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Replaced by Comptroller's Handbook – Lease Financing.

# Leasing Activities

A lease is a contract between the owner of a property, the lessor, and a person or company authorized by the lease contract, the lessee, to use the property. The lease contract specifies the lease term, the amount and frequency of lease payments, and who is responsible for insurance, property maintenance and repairs. Leasing allows the lessee to use the property without making a large cash outlay or incurring additional debt.

There are two types of leases:

- Operating or general leases – short-term leases; the lessor is often responsible for the maintenance of the property.
- Financing leases – also called capital leases; longer-term leases that the lessee uses as a means of financing his or her acquisition of a property.

With operating leases, the lessor often leases property to several different lessees over the property's economic life. Examples of this type of leasing often include: leasing of computer systems and heavy equipment.

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Financing leases often cover much of the economic life of the leased property. They are very similar to purchase financing. Examples of a financing lease include: an airline using a long-term lease to acquire its fleet of aircraft and ground support equipment; and companies and consumers using automobile leases to acquire their vehicles.

Savings associations typically structure lease contracts so that the association realizes return on the investment from three sources:

- Contractual payments from the lessee.
- Disposition of the asset at the termination of the lease.
- Income tax deferral benefits from depreciating the property.

If properly managed, leasing activities may enhance a thrift's asset diversification and product mix, improve its ability to compete in its market, and provide a favorable return on the investment. While leasing can provide benefits to both the lessor and lessee, leasing can be quite complicated and risky. Prior to engaging in any leasing activities, the institution must determine if it has adequate staff and capital resources to conduct such activities safely and profitably. It must also identify, measure, monitor, and control the risks.

- In this section we discuss four topics:
- Regulatory considerations, including a discussion of investment authority and restrictions for both general leasing and finance leasing.
- Underwriting and portfolio management considerations.
- Tax considerations, including the Internal Revenue Service (IRS) requirements for determining if lease payments are fully deductible as expenses.
- Accounting considerations, including a brief discussion of the methods for recording leases.

## REGULATORY CONSIDERATIONS

Federally chartered savings associations may engage in both operating leasing (referred to in OTS regulations as general leasing) and finance leasing. Each are allowable under different statutory lending and investment authorities.



### General Leasing

The Home Owners' Loan Act of 1933 (HOLA) §1464 authorizes federal thrifts 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 560.41(d) of the regulations specifically allows general leasing activities within this investment authority.

Within the general leasing authority, savings associations can make several different types of leases with different purposes and duration. Service leases (or operating leases) are a type of general lease. These typically provide for financing and maintenance services, include an option to cancel, and often are relatively short-term. Savings associations commonly make service leases for computer systems and other equipment.

Businesses often prefer general leasing to financing leasing because in terms of structure, it is less restrictive. An institution may enhance its profitability and product offering by providing businesses a flexible instrument such as a general lease. However, the lack of standard requirements can expose the institution to substantial risk resulting from the following circumstances:

- Lack of demand for the re-inventoried property.
- Inadequate contracts.
- Unexpected depreciation in asset values.
- Asset obsolescence.

- Abuse of property by the lessee.
- A poor resale market.
- Lack of staff expertise in purchasing and disposing of leased property.

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

Successful general leasing requires extensive expertise. The board of directors should adopt prudent policies and procedures in accordance with OTS regulations and policy guidance, and management should closely monitor the institution's compliance with such policies. Institution personnel should follow prudent credit underwriting practices and have extensive knowledge of assets purchased for leasing.

Leasing staff should also be familiar with the accounting and tax issues and be able to structure leases to minimize risks and ensure adequate pricing to cover all costs and provide an adequate profit. Management should also stay current with changes in tax law, accounting standards, customer demand, and other economic factors that may significantly affect its leasing program.

## Finance Leasing

OTS may consider certain lease arrangements to be the functional equivalent of loans. Because the authorization for financing leases comes from HOLA's lending authority, federal savings associations that want to make financing leases under such authority must structure them as the functional equivalent of loans. Institutions must aggregate finance leases with loans for the purpose of determining compliance with the HOLA investment limits. Finance leases are not, however, aggregated with general leases for determining the 10 percent of assets limit.

