in the leased property plus the estimated cost of financing the property over the term of the lease.

10. Evaluate the credit quality of each selected lease. Consider

- the lessee's ability to properly amortize the fixed obligations, including all present and proposed lease arrangements.
- the correlation between projected and achieved operational results, with emphasis on cash flow.
- possible adverse operating trends.
- the reasonableness of residual values and any exposure to income adjustments or loss on termination.

- whether the residual value has been reviewed in the last 12 months.
 - the usefulness of the leased property to a third party given the condition of the property.
 - the support offered by other collateral.
 - potential exposure to income through the recapture of tax benefits or changes in tax laws or rates.
 - the support afforded by guarantors.
 - the support afforded by vendor support arrangements.
 - accelerated payments in the early years of the lease.
 - any concentration of leases.
11. Check central liability file on lessee(s) selected for review that are suspected of having additional liability in other loan areas. Discuss any potential lending limit violations with the EIC and the examiner assigned to loan portfolio management.
12. Assign classification of credit and specific allowance allocation for each lease, if appropriate.
13. To evaluate the credit quality of each selected delinquent or defaulted lease, also consider
- the duration of adverse operating trends and prospects for the future.
 - the reasonableness of the latest appraisal report or other collateral evaluation.
 - the status of any proposed sale or lease.
14. For property acquired for future leasing activity,
- obtain a list of all property acquired and held for future leasing activities as of the examination date. The list should include the date the property was acquired, the book value of the property, and the original cost of the property.
 - determine whether property held for an extended period has been reviewed for impairment of value. If the value of the property is permanently impaired, ensure that the bank has written down the book value to reflect the impairment.
15. For national bank leases of real property to a municipality or public authority (12 CFR 7.1000(d)), determine that the lessee has resources sufficient to make payments on all rentals as they become due. Sufficient resources may be demonstrated by general taxing ability.

Interest Rate Risk

Objective: To determine the quantity of IRR associated with lease financing.

1. Assess the reasonableness of the bank's calculation of the inherent gain or loss for each lease selected for review.

2. Analyze both current and projected yields computed by the bank for reasonableness and accuracy by
 - comparing the yield against the bank's share of investment for leveraged leases.
 - tracing income and lease balances from the yield calculation to the general ledger.
 - obtaining a listing of unearned income-leasing accounts and reconciling the total to the general ledger liability account.
3. Assess the effect of lease financing on the quantity and direction of IRR. Consider
 - the effect of interest rate changes on both the lessee and the lessor.
 - underwriting terms such as lease term, residual valuation, pricing structure for the underlying property (e.g., fixed vs. variable interest rates funding), and the potential exposure to different pricing indices.
 - off-balance-sheet exposures from operating leases.
 - interest rate exposure from debt financing for leveraged leases.
 - the quality and results of sensitivity analysis and portfolio stress testing.
4. Discuss findings with the EIC and provide conclusions regarding the effect of leases on the bank's interest rate risk profile.

Liquidity Risk

Objective: To determine the quantity of liquidity risk associated with lease financing.

1. Evaluate liquidity risk within the bank's leasing portfolio. Consider the following factors in the evaluation:
 - Leasing portfolio growth rates and the corresponding funding strategies
 - The composition and quality of the leasing portfolio and the feasibility of liquidating the leases without undue risk to the bank
 - Bank management's experience in accessing markets (secondary or syndicated), as well as success in selling leases under various market conditions
 - Current market conditions
2. Discuss findings with the EIC and provide conclusions regarding the effect of leases on the bank's liquidity risk profile.

Operational Risk

Objective: To determine the quantity of operational risk associated with lease financing.

1. Assess the effect of lease financing on the quantity and direction of operational risk. Consider

- any operational losses resulting from lease financing activities.
 - control weaknesses identified by audit, loan review, or any other control group.
 - the quality of board oversight.
 - the quality of credit administration, e.g., segregation of duties, financial analysis, property controls, and documentation standards.
 - the quality and independence of the audit and loan review functions.
 - staffing turnover affecting the lease financing.
 - responses to the Internal Control Questionnaire (ICQ).
2. Determine the effectiveness of the bank's risk management systems and internal controls. Complete the Verification Procedures, if necessary.
 3. Discuss findings with the EIC and provide conclusions regarding the effect of leases on the bank's operational risk profile.

Price Risk

Objective: To determine the quantity of price risk associated with lease financing.

1. For off-lease property,
 - determine the reason for off-lease status.
 - evaluate the reasonableness of the latest appraisal or other collateral evaluation and evaluate condition of the property.
 - determine the status of any proposed sale or lease.
 - assign classification of credit and specific valuation allowance allocation for each off-lease property, if appropriate.

Compliance Risk

Objective: To determine the quantity of compliance risk in accordance with applicable laws, regulations, and rulings arising from lease financing activities.

1. Review the bank's history of compliance with leasing-related laws and regulations, particularly those establishing legal lending limits, restrictions on insider lending and affiliates, and specific rules and requirements for lease financing activities. Determine
 - whether financing arrangements meet the limits on loans or extensions of credit under 12 USC 84 and 12 CFR 32.
 - for FSAs, whether financing arrangements meet the limits on loans or extensions of credit under 12 USC 1464(c), 12 USC 1464(u), and 12 CFR 32.
 - whether financing arrangements meet the restrictions on transactions with affiliates under 12 USC 371c and 371c-1 and 12 CFR 223 (Regulation W).
 - whether financing arrangements meet the restrictions on insider lending under 12 USC 375a and 375b and 12 CFR 215 (Regulation O).

2. Determine if there is a new incidence of legal lending limit violation resulting from specific lease financing transactions. Combine the lessee's total obligations to the bank, including the present values³⁵ of the lease payments and residual values based on the "rate implicit in the lease" as defined in GAAP. If the combined total value is greater than the lending limit, cite a violation of the lending limit.

3. Regarding 12 CFR 23, subpart A (for national banks' 12 USC 24(Seventh) and CEBA leases), determine
 - that all leases are net leases under which the bank is not directly or indirectly responsible for servicing, repair, maintenance, purchasing of parts and accessories, or insuring the leased property.
 - that all leases meet the full-payout requirement as defined in the regulations.
 - that any purchase of property is consistent with the provisions of 12 CFR 23.4(a) or (b).
 - that, for property acquired for future leasing activities, the bank's aggregate investment in property acquired for future leasing activities does not exceed 15 percent of the bank's capital and surplus as specified in 12 CFR 23.4(b)(2).

4. Regarding 12 CFR 23, subpart B (for national banks' CEBA leases only), determine
 - that the aggregate book value of all tangible personal property held under CEBA leases does not exceed 10 percent of consolidated bank assets.
 - that the initial lease term was not less than 90 days.
 - whether the bank specifically identifies any records it maintains on its CEBA leases in a manner that distinguishes them from records on 12 USC 24(Seventh) leases.

5. Regarding 12 CFR 23, subpart C (for national banks' 12 USC 24(Seventh) leases only), determine
 - that the lease qualified as the functional equivalent of a loan.
 - that the estimate of the unguaranteed portion of the residual value is reasonable and does not exceed 25 percent of the original cost.
 - that all leases represent noncancelable obligations of the lessee.

6. Regarding 12 CFR 160.41(c) (for FSAs' finance leases), determine
 - that the lease qualified as the functional equivalent of a loan.
 - that all leases meet the "net lease" and "full-payout" requirements.
 - that the estimate of the unguaranteed portion of the residual value is reasonable and does not exceed 25 percent of the original cost.

