

Safety and Soundness

Capital
Adequacy
(C)

Asset
Quality
(A)

Management
(M)

Liquidity
(L)

Capital
Adequacy
(C)

Sensitivity to
Market Risk
(S)

Other
Activities
(O)

Lease Financing

Version 2.0, September 2023

Contents

Introduction.....	1
Background.....	1
Statutory and Regulatory Framework for Leasing.....	2
Leases Equivalent to Loans: 12 USC 24(Seventh) (National Banks).....	2
CEBA Leases: 12 USC 24(Tenth) (National Banks).....	3
12 CFR 23, “Leasing” (National Banks).....	3
Subpart A: General Provisions.....	3
Subpart B: CEBA Leases.....	4
Subpart C: 12 USC 24(Seventh) Leases.....	4
Leases for Public Facilities (National Banks).....	5
12 USC 1464(c) and 12 CFR 160.41 (FSAs).....	5
Finance Leases.....	5
General Leases.....	6
Limits and Restrictions on Banks’ Leasing Activities.....	6
Loan to a Leasing Company as Loans to the Underlying Lessees.....	7
Binding Commitment and Legal Agreement.....	8
Accounting for Leases by Lessors.....	8
Sales-Type Lease.....	9
Direct Financing Lease.....	11
Operating Lease.....	12
Renewals, Extensions, and Off-Lease Property.....	12
Common Control Arrangements.....	13
Other Lease Financing Products and Alternatives.....	14
Equipment Finance Agreement.....	14
Sale-Leaseback.....	15
Tax-Exempt Municipal Lease.....	15
Bank Qualified.....	16
Non-bank Qualified.....	16
Terminal Rental Adjustment Clause Lease.....	17
Small-Dollar Lease.....	17
Risks Associated With Lease Financing.....	17
Credit Risk.....	18
Interest Rate Risk.....	18
Liquidity Risk.....	18
Operational Risk.....	19
Price Risk.....	19
Compliance Risk.....	20
Strategic Risk.....	20
Reputation Risk.....	21
 Risk Management.....	 22
Policies.....	22
Personnel.....	23
Underwriting Standards.....	23

Financial and Repayment Capacity Analysis	24
Valuation and Residual Analysis	25
Lease Documentation Standards	26
Tax Considerations	27
Interest Rate and Liquidity Risk Considerations	28
Control Systems	28
Internal Audit	28
Credit Risk Review	29
Management Information Systems.....	29
Third-Party Risk Management	29
Risk Rating Leases.....	30
Impairment Analysis and Credit Loss Allowances.....	31
Nonaccrual Status	32
Examination Procedures	33
Scope.....	33
Quantity of Risk.....	35
Quality of Risk Management.....	45
Conclusions.....	51
Internal Control Questionnaire	53
Verification Procedures	55
Appendixes.....	59
Appendix A: Comparison of the Leasing Authority for National Banks and FSAs...	59
Appendix B: Examples of Lease Accounting.....	60
Appendix C: Quantity of Credit Risk Indicators	66
Appendix D: Quality of Credit Risk Management Indicators	68
Appendix E: Glossary	71
Appendix F: Abbreviations.....	74
References.....	75

Introduction

The Office of the Comptroller of the Currency’s (OCC) *Comptroller’s Handbook* booklet, “Lease Financing,” is prepared for use by OCC examiners in connection with their examination and supervision of national banks, federal savings associations (FSA), and federal branches and agencies of foreign banking organizations (collectively, banks). Each bank is different and may present specific risks and issues. Accordingly, examiners should apply the information in this booklet consistent with each bank’s individual circumstances. When it is necessary to distinguish among them, national banks, FSAs, and covered savings associations are referred to separately.¹

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). For more information about these laws and regulations, refer to 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 matrixes for assessing quantity of credit risk and quality of credit risk management, followed by a list of reference materials. Terms that are defined in the glossary are in **bold** type on first mention throughout this booklet.

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**.

Banks are permitted under various laws and regulations to provide lease financing.² For banks, lease financing is another competitive product that can satisfy the needs of bank customers. Leases may be safer than other bank products because the transactions are

¹ Generally, references to “national banks” throughout this booklet also apply to federal branches and agencies of foreign banking organizations unless otherwise specified. Refer to the “Federal Branches and Agencies Supervision” booklet of the *Comptroller’s Handbook* for more information regarding applicability of laws, regulations, and guidance to federal branches and agencies. Certain FSAs may make an election to operate as a covered savings association. For more information, refer to OCC Bulletin 2019-31, “Covered Savings Associations Implementation: Covered Savings Associations,” and 12 CFR 101.