As with general leases, institutions may make finance leases for tangible personal property such as vehicles, airplanes, manufactured homes, machinery, equipment, and furniture. Institutions may make a finance lease for consumer or commercial purposes. OTS regulation 12 CFR §560.41(c) specifies several requirements that must be met for a lease to qualify as a financing lease. To consider a lease the functional equivalent of a loan, the institution must structure it to meet the following requirements:

- The lease must be a net, full pay-out lease, that the lessee cannot cancel, notwithstanding the possible early termination of the lease.
- A "full pay-out lease" is a lease on which the institution:

- — receives full payment of amounts it invests in the leased property, plus a reasonable return on the investment over the term of the lease; and
- — does not 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.



- Realization of the lessor's investment must primarily depend on the creditworthiness of the lessee, not the estimated sales price (residual value) of the leased property. "Realization of the investment" means the institution can reasonably expect to get back its full investment in the property, plus financing costs during the lease term from lease payments, tax benefits, and the sale of the property at lease end. The estimate of the sales price of the property at lease end must be reasonable.
- At the termination of the lease, the institution must liquidate or re-lease the property as soon as practical. The institution must reevaluate and record at the lower of fair market value or book value any property held in anticipation of re-leasing.

In addition to being the functional equivalent of a loan to qualify as a financing lease, the institution cannot have direct or indirect involvement in the operation of the property over the lease term and it cannot provide any of the following services during the lease term:

- Servicing, repair, or maintenance of the property.
- Purchasing parts or accessories, unless included in the full pay-out requirement.
- Lending replacement or substitute property while the leased property is serviced.
- Purchasing insurance for the lessee (except where the lessee failed to discharge a contractual obligation to do so).
- Renewing any license, registration, or filing fee for the property unless necessary to protect the institution's interest as an owner or financier of the property.

The characteristics of finance leasing eliminate some of the risk associated with short-term, general leases. The institution, however, is still subject to credit risks, risks associated with estimating residual values at lease end, and the risk of repossession. We discuss in the following section the steps institutions should take in underwriting and servicing leases.

## Underwriting and Portfolio Maintenance Considerations

Historically, institutions focused more on finance leasing than on operating leases. This is due in large part to the characteristics of finance leasing which limit an institution's responsibility for the leased equipment and pass such costs on to the lessee. Lease financing expanded in recent years with the involvement of brokers/servicers who pool leases and offer institutions shares in these pools. Moreover, due to market demands for automobile financing, institutions are making shorter-term leases that often do not meet OTS or accounting requirements for financing leases, yet allow lessees to acquire and use the leased vehicles. Thus, institutions may need to underwrite and structure such operating leases similar to financing leases.

Regardless of how the institution structures the lease, the underwriting considerations the institution should apply in leasing are basic to the administration of any credit portfolio and are just as important in lease financing. The institution must know the borrower (lessee). This includes evaluating the lessees character and credit history as evidence of their willingness to repay the lease obligation as agreed. The institution should evaluate the lessee's income and financial resources to demonstrate their ability to meet the lease obligation according to the terms established. The institution should also carefully review the collateralization and workout covenants (which are often unique) to ensure contracts are written to reduce its risks.

The leasing staff's ability to realistically estimate the value of the leased property at the end of the lease is second only to credit underwriting in importance with respect to the success of any leasing program. Staff may obtain estimates from various industry pricing guides, such as Kelly Blue Book and the National Automobile Dealer's Association (NADA), which look at trends in used car prices and project future retail and wholesale prices for various vehicle makes and models. It is important that the institution use conservative estimates based on wholesale rather than retail values. This is because the institution will likely sell the leased property at wholesale to a wholesaler or retailer at lease end.

Finally, an institution should obtain a clear title to the leased equipment to enable its repossession and liquidation in the event of the lessee's default.