³⁵ In lieu of the present value calculation, examiners can use the following formula as a quick estimate of the obligation of the lessee: Bank cost of acquisition of personal property minus the investment tax credit realized minus the balance of any nonrecourse debt.

- that all leases represent noncancelable obligations of the lessee.
7. Regarding 12 CFR 160.41(d) (for FSAs' general leases), determine that the aggregate book value of all tangible personal property held under general leases does not exceed 10 percent of consolidated bank assets.
 8. Discuss findings with the EIC and provide conclusions regarding the effect of leases on the bank's compliance risk profile.

Strategic Risk

Objective: To determine the level of strategic risk associated with lease financing.

1. Evaluate strategic risk within the bank's lease financing portfolio. Consider the following factors when making your assessment:
 - The bank's lease financing strategy and any planned changes.
 - Management's record of decision making.
 - Board oversight of strategic initiatives.
 - The quality of the bank's lease financing policies, underwriting standards, risk management systems, and consistency with the bank's business strategy and the board's risk appetite.
 - The staff's ability to implement lease financing strategies without exposing the bank to unwarranted risk.
 - The due diligence process for new products and services.
2. Discuss findings with the EIC and provide conclusions regarding the effect of lease financing on the bank's strategic risk profile.

Reputation Risk

Objective: To determine the level of reputation risk associated with lease financing.

1. Evaluate reputation risk within the bank's lease financing portfolio. Consider the following factors in the assessment:
 - Management's ability to anticipate and respond to legal, regulatory, or market forces that could affect reputation risk.
 - The quality of the bank's lease financing policies, credit administration, and problem lease workout function.
 - The adequacy of lease financing controls and the independent review function.
 - The volume of lease financing-related litigation.
2. Determine the volume of the bank's syndicated lease financing activity, if applicable. Review related policies and procedures for appropriateness and assess management's

ability to meet legal and fiduciary responsibilities without incurring unwarranted reputation risk.

3. If the bank engages in a significant volume of complex structured leasing transactions, review and assess management's due diligence procedures, oversight, and internal controls. Consider the results of structured lease reviews by the OCC or other independent parties.
4. Discuss the findings with the EIC and provide conclusions regarding the effect of lease financing on the bank's reputation risk profile.

Quality of Risk Management

**Conclusion: The quality of risk management is
(strong, satisfactory, or weak).**

The conclusion on the quality of risk management considers all risks associated with lease financing.³⁶

Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies often set standards (on risk tolerances, for example) and should be consistent with the bank's underlying mission, values, and principles. A policy review should always be triggered when the bank's objectives or standards change.

Objective: To determine whether the board has adopted effective policies and practices that are consistent with safe and sound banking practices and appropriate to the size, nature, and scope of the bank's lease financing.

1. Evaluate relevant policies to determine whether they provide appropriate guidance for managing the bank's lease financing and are consistent with the bank's mission, values, and principles. Consider the impact of significant policy changes on the quantity of credit risk, if any. Policies and underwriting guidance should do the following:
 - Establish procedures for reviewing lease financing applications.
 - Define types of leasing activities that the bank will consider, including any limits.
 - Define qualified property.
 - Establish minimum standards for documentation.
2. Determine whether policies establish hard and risk-based limits or positions and delineate prudent actions to be taken if the limits are exceeded.
3. Verify that the board of directors periodically reviews and approves the bank's lease financing policies. Determine whether the board of directors considers the compatibility of the policies with the changing market conditions.
4. Test for compliance with established policies or practices. Identify any area with inadequate supervision or undue risk and discuss with the EIC the need to perform additional procedures.

³⁶ Appendix D, "Quality of Credit Risk Management Indicators," provides a detailed matrix for assessing the quality of credit risk management.

Processes

Processes are the procedures, programs, and practices that impose order on a bank's pursuit of its objectives. Processes define how daily activities are carried out. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

Objective: To determine whether the bank has processes in place to define how lease financing is carried out and the adequacy of the lease administration processes.

1. Evaluate whether processes are effective, consistent with underlying policies, and effectively communicated to appropriate staff. Consider
 - whether the board of directors has clearly communicated objectives and risk limits for leases to the bank's management and staff.
 - whether communication to key personnel within the bank's leasing unit is timely.
2. Determine the quality of reports available for administering lease financing effectively. Consider the following:
 - Are periodic property inventory reports prepared by the lessee or trustee?
 - Do reports clearly indicate the condition and location of property?
 - Does the board of directors receive for review at its regular meetings reports listing leases that are past-due, classified, or receiving special attention?
 - Does the board of directors receive accurate reports on lease transaction yields?
3. Assess the bank's process for obtaining inspections on leased personal property. If inspection of the leased property is either infrequent or not feasible, has the bank taken measures to protect its personal property and prevent its misuse?
4. Review the bank's procedures for accepting bids for the purchase of the leased property at termination of the lease to ensure that reasonable estimates of value are obtained. For a lease with no specific purchase options or renewal or extension periods, does the bank require outside appraisals or other reasonable estimates of value before accepting a bid for the purchase of the leased property?
5. Determine whether review procedures are in effect to maintain the necessary insurance coverage on all leased assets. Does the bank's insurance coverage include its potential public liability risk as owner-lessor of the property?
6. Review the adequacy of safeguards in effect to prevent the possibility of a conflict of interest or self-dealing in selecting the following:
 - Seller of the leased property
 - Servicer of the leased property
 - Insurer of the leased property

- Purchaser of the leased property
7. Review the approval process for leases to determine whether
 - provisions within the normal credit policy are met.
 - the originating loan officer(s) or loan and lease committee have adequate lending authority.
 - modifications of terms require the approval of the board or the loan and lease committee that initially approved the lease.
 8. Review the process to ensure that leases are supported by current credit information.
 9. Determine whether commitments are contingent on receipt of certain satisfactory information. If so, is someone other than the account officer responsible for rejecting or accepting that information?
 10. Determine whether the bank's manner of establishing and updating residual values on leased property is in accordance with GAAP. Consider whether
 - residual values are reviewed annually.
 - residual write-downs are in accordance with GAAP if there is an other-than-temporary decline in value.
 - the bank uses modeling to derive residual values, and the underlying assumptions are reasonable.
 - residual schedules balance.
 11. Determine whether the bank's manner of establishing the depreciable life of leased property and depreciation methods is reasonable and in accordance with GAAP. The examiner should consider
 - testing the footings of the depreciation schedules.
 - tracing depreciation expense from depreciation schedules to the subsidiary and general ledgers.
 12. Review the bank's practice of accounting for terminated leases by reviewing leases terminated since the previous examination. Consider whether
 - terminated leases are properly recorded.
 - the sales price for personal property that has been sold was reasonable.
 - any gain or loss on the termination is calculated accurately.
 13. Determine whether appropriate internal controls are in place and functioning as designed, and verify that the bank has an effective process to periodically evaluate internal controls. Complete the ICQ, if necessary, to make this determination.

14. Determine whether the appropriate operational tools exist to safeguard assets and ensure the integrity of accounting data and financial reports for lease financing.
15. Determine whether the bank has established standards and procedures for the use of third-party services in accordance with OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance.”

Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent and should perform appropriately. They should understand the bank’s mission, values, principles, policies, and processes. Banks should design compensation programs to attract, develop, and retain qualified personnel. In addition, compensation programs should be structured in a manner that encourages strong risk management practices.

Objective: To determine management’s ability to supervise lease financing in a safe and sound manner and whether bank management and bank personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to lease financing.

1. Given the scope and complexity of the bank’s lease financing, assess the management structure and staffing. Consider the following:
 - Number of staff members.
 - Whether reporting lines encourage open communication and limit the chances of conflicts of interest.
 - Level of staff turnover.
 - Use of outsourcing arrangements.
 - Capability to address identified deficiencies.
 - Responsiveness to regulatory, accounting, industry, and technological changes.
2. Determine whether management and leasing personnel possess significant current or previous work experience in lease financing. Consider
 - specialized lending experience (e.g., leveraged leasing).
 - tax and accounting experience.
3. Determine whether management and leasing personnel are well educated in lease financing and whether they plan further education in the subject.
4. Assess technical knowledge and ability to manage leasing operations using results of lease administration evaluation and determination of the quantity of risk.
5. Assess performance management and compensation programs. Consider whether these programs measure and reward performance that aligns with the bank’s strategic objectives and risk appetite.

If the bank offers incentive compensation programs, determine whether they are consistent with OCC Bulletin 2010-24, “Interagency Guidance on Sound Incentive Compensation Policies,” including compliance with its three key principles: (1) provide employees with incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance, including active and effective oversight by the bank’s board of directors.

6. If the bank has third-party relationships that involve critical activities, determine whether oversight is consistent with OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance.”

Control Systems

Control systems are the functions (such as internal and external audits, risk review, and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes. Control functions should have clear reporting lines, adequate resources, and appropriate authority. MIS should provide timely, accurate, and relevant feedback.

Objective: To determine whether the bank has systems in place to provide accurate and timely assessments of the risks associated with its lease financing and the effectiveness of control systems employed to manage lease financing.

1. Evaluate the effectiveness of monitoring systems to identify, measure, and track concentrations and exceptions to policies and established limits.
2. Assess the effectiveness of independent risk control functions in lease financing, such as the effectiveness of the loan review function in identifying risk in lease financing. Consider the following:
 - Scope of reviews
 - Frequency of reviews
 - Qualifications of loan review personnel
 - Independence of loan review function
 - Identifications and reporting of emerging risks in loan review reports
3. Assess the scope, frequency, effectiveness, and independence of the internal and external audits of lease financing and determine the adequacy of the audit function for lease financing activities. Consider the following:
 - Scope of the audits
 - Frequency of audits
 - Qualifications of the audit personnel
 - Accessibility to necessary information
 - Board’s responses to audit findings

4. Assess the effectiveness of the compliance review function. Evaluate the scope, timing, and frequency of the reviews, the qualifications of the party performing the reviews, and the reviews' ability to identify potential compliance issues and assess the risk.
5. Determine whether MIS provide timely, accurate, and useful information to evaluate risk levels and trends in the bank's lease financing activities.
6. Determine whether management and the board have appropriately addressed concerns and areas of unwarranted risk.

Conclusions

Conclusion: The aggregate level of each associated risk is
 (low, moderate, or high).
 The direction of each associated risk is
 (increasing, stable, or decreasing).

Objective: To determine, document, and communicate overall findings and conclusions regarding the examination of lease financing.

1. Determine preliminary examination findings and conclusions and discuss with the EIC, including
 - quantity of associated risks (as noted in the “Introduction” section).
 - quality of risk management.
 - aggregate level and direction of associated risks.
 - overall risk in lease financing.
 - violations and other concerns.

Use the following chart to document risk assessment findings and conclusions:

Summary of Risks Associated With Lease Financing				
Risk category	Quantity of risk (Low, moderate, high)	Quality of risk management (Weak, satisfactory, strong)	Aggregate level of risk (Low, moderate, high)	Direction of risk (Increasing, stable, decreasing)
Credit				
Interest rate				
Liquidity				
Operational				
Price				
Compliance				
Strategic				
Reputation				

2. Provide EIC with brief conclusion regarding
 - the adequacy of the bank’s policies or practices regarding leases.
 - how bank officers conform to established policy or practices.
 - adverse trends in the leasing department.

- internal control deficiencies or exceptions.
 - any corrective action recommended for deficient policies, practices, or procedures.
 - the quality of departmental management.
 - the quantity of credit and residual risk in the portfolio.
 - the quality and timeliness of strategic and capital planning for level of risk assumed.
 - the adequacy of MIS.
 - other matters of significance.
3. If substantive safety and soundness concerns that may have a material adverse effect on the bank remain unresolved, further expand the scope of the examination by completing verification procedures.
 4. Discuss examination findings with bank management, including violations, recommendations, and conclusions about risks and risk management practices. Include the following subjects, if relevant:
 - Delinquent leases.
 - Violations of laws, rulings, and regulations.
 - Leases not supported by current and complete financial information.
 - Leases for which documentation is deficient.
 - Personal property deficiencies revealed in inspection reports.
 - Off-lease personal property.
 - Concentrations of leases.
 - Classified leases.
 - Leases to major shareholders, employees, officers, directors, or the interests of officers or directors.
 5. Compose conclusion comments, highlighting any issues that should be included in the ROE. In general terms, address the following subjects:
 - Quantity of risk
 - Quality of risk management
 6. Determine, in consultation with the EIC, whether the risks identified are significant enough to merit bringing them to the attention of the management and the board in the ROE. If so, prepare items for inclusion in a matters requiring attention (MRA) comment.
 7. If necessary, obtain commitments for corrective action.
 8. Update the OCC's information system and any applicable ROE schedules or tables.
 9. Write a memorandum specifically setting out what the OCC should do in the future to effectively supervise lease financing in the bank, including time periods, staffing, and workdays required.

10. Update, organize, and reference work papers in accordance with OCC policy.
11. Ensure that any paper or electronic media that contain sensitive bank or customer information are appropriately disposed of or secured.

Internal Control Questionnaire

An ICQ helps an examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment.

Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written lease financing policies that
 - establish procedures for reviewing lease financing applications?
 - define qualified property?
 - establish minimum standards for documentation?
2. Are lease financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

Records

3. Are separate files maintained for each lease transaction?
4. Do the files show that an officer other than the person who controls the disbursement and receipt of funds reviews and approves, in writing, the acquisition and disposal of assets?
5. Does the bank maintain adequate records to determine whether total CEBA or general leases, as applicable, exceed 10 percent of consolidated bank assets?
6. Is the preparation and posting of subsidiary direct lease financing records performed or reviewed by persons who do not also
 - issue official checks and drafts singly?
 - handle cash?
7. Are the subsidiary lease financing records reconciled at least monthly with the appropriate general ledger accounts, and do persons who do not also handle cash investigate reconciling items?
8. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling subsidiary records of lease receivables to general ledger accounts, and are they handled only by persons who do not also handle cash?
9. Are inquiries about lease balances received and investigated by persons who do not also handle cash?

10. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash?

Interest and Rent

11. Is the preparation and posting of interest and rent records performed or reviewed by persons who do not also
- issue official checks and drafts singly?
 - handle cash?

