Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1114
April 2009
12 CFR 23

April 9, 2009

Subject: Lease of Personal Property to An Affiliate Under 12 C.F.R. Part 23

Dear **[ ]**:

This is in response to your request for a legal opinion on behalf of your client, **[** *Bank , City , State* **]** ("Bank"). Your request concerned the applicability of certain provisions of section 23A of the Federal Reserve Act, 12 U.S.C. § 371c, to a proposed leasing transaction in which the Bank will lease an aircraft to its parent holding company. As discussed below, we conclude that the value of the transaction for purposes of section 23A will be the amount of the Bank's investment in the aircraft, *i.e.*, its book value. Further, the leased airplane may be treated as collateral for purposes of section 23A.

BACKGROUND

The Bank is a second-tier subsidiary of **[ ]** ("BHC"), a major foreign financial services holding company with a presence in ten countries in the Americas and Europe. The BHC has acquired a jet aircraft to facilitate the travel of its executives to and from these areas where it has operations and interests. For tax and other reasons, it would be more advantageous if the Bank owned the aircraft and leased it to the BHC.

Accordingly, the Bank proposes to form an operating subsidiary pursuant to 12 C.F.R. § 5.34 that will purchase the aircraft from the BHC. The aircraft has a fair market value of $20 million but the Bank will purchase it for $19 million.[1] The operating subsidiary will then lease the

[1] This will constitute a purchase of assets from an affiliate and thus will be a "covered transaction" within the meaning of sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1. You represent that the Bank will comply with the requirements of those statutes and the corresponding portions of Federal Reserve Board Regulation W, 12 C.F.R. Part 223, in carrying out this portion of the transaction. Section 23B requires that covered transactions must be at "arm's length," but it does not prohibit a bank from receiving better-than-market terms from its parent holding company.

aircraft to the BHC.[2] The lease will be structured as a "CEBA Lease" under the OCC's personal property leasing regulation, 12 C.F.R. Part 23.[3] It is planned that the term of the lease will be five years with a possibility of renewal (the aircraft will have a useful life of approximately twenty years). The monthly lease payments will be $200,000, representing total payments of $12 million over the term of the lease, with a present value of $9.9 million. The aircraft will have a residual value of $15.9 million at the end of the initial term, which will not be guaranteed by the lessee BHC. (All figures are approximate.)

LEGAL ISSUES

The OCC's personal property leasing regulation provides that when a national bank acts as a lessor of personal property, the lease is subject to the lending limits of 12 U.S.C. § 84 unless the lessee is an affiliate of the bank. In that case, the lease is subject to sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1, and Regulation W, 12 C.F.R. Part 223, instead. 12 C.F.R. § 23.6.[4] The lessee BHC is an affiliate of the Bank as defined in section 23A. 12 U.S.C. § 371c(b)(1)(A). Accordingly, this lease will be treated as a loan or extension of credit to an affiliate that is subject to sections 23A and 23B.[5]

Under section 23A, a loan or extension of credit to an affiliate is a "covered transaction," 12 U.S.C. § 371c(b)(7)(A), and covered transactions are subject to certain capital-based quantitative limits, 12 U.S.C. § 371c(a)(1). Further, a member bank must obtain collateral equaling 100 to 130 percent of a loan or extension of credit to an affiliate, depending upon the type of collateral received. 12 U.S.C. § 371c(c)(1).

You requested our opinion on how these provisions will apply to the lease of the aircraft. Specifically, you posed two questions:

1. What is the value of the transaction? This is relevant both to the quantitative limits on covered transactions and the collateral requirements.

[2] The formation of an operating subsidiary to engage in personal property leasing qualifies for after-the-fact notice under the OCC's operating subsidiary regulation if certain requirements are satisfied. 12 C.F.R. § 5.34(e)(5)(v)(M).

