

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10352]
June 13, 1990]

LEASING OF PERSONAL PROPERTY BY BANK HOLDING COMPANIES

Proposed Amendment to Regulation Y

Comments Invited by July 16, 1990

*To All State Member Banks and Bank Holding Companies
in the Second Federal Reserve District, and Others Concerned:*

The Board of Governors of the Federal Reserve System has issued the following statement:

The Federal Reserve Board has issued for public comment a proposal to add non-full payout leasing to the list of permissible activities in Regulation Y.

Comment is requested by July 16, 1990.

The proposed amendment would raise the maximum estimated residual value of leased personal property on which bank holding companies may rely for their compensation in leasing transactions to up to 100 percent of the acquisition cost of the leased property. The Office of the Comptroller of the Currency has also issued a proposed regulation which would allow national banks to rely on residual values up to 100 percent of the acquisition cost of the leased property. The Competitive Equality Banking Act of 1987 had amended the National Bank Act to expand the leasing authority of national banks.

These higher residual value leasing transactions would be subject to certain volume limitations, and would also remain subject to the prudential limitations currently set forth in Regulation Y.

Printed on the following pages is the text of the Board's proposed amendment to Regulation Y, which has been reprinted from the *Federal Register* of June 1. Comments thereon should be submitted by July 16, and may be sent to the Board of Governors, as set forth in the notice, or to our Domestic Banking Applications Division.

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-0694] Leasing Personal Property

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board is seeking public comment on a proposal to amend the provision in Regulation Y governing leasing transactions by bank holding companies to relax the limitation on reliance on the residual value of leased property. Pursuant to section 4(c)(8) of the Bank Holding Company Act ("BHC Act") (12 U.S.C. 1843(c)(8)), the Board has previously determined that the leasing of personal property subject to certain criteria is so closely related to banking as to be a proper incident thereto. These criteria include a limitation in which the bank holding company may rely on an estimated residual value of the leased property at the end of the lease of no more than 20 percent of the acquisition cost of the leased property in recovering the holding company's full costs of the leasing transaction.

Section 108 of the Competitive Equality Banking Act ("CEBA"), Public Law 100-86, 101 Stat. 579 (August 10, 1987), amended the National Bank Act (12 U.S.C. 24) to expand the authority of national banks to permit investment of up to 10 percent of the assets of the national bank in tangible personal property for lease financing transactions on a net lease basis. This section was enacted in order to permit relaxation of the residual value limitations currently applicable to leasing transactions by national banks. A number of national banks have relied on this authority to engage in personal property leasing transactions with reliance on estimated residual values of up to 100 percent of the acquisition cost of the leased property. A number of states also allow state banks to engage in similar transactions. In view of this, as well as other factors, including the extensive experience gained by bank holding companies in estimating the residual value of property in currently permissible leasing transactions, the Board is proposing to raise the maximum estimated residual value of leased personal property on which bank holding companies may rely for their compensation in leasing transactions to up to 100 percent of the acquisition cost of the leased property. These higher

residual value leasing transactions would be subject to certain volume limitations, and would also remain subject to the prudential limitations currently set forth in Regulation Y.

DATES: Comments must be received by July 16, 1990.

ADDRESSES: Comments, which should refer to Docket No. R-0694, may be mailed to the Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, NW, Washington, DC 20551, to the attention of Mr. William W. Wiles, Secretary; or delivered to room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. Comments may be inspected in room B-1122 between 9 a.m. and 5 p.m., except as provided in § 261.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Scott G. Alvarez, Assistant General Counsel (202/452-3583), Thomas M. Corsi, Attorney (202/452-3275), or Donna R. Nordenberg, Attorney (202/452-3281), Legal Division; or Sidney M. Sussan, Assistant Director (202/452-2638), Division of Banking Supervision and Regulation, Board of Governors. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

Background

Since 1971, bank holding companies have been permitted to engage in full payout leasing of personal property. Section 225.25(b)(5) of the Board's Regulation Y currently provides that these leasing transactions must be on a nonoperating basis and only upon the order of customers. At the inception of the lease, a bank holding company must expect to realize a return of its full leasing costs mainly from rentals and estimated tax benefits. Under current regulations, a bank holding company may also rely for compensation on the estimated residual value of the leased property in an amount up to 20 percent of the acquisition cost of the leased property. In the case of a personal property lease of no more than seven years in duration, a bank holding company may rely for compensation on certain guarantees in an amount up to 60 percent of the acquisition cost of the leased property.