Depreciation (Operating and Leveraged Leases)

12. Is the preparation and posting of periodic depreciation records performed or reviewed by persons who do not also have sole custody of property?
13. Do the bank's procedures require that depreciation expense be charged at least quarterly?
14. Do persons who do not also have sole custody of the property balance the subsidiary depreciation records to the appropriate general ledger controls at least quarterly?

Property Acquired for Future Leasing Activity

15. Do the bank's procedures require the persons who have access to property to have "sole custody of property" so that
- its physical character or use would make any unauthorized use or disposal readily apparent?
 - inventory control methods sufficiently limit accessibility?
16. Is the addition, lease, or other disposal of property approved by the signature of an officer who does not also control the related disbursement or receipt of funds?
17. Is the preparation and maintenance of property subsidiary records for additions, leases, and other disposals performed or reviewed by persons who do not have sole custody of the property?
18. Are subsidiary property records balanced at least quarterly to the appropriate general ledger accounts by persons who do not also have sole custody of property?
19. Is the existence of property checked or tested, such as in a physical inventory, and are any differences between the property's characteristics and its description in property records investigated by persons who do not also have sole custody of property?
20. Does the bank maintain separate property files that include bills of sale, invoices, titles, or other evidence of ownership?

Conclusion

21. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated through the steps in this section (explain negative answers briefly and indicate conclusions as to their effect on specific examination or verification procedures)?

22. Based on the answers to the foregoing questions, internal control for lease financing is considered (strong, satisfactory, or weak).

Verification Procedures

Verification procedures are used to verify the existence of assets and liabilities, or test the reliability of financial records. Examiners generally do not perform verification procedures as part of a typical examination. Rather, verification procedures are performed when substantive safety and soundness concerns are identified that are not mitigated by the bank's risk management systems and internal controls.

1. Ascertain the bank's policy for establishing the depreciable life of leased property and
 - determine that depreciation schedules for leased property are based on GAAP for fixed assets.
 - test the footings of the depreciation schedules.
 - trace depreciation expense from depreciation schedules to the subsidiary and general ledgers.
2. Review leases terminated since the previous examination and
 - test for reasonableness of sale price.
 - check the computation of gain or loss on the sale, and trace sale proceeds to the general ledger.
3. Review yields computed by the bank or lease packager and
 - determine whether the bank inflates actual yield by netting residual value from equity investment and by applying tax benefits at the inception of the lease.
 - determine that yields on lease transactions are being accurately reported to the board of directors or its committee.
4. Determine whether sampling is needed to complete the following verification procedures. If so, select a sample of leases and
 - reconcile the trial balance of lease records to subsidiary controls, the general ledger, and the call report if using a quarter-end examination date.
 - determine that the lease is properly categorized as a direct financing, operational, or leveraged lease.
 - prepare and mail confirmation forms to lessee. Confirmation forms should include a description and location of the property, monthly or annual rentals, terms, outstanding balance, and other major provisions and options.
 - prepare and mail confirmation forms to lenders and trustees in leveraged lease transactions and verify the outstanding balance of lender's note receivable and the terms.
 - determine that (1) an order to purchase or a legally binding agreement indemnifying the bank against loss was executed before the bank was committed to purchase and deliver the property, or that (2) the acquisition of these assets is consistent with the

bank's existing leasing business or with a business plan for entry into the leasing business or for expansion of the bank's existing leasing business.³⁷

- determine that the files contain bills of sale, invoices, titles, or other evidence of ownership for the property leased.
 - ascertain that a properly executed noncancelable lease is held.
 - determine that the bank has recorded ground leases or waivers from owners or mortgage holders of property on which the leased property is located.
 - review insurance coverage and determine that property damage coverage is adequate relative to book value and that liability insurance is in effect.
 - determine that periodic inspection reports are being received.
 - when a lease is to a corporation, determine that corporate resolutions to lease have been executed.
 - check computation of depreciation.
 - ascertain compliance with the Internal Revenue Code on all major tax-oriented leases.
5. For direct financing leases selected above,
- obtain or prepare a listing of unpaid monthly rentals and reconcile to the general ledger and ensure that the proper lease amounts are recorded in the general ledger.
 - verify that the lease receivable amount is correctly recorded and includes minimum rental payments plus residual value.
 - compare the amount of the lease payments to the lease agreement.
 - recalculate the amount of unearned income.
 - check the computation of investment tax credit.
6. For operating leases selected above,
- reconcile the bank's recorded cost of the property to purchase invoices and payment drafts.
 - compare rental income from operating leases in the general ledger to the amounts of stated rents in the individual leases.
 - check the computation of any investment tax credits.
7. For leveraged leases selected above, determine
- the monthly payments to loan participants to ensure interest expense is properly recorded.
 - that the investment is recorded in accordance with GAAP.
 - that the lease income is properly recognized in accordance with GAAP.
 - the reasonableness of assumptions (tax position, residual value, etc.) the bank uses in its analysis.
 - the computation of any applicable investment tax credits.

³⁷ This requirement does not apply to FSAs.

- the appropriate verification procedures for the type of loan involved if the bank is a lender of the lease.
 - that provisions in the lease for default and early termination due to obsolescence and casualty losses agree with the terms of debt.
 - whether the lease and debt permit equity holder(s) to correct or prevent defaults and foreclosures by fulfilling the obligations of the lessee or repaying the debt early.
 - that all debt instruments contain a nonrecourse provision that negates any bank liability.
 - whether the bank has obtained a favorable IRS ruling on the tax benefits and whether the lessee has indemnified the lessor against the loss of tax benefits because of future changes in tax laws.
8. In addition to the procedures detailed above for leveraged leases, perform the following steps for equity participations:
- Determine that all participations are without recourse.
 - Determine that the bank has taken the necessary steps to ensure that it does not become a general partner with the participants.
 - Compare participations purchased to approvals recorded in the minutes of the board of directors or committee meetings.
9. For delinquent and defaulted leases selected above,
- determine the cost to the bank of repossessing and selling the property or repossessing and converting it to income-producing status through re-lease.
 - evaluate the reports submitted to the board of directors or its loan or leasing committee to evaluate if the reports are complete in their evaluation of risk factors, loss potential, and causes of delinquency or default, and if they propose a course of action.
10. For commitments to lease,
- evaluate the reasonableness of estimated residual value.
 - compare lease commitments to approvals recorded in minutes of board of directors or committee meetings.
11. For national bank leases of real property to a municipality or public authority (12 CFR 7.1000(d)), determine that the lease agreement provides that, upon expiration, the lessee becomes title holder of the property.
12. For off-lease property,
- determine the cost to the bank of selling the property or converting it to income-producing status through re-lease.
 - determine whether the bank disposes of off-lease property as soon as practical.

- determine whether any of the property has been off-lease for five years or more. If so, determine whether the bank received an extension from the OCC.
- balance the aggregate book value to the general ledger.

13. For property acquired for future leasing activity,

- obtain a list of all property acquired and held for future leasing activities as of the examination date. The list should include the date the property was acquired, the book value of the property, and the original cost of the property.
- determine that the acquisition of these assets is consistent with the bank’s existing leasing business or consistent with a business plan for expansion of the bank’s existing leasing business or for entry into the leasing business as required by 12 CFR 23.4(b)(1).³⁸
- obtain all subsidiary asset ledgers, add up the numbers on a test basis, and check against the general ledger control accounts.
- test the propriety of significant acquisitions. To do so, compare each such acquisition’s cost with that of similar assets, review the method used to select a vendor, and inspect the asset in person.
- test the propriety of the lease price by comparing the price with that of similar assets and by reviewing the method used to establish the lease price.