While thrift management and examiners should be aware of the various lease underwriting and portfolio maintenance issues (see the General Questionnaire at the end of this Section), a few areas merit particular attention.

## Documentation

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

- A lease financing agreement evidencing 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 Uniform Commercial Code (UCC) that perfects the lessor's right in the property.
- An assignment from the original lessor, passing rights under the financing arrangement to the institution (only if it purchases the lease from a broker or invests in a pool of leases).

Management must understand the documentation regardless of the structure of the transaction. Legal counsel familiar with leasing and answerable to the institution should thoroughly review the documentation. There should be clear recourse to the collateral in the event of a default by the lessee.

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

The board and management should have an effective working knowledge of the leasing operation, backed up by thorough, institution-specific policies and procedures.

## Servicers

Servicers of lease pools have been known to make arrangements 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 thrifts investing in the lease pools and lack of attention to the quality and performance of leases accepted. Regardless of any take-out arrangements that may exist, the thrift must be aware of the composition and performance of its lease portfolio. This is crucial if the servicer fails and the thrift assumes control of the pools.

## Lending Limitations

Both general and financing leases are considered loans or extensions of credit for purposes of 12 CFR §§ 560.93, 563.41, 563.42, and 563.43. Thus, the amount of funds advanced on behalf of the lessee/borrower, together with any other extensions of credit, must be aggregated and meet OTS's loans to one borrower, transactions with affiliates, and insider lending rules.

With respect to the loans to one borrower rule, if an institution uses its general leasing authority to lease property it already owns, such as its previously leased or repossessed property, the limitations of 12 CFR § 560.93 may not apply. This is because such extensions of credit are excluded from the definition of a loan. (See the Office of the Comptroller of the Currency's (OCC's) definition in 12 CFR § 32.2(j)(iii).)

Loans to a third party to finance their leases, especially pools, can exhibit characteristics that result in the credits being considered loans to the originating or brokering company, rather than loans to the individual lessees. This can result in a violation of the regulatory limitations for loans to one borrower.

Section 32.3(b)(10) of the OCC's regulations (12 CFR § 560.93 applies to thrifts) sets forth criteria that the institution must meet for OTS to treat a loan to a leasing company as separate loans to underlying lessees. These criteria include:

- Institution evaluation of the creditworthiness of the lessee on a lease-by-lease-basis.
- The loan to the leasing corporation is without recourse.
- The institution has a valid security interest in the leased equipment.

Any institution engaging in a leasing program must be able to document how and why the lease financing conforms to the lending limitation regulations.

The provision, by a thrift, of a lease financing or credit line to a leasing company in no way lessens the need to secure, understand, and retain information and analyses on the underlying lessees, as noted above.

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### Leveraged Leases

Leveraged leasing is a three-party arrangement involving:

- The lessee, who leases the property and makes lease payments, thus providing cash flow.
- The lessor, who purchases the property for the lessee and provides some equity funding (commonly called the equity participant).
- The lender (long-term creditor), who provides funding for the purchase of the property.

In a leveraged lease, the lessor purchases the asset by providing only a percentage (usually 20 to 40 percent) of the capital needed. The lender provides the balance of the purchase price to the lessor. The security provided to the lender includes a first lien on the equipment and an assignment of the lease and lease payments.

If the asset purchase price is very large, there may be several equity owners (lessors) and debt holders. In this case, an owner trustee may be named to hold title to the asset and to represent the equity owners.

The lessor, as the owner, can depreciate the property for income tax purposes, based on the total cost of the asset, not just the invested amount. The lessor will also receive the portion of the rental payments attributable to the difference the lessor charges for the lease and the rate he or she pays the lender.