In 1987, section 108 of CEBA amended the National Bank Act to permit national banks to lease tangible personal property so long as the leases are on a

net lease basis¹ and represent, in the aggregate, no more than 10 percent of the bank's assets. The legislative history indicates that this amendment was intended to permit the Comptroller to relax or eliminate the residual value limitation in the Comptroller's existing regulations authorizing personal property leasing activities by national banks in a manner consistent with sound banking practices. S. Rep. No. 19, 100th Cong., 1st Sess. 43 (1987). The legislative history of section 108 also indicates that the section is not intended to allow national banks to engage in the daily or short-term equipment or automobile rental business. H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 143 (1987).

In reliance on this statutory authorization, a number of national banks currently engage in leasing personal property with reliance on residual values as high as 100 percent of the cost of the leased property. The Comptroller has recently proposed to amend its regulations to permit personal property leasing activities by national banks without restriction on the residual value that may be relied on by the bank.² The Comptroller also proposes to limit the volume of leasing transactions entered into by national banks pursuant to section 108 to 10 percent of the national bank's total consolidated assets. A number of states have also permitted state-chartered banks to conduct leasing activities without limit on the amount of residual value that may be relied on by the lessor bank.³

The Board recently approved the application of Security Pacific Corporation to engage in personal property leasing transactions that rely on estimated residual values of the leased property for compensation to a greater extent than Regulation Y currently allows (hereinafter "higher residual value leases").⁴ In its Security Pacific Order, the Board permitted reliance on residual values of up to 100 percent of the property's acquisition cost. Security Pacific proposed to conduct these higher residual value leasing activities within the volume

¹ A "net lease basis," as defined by the leasing provisions of the Office of the Comptroller of the Currency ("Comptroller"), is essentially identical to a "nonoperating basis" under Regulation Y.

² 54 FR 53,071 (1989) (proposed December 27, 1989).

³ A number of states including California, Florida, Maryland, Michigan, Illinois and Indiana allow banks to lease personal property without a limit as to the amount of residual value on which the bank may rely.

⁴ *Security Pacific Corporation*, 78 Federal Reserve Bulletin _____ (Order dated April 30, 1990).

restrictions imposed on national banks by section 108 of CEBA. Security Pacific also committed that higher residual value leases would have a minimum lease term of one year and that these leasing activities would otherwise conform to the existing provisions of § 225.25(b)(5) governing leasing activities of bank holding companies.

Proposal

In light of these developments in the leasing powers and activities of banks, the Board proposes in this amendment to raise the maximum estimated residual value of leased personal property on which bank holding companies may rely for their compensation in leasing transactions to up to 100 percent of the acquisition cost of the leased property. The Board is further proposing to limit the volume of lease transactions conducted by bank holding companies in which the companies rely on higher residual values in a manner similar to the statutory limitations imposed on national banks by section 108. Under this proposal, higher residual value leases must have a minimum lease term of at least 90 days, and the leasing activity must otherwise conform to the current leasing provisions of Regulation Y. Finally, the Board proposes that bank holding companies maintain separate records for leasing transactions conducted with reliance on higher residual values.

Section 4(c)(8) Analysis

Section 4(c)(8) of the BHC Act allows bank holding companies to engage in nonbanking activities that the Board determines are so closely related to banking as to be a proper incident thereto.

A. Closely related to banking. As noted above, the Board has previously determined that leasing tangible personal property is an activity that is closely related to banking where the leases meet certain criteria including requirements that the leases do not rely on an estimated residual value in excess of 20 percent of the acquisition cost of the property, serve as the functional equivalent of an extension of credit, and are on a nonoperating basis. 12 CFR 225.25(b)(5). The question raised by this proposal is whether leasing activities conducted within these parameters, except with reliance on a residual value that exceeds 20 percent of the cost of the property, are closely related to banking.