³⁸ FSAs do not need to conform to this requirement. See the “Statutory and Regulatory Framework for Leasing” section of this booklet for more details.

Appendixes

Appendix A: Comparison of the Leasing Authority for National Banks and FSAs

Generally, the finance leases and general leases for FSAs are similar to the national banks' 12 USC 24(Seventh) leases and the CEBA leases, respectively. There are, however, several key differences, which are summarized in the following table.

Table 1: Comparison of the Leasing Authority for National Banks and FSAs

Key features and requirements	National banks		Federal savings associations	
	12 USC 24 (Seventh) leases	12 USC 24(Tenth) leases (CEBA)	Finance leases	General leases
Functional equivalent of a loan	Yes	No	Yes	No
Tangible personal property	Yes	Yes	Yes	Yes
Intangible personal property	Yes	No	No	No
Net lease	Yes	Yes	Yes	No
Full-payout	Yes	Yes	Yes	No
25 percent maximum residual value	Yes	No	Yes	No
Investment limit of 10 percent of total assets	No	Yes	Yes ^a	Yes
Separate documentation required	No	Yes	No	No
90-day minimum lease term	No	Yes	No	No
Conforming commitment or agreement required prior to property purchase (unless the purchase is consistent with an existing leasing business or with a plan, for which a limit of 15 percent of capital and surplus applies)	Yes	Yes	No	No
Off-lease property is subject to a maximum five-year holding period and requires OCC permission for extensions	Yes	Yes	No ^b	No

^a Business finance leases have a limit of 10 percent of assets (20 percent if amounts in excess of 10 percent are used only for small business) and consumer finance leases have a limit of 30 percent of assets (35 percent if the amounts in excess of 30 percent are direct lending by the FSA). See 12 USC 1464(c)(2)(A) and (D), and 12 CFR 160.41(c).

^b For finance leases, FSAs are required to liquidate or re-lease off-lease property as soon as practicable under 12 CFR 160.41(c). FSAs are not subject, however, to the five-year holding period rule pertaining to national banks.

Appendix B: Examples of Lease Accounting

Example 1: Operating Lease

The following is a description of an operating lease on office equipment:

Lessor’s cost of the leased property.....	\$10,000
Fair value of the leased property at inception of the lease.....	\$10,000
Monthly lease payments.....	\$270
Residual value (not guaranteed) at end of lease.....	\$4,000
Present value of lease payments discounted at the implicit interest rate of 12.04 percent.....	\$7,035
Economic life of the property.....	60 months
Lease term.....	30 months

The lease does not transfer ownership of the property to the lessee at the end of the lease, nor does it contain a bargain purchase agreement. Further, collection of the minimum lease payments is reasonably predictable, as is the amount of unreimbursed costs to be incurred by the lessor.

The lease meets both of the two additional qualification criteria for the lessors set forth in the “Accounting Categorization of Leases by Lessors” section of this booklet, because

- collection of the minimum lease payments is reasonably predictable.
- the amount of unreimbursed costs to be incurred by the lessor is substantially predictable.

The lease does not meet any of the four ownership transfer requirements, however, in that

- the lease does not transfer ownership of the property at the end of the lease.
- the lease does not contain a bargain purchase option.
- the lease term is less than 75 percent of the estimated economic life of the equipment.
- the present value (\$7,035) of the minimum lease payments is less than 90 percent of the fair value of the property.

Accordingly, the lease would be classified as an operating lease.

The journal entry on the books of the lessor to record this operating lease is as follows:

To record the purchase of the office equipment:

Office equipment.....	\$10,000	
Cash.....		\$10,000

The following entries are recorded monthly:

To record the monthly rental income:

Cash.....	\$270	
Rental Income.....		\$270

To record the monthly depreciation:

Depreciation expense.....	\$200	
Accumulated depreciation.....		\$200

Example 2: Direct Financing Lease

The following is a description of a direct financing lease on office equipment:

Lessor’s cost of the leased property.....	\$10,000
Fair value of the leased property at inception of the lease.....	\$10,000
Monthly lease payments.....	\$245
Residual value (not guaranteed) at end of lease.....	\$1,000
Present value of lease payments discounted at the implicit interest rate of 10 percent.....	\$9,382
Economic life of the property.....	60 months
Lease term.....	48 months

The lease does not transfer ownership of the property to the lessee at the end of the lease, nor does it contain a bargain purchase agreement. Further, collection of the minimum lease payments is reasonably predictable as is the amount of unreimbursed costs to be incurred by the lessor.

The lease meets two of the four ownership transfer criteria set forth in the “Accounting Categorization of Leases by Lessors” section of this booklet, in that

- the lease term *is at least 75 percent* of the estimated economic life of the equipment.
- the present value (\$9,382) of the minimum lease payments *is more than 90 percent* of the fair value of the property.

In addition, the lease also meets both of the two additional qualification requirements for the lessors, because

- collection of the minimum lease payments is reasonably predictable.
- the amount of unreimbursed costs to be incurred by the lessor is substantially predictable.

Since the lease meets at least one of the four ownership transfer criteria and both of the two additional qualification requirements for the lessors, it must be classified as a non-operating (i.e., direct financing) lease.³⁹

The journal entries on the books of the lessor to record this direct financing lease are as follows:

To record the purchase of the office equipment:

Office equipment.....	\$10,000	
Cash.....		\$10,000

To record the lease as a direct financing lease:

Lease receivable, gross.....	\$12,760 ⁴⁰	
Office equipment.....		\$10,000
Unearned income.....		\$2,760

The following entries are recorded monthly:

To record the lease payment:

Cash.....	\$245	
Rental income.....		\$245

To record the interest income earned during the month:⁴¹

Unearned income.....	\$98	
Interest income.....		\$98 ⁴²

³⁹ In this example, the lease meets two of the four ownership transfer criteria. Meeting any of the criteria would cause it to be classified as a non-operating lease by the lessor, if both of the two additional qualification requirements have also been met.

⁴⁰ $\$245 \times 48 + \$1,000 = \$12,760$.

⁴¹ This entry is recorded monthly. The amount, however, decreases as the outstanding balance of the lease receivable decreases.

⁴² $(\$10,000 - \$245) \times 12.09 \text{ percent} / 12 = \98 (\$10,000 initial investment subtracted by the first lease payment at the beginning of the lease term, multiplied by the implicit interest rate).

Example 3: Leveraged Lease

The following is a description of a leveraged lease on equipment:

Lessor’s cost of the leased property.....	\$500,000
Residual value (not guaranteed) at end of lease.....	\$50,000
Annual lease payments.....	\$86,250
Lease term.....	8 years
Depreciable life of property for tax purposes.....	5 years

Financing:

Equity investment by lessor	\$100,000
Long-term nonrecourse debt at 10 percent	\$400,000
Depreciation allowable to lessor for income tax purposes.....	\$500,000
Lessor’s income tax rate (federal and state).....	40%

The following is a schedule of the lessor’s debt amortization.⁴³

Year	Cash payment	Interest expense at 10%	Principal reduction	Unamortized principal
0				400,000 ⁴⁴
1	74,978	40,000	34,978	365,022
2	74,978	36,502	38,476	326,546
3	74,978	32,655	42,323	284,223
4	74,978	28,422	46,556	237,667
5	74,978	23,767	51,211	186,456
6	74,978	18,646	56,332	130,124
7	74,978	13,012	61,966	68,158
8	74,978	6,820	68,158	(0)
Total	599,824	199,824	400,000	

⁴³ For simplicity, this table assumes one annual payment at the end of each year. In practice, lease payments are generally made at the beginning of each month.