For example, an airline leases an aircraft costing $100 million for 15 years at $12.5 million each year (representing a 9 percent lease rate). The lessor obtains a 15-year bank loan for $80 million at an interest rate of 7.5 percent with payments of $9.06 million. At the end of the lease, the lessor expects to sell the aircraft for $20 million. The airline is responsible for all operating expenses, maintenance, and insurance. If everything goes as planned, the cash flows to the lessor will be as follows:

Year 1
Lessor's down payment: -$20.00 million

Years 1-15
Lease income: $12.50 million
Loan payment: -$ 9.06 million
Yearly net cash flow: $ 3.44 million

Lessor's annual depreciation expense:
$80 million / 15 years = $5.33 million
(This will cover the lease income and result in excess depreciation of $2.11 million that can offset the lessor's other income.)

Year 15
Sale price at end of lease: $20 million
(The lessor receives the amount of the initial investment.)

If realized, the above cash flows result in a [illegible]5 percent return to the lessor. However, leveraging cuts both ways. The early termination of the lease and forced liquidation of the property can result in equally large losses.

Leveraged lease financing provides lessors with the ability to leverage their capital into a larger lease(s) than they could fund with their capital alone – hence the name "leveraged leasing." Savings associations can participate in leveraged leases either as the lessor or as the financing institution. They can do so either directly or through a subsidiary. However, such activities are highly risky and the institution must control such risks. Failure to control such risks will subject the institution to criticism and possible supervisory action.

One of the risks of leveraged lease transactions is their complexity, stemming from the large dollar amounts and number of parties involved, and the unique relationship between the parties. Legal expenses and administrative costs associated with leveraged leasing generally limit its use to financing for large capital investments.

Because of the complexity, institutions should have qualified staff with a current working knowledge of all aspects of leasing, including the risks involved, applicable laws and regulations, and tax consequences. Moreover, when structuring leveraged leases, institutions should consider all relevant aspects of how the leasing activities will affect the institution, including capital requirements, estimated future cost of funds, and cash flows. The return on the institution's investment in leveraged leases depends largely on these factors, and even a slight change in the variables can affect profitability.

As with financing and operating/general leases, the residual value of the property at lease-end is a major element of the return on the investment. The institution should carefully estimate and support the value. Because leveraged leases generally involve the financing of very costly property, institutions should periodically inspect properties for condition and possible misuse to prevent rapid deterioration of the value of the property before the lease term expires. Institutions should also monitor properties for obsolescence or market value decline, to assist in structuring profitable lease programs in the future.

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Institutions should carefully scrutinize the financial capacity of all parties involved in the lease. Should the lessee default, the lessor will have to repay the loan if they want to recapture at least a part of their investment. Thus, an institution should not enter into a leveraged lease as the lender unless the lessor has the capacity to maintain the lease for a time in the event the lessee defaults.



### Consumer Leasing

A large part of the leasing done by thrifts is consumer leasing of vehicles and other personal property. This type of leasing creates a homogeneous portfolio of leases that, if underwritten properly, may involve less credit risk than business leasing. Underwriting consumer leases is very similar to underwriting consumer loans, with three major exceptions:

- The lease terms are often shorter and may not provide for the full pay-out of the acquisition cost of the leased property.
- Down payments (capital reduction costs) and monthly leases payments are typically lower than loan purchase payments, so there is no equity build-up.
- Profitability is dependent on the lessor receiving proceeds from the sale of the leased property. Actual proceeds may be much less than proceeds estimated at the beginning of the lease.

Originating leases to consumers requires adherence to the Federal Reserve Board's Regulation M (12 CFR Part 213). This regulation requires comprehensive disclosures for leases of personal property with a contractual obligation of up to $25,000 and a term of more than four months. These may be general or financing leases. Regulation M provides a model disclosure form. Thrifts engaging in consumer leasing must thoroughly understand and comply with Regulation M.

### Strategies to Mitigate Risks Associated with Leasing

As mentioned previously, leasing activities may involve considerable risks. Such risks may stem from the failure of the lessee to meet the terms of the lease contract or the inability of the institution to accurately estimate cash flows from the lease, such as tax advantages or the residual value of the property at lease-end.

With each lease transaction, the institution 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. (The Examination Handbook Section 440, Present Value Analysis, discusses lease calculations.) Any change in variables during the lease term will affect the rate of return.