In *National Courier Ass'n v. Board of Governors*, 516 F.2d 1229 (D.C. Cir. 1975), the court suggested three alternative guidelines for determining whether an

activity is closely related to banking:

1. Banks generally have in fact provided the proposed services; or,
2. Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services; or,
3. Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.

The court provided these guidelines as alternative justifications for determining whether a particular activity met the closely related to banking test, and expressly held that the Board may also consider other approaches.⁵

The Board requests public comment on whether the activity being proposed should be considered so closely related to banking as to be a proper incident thereto by the Board, and consequently be made a permissible nonbanking activity for bank holding companies. In light of the fact that national banks and many state banks are permitted to, and do, conduct directly leasing activities of the type being proposed here, the Board believes that a reasonable basis exists for determining that the proposed leasing activities are closely related to banking within the meaning of section 4(c)(8).

B. Proper incident to banking. Section 4(c)(8) of the BHC Act states that, in determining whether a proposed activity is a proper incident to banking, the Board is required to consider whether the performance of the activity by a bank holding company affiliate "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices."

1. Public Benefits

The Senate Report accompanying CEBA stated that relaxation of the residual value limitation applicable to leasing transactions was necessary to allow national banks to compete more effectively with thrifts⁶ and other nonbank lessors, and respond to customer demand for a broader range of lease financing transactions. S. Rep. No. 19, 100th Cong., 1st Sess. 43 (1987). The

⁵ See *Alabama Ass'n of Insurance Agents v. Board of Governors*, 533 F.2d 224 (5th Cir. 1976).

⁶ Since 1982, savings associations have been permitted to engage in leasing transactions with reliance on a residual value of up to 70 percent. 12 CFR 545.79(b).

Board notes that the current residual value limitation appears to constrain bank holding companies from initiating some types of equipment leases that are arranged by their bank and nonbank competitors. The Board requests public comment on whether relaxing the residual value requirement applied to bank holding companies to the same extent that this requirement has been relaxed for national banks would allow bank holding companies to compete more equally in these leasing transactions. The Board also requests comment on whether other public benefits may be expected to result from this proposal.

2. Adverse effects

At the time that the Board adopted its regulations authorizing bank holding companies to engage in leasing activities in 1971, and again in 1976 when the Board modified its regulations to permit certain types of automobile leasing activities, the Board focused on the potential adverse effects that might be associated with reliance by bank holding companies on high residual values in leasing transactions. In order to address the concern that authorizing leasing activities would encourage speculation by bank holding companies in personal property, the Board limited the reliance bank holding companies could place on residual value to a maximum of 20 percent of the cost of the leased property. The Board also established a number of other requirements designed to discourage speculation in the residual value of leased property, including limitations that prevent bank holding companies from maintaining an inventory of property.

In order to address potential adverse effects that may result from reliance on residual values in excess of 20 percent, the Board proposes that bank holding companies continue to abide by these limitations in conducting leasing transactions with higher residual value reliance, including that: (1) Bank holding companies will acquire property to be leased only in connection with a specific leasing transaction under consideration, (2) bank holding companies will either sell or re-lease the leased property within two years of the expiration of the initial lease, and (3) the leases are on a non-operating basis. The Board also proposes that leases arranged by bank holding companies that rely on higher residual values have a minimum term of at least 90 days. The Board requests public comment on whether it is appropriate in the context of higher

residual value leasing to require a minimum lease term longer than 90 days, such as, for example, one year.

In addition, the Board proposes to adopt the volume limitation currently imposed by statute on the higher residual value leasing activities of national banks. This would limit the total volume of bank holding company investments in leases with estimated residual values in excess of 20 percent of the acquisition cost of the leased property to no more than 10 percent of the bank holding company's total consolidated assets. This quantitative limitation is an aggregate limitation that would apply to bank holding companies on a consolidated basis. This limitation would not in any way limit leasing activities conducted directly by bank subsidiaries of the bank holding company. Without limiting the leasing activities of banks, higher residual value leasing activities conducted within a bank subsidiary of the holding company would be counted towards the volume limitation in determining the amount of higher residual value leasing activities that may be conducted by the bank holding company and its nonbank affiliates. The proposed quantitative limitation would not apply to leasing transactions that are conducted under the current provisions of Regulation Y in which reliance on residual value is limited to 20 percent of the acquisition cost of the leased property. In addition, these quantitative limitations would not apply to companies advised by bank holding company leasing subsidiaries.