⁴⁴ Initial balance.

Unlike income on non-leveraged leases, income on leveraged leases is allocated as after-tax cash flow. The after-tax cash flow must be calculated for each accounting period. To make this calculation, the annual taxable income and resultant tax liability is computed. These amounts are presented in the following table.

Year	Rental income	Depreciation expense	Interest expense	Taxable income/loss	Tax savings (expense) ⁴⁵
1	86,250	150,000	40,000	(103,750)	41,500
2	86,250	120,000	36,502	(70,252)	28,101
3	86,250	90,000	32,655	(36,405)	14,562
4	86,250	60,000	28,422	(2,172)	869
5	86,250	30,000	23,767	32,483	(12,993)
6	86,250	0	18,646	67,604	(27,042)
7	86,250	0	13,012	73,238	(29,295)
8	136,250 ⁴⁶	50,000 ⁴⁷	6,820	79,430	(31,772)
Total	740,000	500,000	199,824	40,176	(16,070)

Once the annual income-tax effect has been computed, the after-tax cash flow can be calculated:

Year	Rental income	Interest expense	Principal reduction	Tax savings (expense)	Annual cash flow ⁴⁸
0					(100,000) ⁴⁹
1	86,250	40,000	34,978	41,500	52,772
2	86,250	36,502	38,476	28,101	39,373
3	86,250	32,655	42,323	14,562	25,834
4	86,250	28,422	46,556	869	12,141
5	86,250	23,767	51,211	(12,993)	(1,721)
6	86,250	18,646	56,332	(27,042)	(15,770)
7	86,250	13,012	61,966	(29,295)	(18,023)
8	136,250	6,820	68,158	(31,772)	29,500
Total	740,000	199,824	400,000	(16,070)	24,106

⁴⁵ At an assumed federal/state combined tax rate of 40 percent.

⁴⁶ Includes the proceeds from the sale of the residual value.

⁴⁷ Represents remaining cost related to residual value.

⁴⁸ Rental income plus tax savings (or less tax expense), less interest expense and principal reduction.

⁴⁹ Initial investment.

Based on the original investment and the expected after-tax cash flows, a constant rate of return is computed for each year in which there is a positive investment. Income is allocated based on this constant rate.

Year	Investment in lease, beginning of year	Annual Cash Flows ⁵⁰			Investment in lease, end of year
		Total	Allocate to income (after tax)	Allocate to investment	
1	100,000	52,772	10,966	41,806	58,194
2	58,194	39,373	6,381	32,992	25,202
3	25,202	25,834	2,764	23,070	2,132
4	2,132	12,141	234	11,907	(9,775)
5	(9,775)	(1,721)	0	(1,721)	(8,054)
6	(8,054)	(15,770)	0	(15,770)	7,716
7	7,716	(18,023)	846	(18,869)	26,585
8	26,585	29,500	2,915	26,585	0
		124,106	24,106	100,000	

Even though the yield on a leveraged lease is computed on an after-tax basis, the lease is recorded and accounted for on a pre-tax basis. Accordingly, the following journal entries record the acquisition of the property and the lease activity during the first year of the lease:

At origination:

To record the initial investment in the lease:

Lease receivable.....	\$140,176	
Unearned income.....		\$40,176
Cash.....		\$100,000

Unearned income is the sum of the annual pre-tax cash flows.

At end of year one:

To record the collection of first year's rent net of mortgage payments:

Cash.....	\$11,272	
Lease receivable.....		\$11,272

Lease receivable represents annual rental payments less debt payments.

⁵⁰ Lease income is recognized as 10.97 percent of the unrecovered investment at the beginning of each year in which the net investment is positive. This rate, when applied to the net investment of years that have a positive balance at the beginning of the year, determines the after-tax net income in those years.

To recognize the first year’s portion of pre-tax unearned income:

Unearned income.....	\$18,276	
Rental income.....		\$18,276

Pre-tax unearned income is allocated in the same proportion as after-tax income allocation, as shown in the table on the previous page.

To record the first year’s tax credit from operations and deferred taxes:

Income tax payable (receivable).....	\$41,500	
Income tax expense.....	\$7,310	
Deferred income tax liability.....		\$48,810

Appendix C: Quantity of Credit Risk Indicators

Examiners should consider the following indicators when assessing the quantity of credit risk associated with lease financing activities.

Low	Moderate	High
The level of lease exposures is low relative to capital.	The level of lease exposures is moderate relative to capital.	The level of lease exposures is high relative to capital.
Leasing portfolio growth rates are supported by local, regional, or national economic trends. Growth has been planned for and is commensurate with management and staff expertise and operational capabilities.	Leasing portfolio growth rates exceed local, regional, or national economic trends. Growth has not been planned for or exceeds planned levels and may test the capabilities of management, leasing staff, and MIS.	Leasing portfolio growth rates significantly exceed local, regional, or national economic trends. Growth has not been planned for or exceeds planned levels, and stretches the experience and capability of management, leasing staff, and MIS. Growth may also be in new products or outside the bank's traditional lending or leasing area.
Interest and fee income from lease financing activities is not a significant portion of loan income.	Interest and fee income from lease financing activities is an important component of loan income; however, the bank's lending and lease financing activities remain diversified.	The bank is highly dependent on interest and fees from lease financing activities. Management may seek higher returns through higher-risk product or customer types. Lease yields may be disproportionate relative to risk.
The bank's leasing portfolio is well diversified, with no single large concentrations or a few moderate concentrations. Concentrations are well within reasonable risk limits. The leasing portfolio mix does not materially affect the risk profile.	The bank has a few material leasing concentrations that may approach internal limits. The leasing portfolio mix may increase the bank's credit risk profile.	The bank has large leasing concentrations that may exceed internal limits. The leasing portfolio mix increases the bank's credit risk profile.
Lease underwriting is conservative. Leases with structural weaknesses or underwriting exceptions are occasionally originated; however, the weaknesses are effectively mitigated.	Lease underwriting is satisfactory. The bank has an average level of leases with structural weaknesses or exceptions to underwriting standards. Exceptions are reasonably mitigated and consistent with competitive pressures and reasonable growth objectives.	Lease underwriting is liberal and policies are inadequate. The bank has a high level of leases with structural weaknesses or material underwriting exceptions. The volume of exceptions exposes the bank to increased loss in the event of default.
Residual sizes and advance rates are conservative. Residual controls and monitoring are effective. Property and residual valuations are reasonable, timely, and well supported. Field audits are timely and appropriate.	Residual sizes are acceptable. Advance rates are moderate, but mitigated by satisfactory controls and monitoring systems. Some valuations may not be well supported or timely. Field audits are generally appropriate.	Residual sizes are liberal. Advance rates may be aggressive. Residual controls and monitoring systems may not effectively mitigate risk. Residual valuations are not regularly obtained, frequently unsupported, or reflect inadequate protection. Field audits are inadequate or not performed in a timely manner.