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.

To effectively minimize these risks, the leasing department should exhibit several key characteristics:

- Comprehensive and prudent written policies, procedures, and internal controls.

- 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.

### Tax Considerations

Tax benefits to the lessor generally stem from the lessor's ability to depreciate the property over a shorter time than the property's economic life. This 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.

The lessee also has tax benefits. The full amount of the annual lease payments as well as the cost of operating the property is a deductible business expense for income tax purposes if the Internal Revenue Service (IRS) agrees that a particular contract is a genuine lease and not simply an installment sale called a lease. This makes it important that a lease contract be written in a form acceptable to the IRS. 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; therefore, the institution should continually monitor tax law changes.

## ACCOUNTING CONSIDERATIONS

Generally Accepted Accounting Principles (GAAP) regarding lease accounting are very extensive. The institution should refer to GAAP specifically for a detailed understanding of the accounting and reporting requirements of lease transactions. SFAS No. 13 discusses the accounting for capital[1] leases and operating leases from the perspective of the lessor and the lessee.

You should ascertain that the institution is using proper accounting treatment and appropriately recording lease transactions. In certain cases, institutions have accepted leases that purport to be straight financing leases of new equipment but, in actuality, are the sale and leaseback by the lessee of the lessees current machinery and/or equipment. You should carefully review sale/leaseback transactions. Often, failing businesses use sale/leasebacks to generate cash flow.

Lease classification is generally dependent upon six criteria for lessors and four criteria for lessees. If any one of the following four common criteria for both lessors and lessees are met, the lease may qualify as a capital lease:

- 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 is equal to 75 percent or more of the estimated life of the leased property. This criterion is not used for purposes of classifying the lease if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use.
- The present value at the beginning of the minimum lease term of the lease payments equals 90 percent or more of the fair value of the leased property.

Lessors must meet two additional criteria:

- The collectibility of the minimum lease payments is reasonably predictable.
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

### Lessor

If, at inception, a lease meets any one of the first four criteria and both of the last two criteria, the lessor typically classifies the lease as a direct financing lease. Thus, the lessor records as assets the present value of total lease receivables (aggregate rentals due under the lease) and the residual value. The lessor records the excess of these combined assets over the actual cost of the leased asset as

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[1] The accounting definition of capital leases is very similar to OTS's financing leases.

unearned income. Subsequently the lessor amortizes the unearned income over the life of the lease on the level yield basis. Lease rental payments received reduce the recorded asset.



If none of the first four criteria are met or at least one of the last two criteria is not met, the lessor records the lease as an operating lease. Thus, the lessor records the cost of the leased asset on the balance sheet and depreciates the asset using the lessor's normal depreciation policy. Lease payments received are recorded in income as rent over the lease term.

### Lessee

If, at inception, a lease meets any one of the first four criteria, the lessee classifies the lease as a capital lease. The lessee records an asset and a liability equal to the present value of the minimum lease payments exclusive of any executionary costs the lessor will pay.

If none of the first four criteria is met, the lessee records the lease as an operating lease. The lessee records the lease payment as accrued expense on a regular basis.

## REFERENCES

### United States Code (12 USC)

#### *Home Owners' Loan Act of 1933*

| | |
|---|---|
| §1464 (c)(2)(C) | Investments in Personal Property |
| §1464 (c)(2)(D) | Consumer Loans and Certain Securities |

### Code of Federal Regulations (12 CFR)

| | |
|---|---|
| §559.4 | What activities are pre-approved for service corporations? |
| §560.30 | General Lending and Investment Powers |
| §560.41 | Leasing |
| §560.93 | Lending Limitations |
| §563.41 | Transactions with Affiliates (TWA) |
| §563.42 | Additional TWA Standards |
| §563.43 | Loans to Insiders |

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## Financial Accounting Standards Board, Statement of Financial Accounting Standards

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|---|---|
| No. 13 | Accounting for Leases |
| No. 27 | Accounting for Sales with Leasebacks |
| No. 98 | Accounting for Leases |