[3] A "CEBA Lease" is one that satisfies the requirements of 12 U.S.C. § 24(Tenth), which was enacted as section 108 of the Competitive Equality Banking Act of 1987 ("CEBA"), Pub. L. No. 100-86, 101 Stat. 579. The anticipated purchase price of the aircraft represents less than 0.5 percent of the Bank's consolidated assets, and neither the Bank nor any of its operating subsidiaries is currently a party to other CEBA Lease transactions. Accordingly, the ten percent of assets limitation specified in 12 U.S.C. § 24(Tenth) and 12 C.F.R. § 23.10 will not be an issue.

[4] Federal Reserve Board Regulation W, 12 C.F.R. Part 223, implements sections 23A and 23B. The reference to Regulation W was added to section 23.6 in 2008. 73 Fed. Reg. 22216, 22244 (April 24, 2008). This amendment was simply a clarification and made no substantive change. Therefore, this letter will discuss applicable sections of Regulation W in addition to section 23A.

[5] You represent that the payment terms and all other terms and conditions of the lease will be "arm's length" in compliance with section 23B and section 223.51 of Regulation W. Thus, the only issues relate to section 23A.

2. How do the collateral requirements of section 23A apply to the lease of the aircraft? In particular, can the leased aircraft be counted as collateral?

ANALYSIS

A. Value of Transaction

Regulation W provides that a credit transaction[6] with an affiliate must be valued at the greater of:

> (i) the principal amount of the transaction;
> (ii) the amount owed by the affiliate to the member bank under the transaction; or
> (iii) the sum of —
> (A) the amount provided to, or on behalf of, the affiliate in the transaction; and
> (B) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

12 C.F.R. § 223.21(a)(1). The question is, which of these three options would apply to the Bank's proposed lease transaction?

We believe paragraph (iii)(A), the amount provided to, or on behalf of, the affiliate in the transaction, is the option that should apply to the subject lease. The OCC regulation treats a lease as a loan or extension of credit, and paragraph (iii)(A) is intended to cover most credit transactions.[7] Further, we construe "the amount provided to . . . the affiliate" in the case of a lease to be the lessor bank's investment in the leased property, *i.e.*, its book value. Using book value to measure the covered transaction is both appropriate and consistent with the policy objectives of Regulation W because this is the amount the bank has put at risk for the benefit of an affiliate in order to enter into an affiliate lease.

Therefore, we conclude that the value of the transaction is the "amount provided to . . . the affiliate in the transaction," 12 C.F.R. § 223.21(a)(1)(iii)(A), which in this case is $20 million.[8] This is the covered transaction amount that the collateral requirement will be

[6] In Regulation W, the term "credit transaction" includes loans and extensions of credit. 12 C.F.R. § 223.3(i).

[7] 67 Fed. Reg. 76560, 76578 (Dec. 12, 2002) (preamble to Regulation W). None of the other options is well-suited to a lease. Paragraph (iii)(B) is not applicable in the present case because the Bank will not be obligated to make any payments to the BHC. Paragraph (ii) is not applicable because it is intended to apply to a transaction in which an affiliate fails to pay a member bank a fee for the latter's services when due, while paragraph (i) is intended to apply to instruments purchased at a discount, such as zero coupon bonds. *Id.*

[8] Although it was purchased for $19 million, the aircraft must be recorded on the financial statements of the Bank at fair market value, *i.e.*, $20 million, and the $1 million difference between the fair market value of the aircraft and the purchase price must be accounted for as a contribution to capital. Therefore, capital surplus will increase by $1 million. *See* OCC Bank Accounting Advisory Series Topic 10E, "Related Party Transactions" (January 2007). The Bank must notify the OCC after the capital contribution has been completed. 12 C.F.R. § 5.46(i)(3).

based upon, see below, and that will be applied to the Bank's covered transaction quantitative limits, 12 U.S.C. § 371c(a)(1).

B. Collateral

Section 23A and Regulation W require that a loan or extension of credit to an affiliate must be collateralized, and personal property is acceptable collateral. 12 U.S.C. § 371c(c)(1)(D); 12 C.F.R. § 223.14(b)(1)(iv). You asked whether the leased aircraft itself may be counted as collateral to satisfy this requirement. We conclude that the leased property should be considered collateral for purposes of section 23A.