Low	Moderate	High
Lease documentation exceptions and other underwriting variances are low and have minimal impact on the bank's risk profile.	The level of lease documentation exceptions and other underwriting variances is moderate; however, exceptions are reasonably mitigated and corrected in a timely manner. The risk of loss from these exceptions is not material.	The level of lease documentation exceptions and other underwriting variances is high. Exceptions are not mitigated or not corrected in a timely manner. The risk of loss from the exceptions is heightened.
Distribution of leases across the pass category is consistent with a conservative risk appetite. Migration trends within the pass category favor the less risky ratings. Lagging indicators, including past-dues and nonaccruals, are low and stable.	Distribution of leases across the pass category is consistent with a moderate risk appetite. Migration trends within the pass category may favor riskier ratings. Lagging indicators, including past-dues and nonaccruals, are moderate and may be slightly increasing.	Distribution of leases across the pass category is heavily skewed toward riskier pass ratings. Lagging indicators, including past-dues and nonaccruals, are moderate or high and the trend is increasing.
The volume of adversely rated leases is low and is not skewed toward more severe risk ratings.	The volume of adversely rated leases is moderate, but is not skewed toward more severe ratings.	The volume of adversely rated leases is moderate or high, skewed to the more severe ratings, and increasing.
Lease refinancing and renewal practices raise little or no concern regarding the quality of leases and the accuracy of problem leases data.	Lease refinancing and renewal practices pose some concern regarding the quality of leases and the accuracy of problem leases data.	Lease refinancing and renewal practices raise substantial concerns regarding the quality of leases and the accuracy of problem leases data.

Appendix D: Quality of Credit Risk Management Indicators

Examiners should consider the following indicators when assessing the quality of credit risk management of lease financing activities.

Strong	Satisfactory	Weak
There is a clear, sound leasing credit culture. Board and management's appetite for risk is well communicated and fully understood.	The leasing credit culture is generally sound, but the culture may not be uniform and risk appetite may not be clearly communicated throughout the bank.	The leasing credit culture is absent or materially flawed. Risk appetite may not be well understood.
Leasing initiatives are consistent with a conservative risk appetite and promote an appropriate balance between risk taking and strategic objectives. New leasing products and industries are well researched, tested, and approved before implementation.	Leasing initiatives are consistent with a moderate risk appetite. Generally, there is an appropriate balance between risk taking and strategic objectives; however, anxiety for income may lead to higher-risk transactions. New products may be launched without sufficient testing, but risks are generally understood.	Leasing initiatives are liberal and encourage risk taking. Anxiety for income dominates planning activities. The bank engages in new products without conducting sufficient due diligence or implementing the appropriate controls.
Management is effective. Leasing staff possesses sufficient expertise to effectively administer the risk assumed. Responsibilities and accountability are clear. Appropriate remedial or corrective action is taken when necessary.	Leasing is satisfactorily managed, but improvement may be needed in one or more areas. Leasing staff generally possesses the expertise to administer assumed risks; however, additional expertise may be required in one or more areas. Responsibilities and accountability may require some clarification. In general, appropriate remedial or corrective action is taken when necessary.	Leasing risk management is deficient. The leasing unit may not possess sufficient expertise or may demonstrate an indifference or unwillingness to effectively administer the risk assumed. Responsibilities and accountability may not be clear. Corrective actions are insufficient to address root causes of problems.
Diversification management is effective. Lease concentration limits are set at reasonable levels and risk management practices are sound, including management's efforts to reduce or mitigate exposures. Management effectively identifies and understands correlated risk exposures and their potential impact.	Diversification management is adequate, but certain aspects may need improvement. Lease concentrations are identified and reported, but limits and other action triggers may be absent or moderately high. Concentration management efforts may be focused at the individual lease level, while portfolio-level efforts may be inadequate. Correlated exposures may not be identified and their risks not fully understood.	Diversification management is passive or deficient. Management may not identify concentrations, or take little or no action to reduce, limit, or mitigate the associated risk. Limits may be present but represent a significant portion of capital. Management may not understand exposure correlations and their potential impact. Concentration limits may be exceeded or raised frequently.
Lease management and personnel compensation structures provide appropriate balance between lease/revenue production, lease quality, and portfolio administration, including risk identification.	Lease management and personnel compensation structures provide reasonable balance between lease/revenue production, lease quality, and portfolio administration.	Lease management and personnel compensation structures are skewed to lease/revenue production. There is little evidence of substantive incentives or accountability for lease quality and portfolio administration.

Strong	Satisfactory	Weak
Lease staffing levels and expertise are appropriate for the size and complexity of the unit. Staff turnover is low and the transfer of responsibilities is orderly. Training programs facilitate ongoing staff development.	Lease staffing levels and expertise are generally adequate for the size and complexity of the unit. Staff turnover is moderate and may result in some temporary gaps in portfolio management. Training initiatives are adequate.	Lease staffing levels and expertise are deficient. Turnover is high. Management does not provide sufficient resources for staff training.
Lease financing policies effectively establish and communicate portfolio objectives, risk limits, loan underwriting standards, and risk selection standards.	Lease financing policies are fundamentally adequate. Enhancement, while generally not critical, can be achieved in one or more areas. Specificity of risk limits or underwriting standards may need improvement to fully communicate policy requirements.	Lease financing policies are deficient in one or more ways and require significant improvements. Policies may not be clear or are too general to adequately communicate portfolio objectives, risk limits, and underwriting and risk selection standards.
Staff effectively identifies, approves, tracks, and reports significant policy, underwriting, and risk selection exceptions individually and in aggregate, including risk exposures associated with off-balance-sheet activities.	Staff identifies, approves, and reports significant policy, underwriting, and risk selection exceptions on a lease-by-lease basis, including risk exposures associated with off-balance-sheet activities; however, little aggregation or trend analysis is conducted to determine the effect on portfolio quality.	Staff does not identify, approve or report policy, underwriting, or risk selection exceptions or does not report them individually or in aggregate or does not analyze the exceptions' effects on portfolio quality. Risk exposures associated with off-balance-sheet activities may not be considered.
Credit analysis is thorough and timely both at underwriting and periodically thereafter.	Credit analysis appropriately identifies key risks and is conducted within reasonable time frames. Post-underwriting analysis may need improvement.	Credit analysis is deficient. Analysis is superficial and key risks are overlooked. Credit data are not reviewed in a timely manner.
Risk rating and problem leases review and identification systems are accurate and timely. Credit risk is effectively stratified for both problem and pass-rated credits. Systems serve as effective early warning tools and support risk-based pricing, the ALLL, and capital allocations.	Risk rating and problem leases review and identification systems are adequate. Problem and emerging problem credits are adequately identified, although room for improvement exists. The graduation of pass ratings may need to be expanded to facilitate early warning, risk-based pricing, or capital allocations.	Risk rating and problem leases review and identification systems are deficient. Problem credits may not be identified accurately or in a timely manner, resulting in misstated levels of portfolio risk. The graduation of pass ratings is insufficient to stratify risk for early warning or other purposes.
Special mention ratings do not indicate any issues regarding administration of the leasing portfolio.	Special mention ratings generally do not indicate administration issues within the leasing portfolio.	Special mention ratings indicate management is not properly administering the leasing portfolio.
MIS provides accurate, timely, and complete leasing portfolio information. Management and the board receive appropriate reports to analyze and understand the impact of lease financing activities on the bank's credit risk profile, including off-balance-sheet activities. MIS facilitates timely exception reporting.	Management and the board generally receive appropriate reports to analyze and understand the impact of lease financing activities on the bank's credit risk profile; however, modest improvement may be needed in one or more areas. Generally, MIS facilitates timely exception reporting.	The accuracy or timeliness of MIS may be materially deficient. Management and the board may not be receiving sufficient information to analyze and understand the impact of lease financing activities on the credit risk profile of the bank. Exception reporting requires improvement.