The Board also proposes that bank holding companies capitalize their leasing subsidiaries to an extent necessary to support fully this activity and commensurate with industry standards. Further, where applicable, segregation of leasing records would be required to distinguish a bank holding company's leasing activities that rely on existing provisions from those leasing activities that rely on the expanded residual value provisions of this proposal. This would not represent a new recordkeeping requirement, but would be satisfied where a bank holding company segregates the leasing records normally maintained by the holding company for ease of monitoring.

The Board requests public comment regarding whether these criteria are appropriate for addressing any potential adverse effects that may be associated with reliance by bank holding companies on higher residual values in

leasing transactions. The Board also will consider public comment on any other aspect of this proposal.

Section-by-section Analysis

Section 225.25(b)(5)(i): The proposal retains in full the existing leasing provision of § 225.25(b)(5) redesignating it as § 225.25(b)(5)(i). Thus, bank holding companies may continue to enter into leasing transactions that comply with existing criteria without restriction as to total volume. Section 225.25(b)(5)(ii): The proposed amendment adds § 225.25(b)(5)(ii) which authorizes bank holding companies to lease tangible personal property subject to the limitations set forth in paragraph (b)(5)(i) above except that the companies may rely for their compensation on residual values in excess of 20 percent of the acquisition cost of the property. This section would also limit the total volume of these leases, set a minimum lease term of 90 days, and require that records of a holding company's leasing activities under this proposal be segregated from records of the holding company's leasing activities under existing provisions.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*), the Board of Governors of the Federal Reserve System certifies that this notice of proposed rulemaking, if adopted as a final rule, will not have a significant economic impact on a substantial number of small entities that would be subject to the regulation.

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, Banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844), the Board proposes to amend 12 CFR part 225 as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1843(c)(8), 1844(b), 3106, 3108, 3907, and 3909.

2. In § 225.25, paragraph (b)(5) is redesignated as paragraph (b)(5)(i); paragraphs (b)(5) (i) through (vi) are redesignated as paragraphs (b)(5)(i) (A) through (F); and paragraphs (b)(5)(iv) (A) through (D) are redesignated as paragraphs (b)(5)(i)(D) (1) through (4).

3. In § 225.25, paragraph (b)(5) is further amended by adding new paragraph (b)(5)(ii) to read as follows:

§ 225.25 List of permissible nonbanking activities.

* * * * *
(b) * * *
(5) * * *

(ii) *Leasing tangible personal property.* Leasing tangible personal property or acting as agent, broker, or adviser in leasing such property where, in calculating the return described in paragraph (b)(5)(i)(D), the lessor relies on rental payments, estimated tax benefits (as described in paragraph (b)(5)(i)(D)(2)), and an estimated residual value of the property at the expiration of the initial term of the lease that exceeds 20 percent, but in no event exceeds 1 percent, of the acquisition cost of the property to the lessor, if—

(A) The activity otherwise meets the requirements of paragraph (b)(5)(i);

(B) The aggregate amount of leases in which the bank holding company, or any of its bank or nonbank subsidiaries, relies on an estimated residual value in excess of 20 percent of the acquisition cost of the property is limited to no more than 10 percent of the bank holding company's total consolidated assets;

(C) The minimum initial lease term is 90 days;

(D) The bank holding company's leasing affiliate maintains capitalization fully adequate to meet its obligations and support its activities, and commensurate with industry standards for comparable leasing activities; and

(E) The bank holding company maintains separately identifiable records of the leasing activities conducted under paragraphs (b)(5)(i) and (b)(5)(ii) where it conducts leasing activities under the authority of both paragraphs.

Board of Governors of the Federal Reserve System, May 25, 1990.

William W. Wiles,
Secretary of the Board.

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