"Collateral" may be defined as an asset pledged as security to ensure payment or performance of an obligation. If the borrower defaults, the asset pledged may be taken and sold by the lender. Thomas P. Fitch, Dictionary of Banking Terms 92 (5th ed. 2006). Thus, in a typical secured loan, property that is purchased with the loan proceeds serves as collateral for the loan, and the bank may seize and sell the property if the borrower defaults. The Federal Reserve Board has said that "[t]he purpose of section 23A's collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended." 67 Fed. Reg. 76560, 76573 (December 12, 2002) (preamble to Regulation W).

To ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates, Regulation W requires that a member bank's security interest in any collateral must be perfected in accordance with applicable law. *Id.* at 76574. That is not necessary in the case of a lease because the lessor actually has a better form of security than the regulation requires — ownership of the property, as opposed to a mere security interest.[9]

Both the courts and the Federal Reserve Board have treated leased property as collateral in an extension of credit. Some cases have described leased personal property as "collateral" for the lease. *Davis v. Ford Motor Credit Co.*, 599 So. 2d 1123 (Ala. 1992); *Tri-Continental Leasing Corp. v. Cicerchia*, 664 F. Supp. 635 (D. Mass. 1987); *Contractors, Inc. v. Form-Eze Systems, Inc.*, 681 P.2d 148 (Ore. App. 1984). The Federal Reserve Board has also characterized leased property as collateral, albeit not in the context of section 23A. In its decision reaffirming automobile leasing as a permissible activity for bank holding companies under its Regulation Y, the Board noted the similarity between leases and secured loans and observed: "The vehicle serves as a type of collateral to guarantee payment on both the installment loan and the lease." 62 F.R.B. 928, 932 (1976). The Board also found that projecting the residual value of leased property "draws upon the same knowledge and expertise with regard to the value of collateral that banks rely upon when making secured loans." *Id.* at 934.

[9] Upon default of the borrower, a secured creditor does not receive ownership or unfettered possession of the collateral, but simply the right to satisfy the obligation out of the proceeds from the sale of the collateral. 79 C.J.S. *Secured Transactions* § 7 (2006).

Treating the leased property as collateral for purposes of section 23A makes economic and practical sense while still upholding the safety and soundness concerns behind section 23A's collateral requirement. We therefore conclude that the Bank may treat the aircraft as collateral for purposes of section 23A.

C. Application to Bank's Lease

The amount of collateral that section 23A requires for extensions of credit varies depending upon the type of collateral obtained. For example, if the collateral is U.S. Treasury obligations, certain other types of instruments, or a segregated, earmarked deposit account, 100 percent of the amount of the transaction is required, while if the collateral is personal property, 130 percent is required. 12 U.S.C. § 371c(c)(1); 12 C.F.R. § 223.14(b)(1).

Regulation W provides an example of how to calculate the amount of collateral that is required. 12 C.F.R. § 223.14(b)(2). Based on that example, the collateral for this transaction would be computed as follows. The amount of the covered transaction is $20 million and the aircraft that serves as collateral is personal property valued at $20 million. In round numbers, $20 million is 130 percent of $15,385,000. Therefore, $15,385,000 of the lease transaction value is secured by the aircraft, leaving a balance of $4,615,000 to be secured with other collateral. You represent that the Bank will obtain U. S. Treasury obligations or other instruments listed in 12 C.F.R. § 223.14(b)(1)(i) as the additional collateral. Since these obligations qualify for 100 percent collateral treatment, that is, they collateralize a covered transaction dollar-for-dollar, $4,615,000 of such collateral will be needed. As the aircraft depreciates over time, the amount of collateral may be correspondingly reduced.

CONCLUSION

The analysis set forth in this letter is based upon your representations and a material change in these facts could require different conclusions. If you have further questions please contact Christopher Manthey, Special Counsel, Bank Activities and Structure Division, at (202) 874-5300.

Sincerely,

signed

Eric Thompson
Director
Bank Activities and Structure Division