Appendix E: Glossary

Bargain purchase option: A provision allowing the lessee the option of purchasing the leased property for an amount lower than the expected fair value of the property at the date the option becomes exercisable.

Bargain renewal option: A provision allowing the lessee the option of renewing the lease for an amount lower than the expected rental for equivalent property under similar terms and conditions at the date the option becomes exercisable.

CEBA leases: Lease activities allowed under section 108 of the Competitive Equality Banking Act of 1987 and permissible under 12 USC 24(Tenth).

Equipment finance agreement (EFA): A loan to finance an equipment purchase by creating a security interest on the equipment under the UCC. The borrower in an EFA is considered the owner of the equipment for tax purposes and can retain the equipment at the end of the term without having to pay a purchase option price. EFAs usually require no large upfront down payments.

Estimated economic life of the leased property: The period over which one or more users can expect the property to be economically usable when used for its intended purpose.

Fair value of leased property: The property's selling price in an arm's-length transaction between unrelated parties.

Finance leases: Leases made by FSAs under HOLA's lending authority and OCC regulation 12 CFR 160.41(c). These leases are the functional equivalent of loans and are similar to national banks' 12 USC 24(Seventh) leases.

Full-payout leases: Leases in which the bank reasonably expects to realize the return of both its full investment in the leased property and its estimated cost of financing the property over the term of the lease from rental payments, estimated tax benefits, and the estimated residual value of the property.

General leases: Short-term operating leases made by FSAs under section 5(c)(2)(C) of HOLA (12 USC 1464(c)(2)(C)) and OCC regulation 12 CFR 160.41(d). These leases are similar to the 12 USC 24(Tenth) leases (CEBA leases) for national banks.

Gross investment in leases: The sum of the minimum lease payments (including any guarantee of residual value), the unguaranteed estimated residual value of the property, and any investment tax credit.

Implicit interest rate: The discount rate (interest rate) that would make the aggregate present value of the minimum lease payment and the unguaranteed residual equal the fair value of the property at the inception of the lease less any investment tax credit retained by the lessor.

Incremental borrowing rate: The interest rate the lessee would have had to pay, at the inception of the lease, to borrow funds to purchase the leased asset.

Indenture trustee: An individual chosen to hold the mortgage on leased property on behalf of the debt participants. Such trustees are most common in leveraged leases involving many parties.

Initial direct costs: Costs that are directly associated with the origination of the leasing transaction. They are incurred by the lessor and paid to independent third parties.

Lease term: The fixed, noncancelable term of the lease plus the following: bargain renewal options, ordinary renewal options before the bargain renewal option is exercisable, renewals, extensions at the lessor's option, and any period during which failure to renew penalizes the lessee sufficiently to make renewal appear reasonably certain.

Minimum lease payments: The sum of the payments over the noncancelable term of the lease plus any residual payments guaranteed by the lessee or a creditworthy unrelated third party.

Net investment in a lease: The gross investment less any unamortized unearned income arising from the transaction.

Net lease: A lease under which the bank/lessor will not, directly or indirectly, provide or be obligated to provide for

- servicing, repair, or maintenance of the leased property during the lease term;
- parts or accessories for the leased property;
- loan of replacement or substitute property while the leased property is being serviced;
- payment of insurance for the lessee, except when the lessee has failed in its contractual obligation to purchase or maintain required insurance; or
- renewal of any license or registration for the property unless renewal by the lessor is necessary to protect its interest as owner or financier of the property.

Noncancelable lease: A lease that can be canceled only with the permission of the lessor or upon the development of circumstances that appeared to be remote possibilities at the inception of the lease.

Nonrecourse debt: Borrowed funds that give the creditor recourse only to the specific financed property. The creditor has no right to the borrower's other assets.

Off-lease property: Property that was subject to a lease that has been terminated and that is now being held by the bank before being sold, re-leased, or otherwise disposed of.

Owner trustee: An individual chosen to hold title to leased property on behalf of equity participants. Such a trustee is most common in leveraged leases involving many parties.

Residual value of leased property: The estimated fair value of leased property at the end of the noncancelable lease term.

Section 24(Seventh) leases: Leases by national banks under the authority of 12 USC 24(Seventh) that are the functional equivalent of loans, similar to FSAs' finance leases.

Terminal rental adjustment clause (TRAC) lease: A lease that contains a stated value of the equipment at maturity and is generally used for "over-the-road" vehicles such as trucks, tractors, and trailers. It provides the lessee with a predetermined purchase provision and the lessor with a residual value guaranteed by the lessee at the end of the lease.

Unearned income: The total income expected to be earned over the remaining life of the lease. At inception, unearned income is the difference between the lessor's investment in the property and the gross investment in the lease. Unearned income has three components: minimum lease payments, unguaranteed residual value, and investment tax credit.

Unguaranteed residual value: The estimated residual value at the end of the lease term less any portion guaranteed by the lessee or any third party unrelated to the lessor.

Appendix F: Abbreviations

ALLL	allowance for loan and lease losses
ASC	Accounting Standards Codification
BQ	bank qualified
CEBA	Competitive Equality Banking Act of 1987
EFA	equipment finance agreement
EIC	examiner-in-charge
FASB	Financial Accounting Standards Board
FSA	federal savings association
GAAP	generally accepted accounting principles
HOLA	Home Owners' Loan Act
ICQ	Internal Control Questionnaire
IRR	interest rate risk
IRS	Internal Revenue Service
MIS	management information system
MRA	matters requiring attention
NBQ	non-bank qualified
OCC	Office of the Comptroller of the Currency
ROE	report of examination
TRAC	terminal rental adjustment clause
UBPR	Uniform Bank Performance Report
UCC	Uniform Commercial Code

References

Laws

- 12 USC 24(Seventh) and (Tenth), “Corporate Powers of Associations”
- 12 USC 84, “Lending Limits”
- 12 USC 371c, “Banking Affiliates”
- 12 USC 371c-1, “Restrictions on Transactions with Affiliates”
- 12 USC 375a, “Loans to Executive Officers of Bank”
- 12 USC 375b, “Extension of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks”
- 12 USC 1464 (Home Owners’ Loan Act, section 5), “Federal Savings Associations”
- 26 USC 265, “Expenses and Interest Relating to Tax-Exempt Income”

Regulations

- 12 CFR 7.1000(d), “National Bank Ownership of Property”
- 12 CFR 23, “Leasing” (national banks)
- 12 CFR 32, “Lending Limits”
- 12 CFR 160.41, “Leasing” (federal savings associations)
- 12 CFR 215, “Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O)”
- 12 CFR 223, “Transactions Between Member Banks and Their Affiliates (Regulation W)”

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- “Other Consumer Protection Laws and Regulations”

Examination Process

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- “Community Bank Supervision”
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- Corporate Decision No. 2012-06 (February 28, 2012)
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OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance” (October 30, 2013)

Other

FASB Accounting Standards Codification

ASC 450–20, “Loss Contingencies”

ASC 840, “Leases”