² For more information, refer to the “Statutory and Regulatory Framework for Leasing” section of this booklet.

secured, and leases can be more profitable than loans because of certain advantages inherent in their structure, such as potential tax benefits.³

Leasing is a way for lessees to conserve capital because, in effect, they obtain up to 100 percent financing on the right to use or control an identified asset for a period of time from the lessor. Depending on the structure of the lease, when the lessor maintains ownership of the asset and related tax deductions of the leasing arrangement, both the risks of ownership (such as the possibility that the product becomes obsolete) and the rights to claim tax deductions can be transferred to the lessor. The lessor can share the tax benefits by lowering the lease payment requirement for the lessee. Operating lease liabilities⁴ under Accounting Standards Codification (ASC) Topic 842, “Leases,” are required to be reported as an other liability on the balance sheet of the lessee, which could affect certain financial ratios of the lessee.

Statutory and Regulatory Framework for Leasing

National banks and FSAs are subject to different statutes and regulations granting leasing authority. Refer to appendix A of this booklet for a comparison of leasing authorities for national banks and FSAs. Examiners with questions about leasing statutes and regulations, including those about the permissibility of lease financing, should consult with their assigned OCC legal counsel.

Leases Equivalent to Loans: 12 USC 24(Seventh) (National Banks)

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*.⁵ 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**⁶ that are the functional equivalent of loans.

To consider a lease the functional equivalent of a loan, a national bank must structure the lease as a **full-payout lease** and net lease as those terms are defined in 12 CFR 23.2(e) and

³ 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), flow to them. These transactions can be complex, however, and consequently warrant due diligence and risk management commensurate with the transaction.

⁴ Refer to the “Accounting for Leases by Lessors” section of this booklet for a description of operating leases.

⁵ Refer to 563 F.2d 1377 (9th Cir. 1977), *cert. denied* 436 U.S. 956 (1978).

⁶ Refer to 12 CFR 23.2(f) for the definition of “net lease.”

(f), respectively. In addition, for a lease to qualify as the functional equivalent of a loan 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.⁷

CEBA Leases: 12 USC 24(Tenth) (National Banks)

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.

12 CFR 23, "Leasing" (National Banks)

12 CFR 23 is the OCC's implementing regulation for 12 USC 24(Seventh) and 12 USC 24(Tenth). 12 CFR 23 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.⁸

⁷ Refer to the "Limits and Restrictions on Banks' Leasing Activities" section in this booklet for a full discussion of these restrictions. Refer also to 12 CFR 32, 12 CFR 223, and 12 CFR 215.

⁸ 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.

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.⁹ 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 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.

⁹ For more information, refer to the "Binding Commitment and Legal Agreement" section of this booklet.

Leases for Public Facilities (National Banks)

A longstanding OCC interpretive ruling allows national banks to enter into leases for public facilities with municipalities or other public authorities.¹⁰ 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.

12 USC 1464(c) and 12 CFR 160.41 (FSAs)

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 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.

Finance Leases

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 the lease on a net-lease and full-payout basis as defined in 12 CFR 160.41(b). 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.¹¹

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.¹² 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

¹⁰ For more information, refer to OCC Interpretive Letter No. 847.

¹¹ Refer to 12 CFR 160.41(c) for a detailed listing of the requirements.

¹² 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 (refer to Interpretive Letter No. 770, 1997); (2) when it is equivalent to a secured real estate loan (refer to Interpretive Letter No. 806, 1997); and (3) when the lease is for financing of public facilities (refer to the "Leases for Public Facilities (National Banks)" section of this booklet). A finance lease in real estate or premises that are no longer used in banking operations could also be included in other real estate owned when appropriate under generally accepted accounting principles (GAAP).

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 Leases

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.

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 bank'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 (national banks and FSAs¹³), 12 USC 1464(u) (FSAs), and 12 CFR 32 (national banks and FSAs) regarding legal lending limits to one borrower.
- 12 USC 371c and 371c-1 and 12 CFR 223 (Regulation W) regarding restrictions on transactions with affiliates.
- 12 USC 375a and 375b and 12 CFR 215 (Regulation O) regarding restrictions on insider lending.

Any bank engaging in a leasing program should 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 Topic 842.

¹³ FSAs are subject to 12 USC 84 pursuant to 12 USC 1464(u).

The outstanding obligation of the lessee under a leveraged lease that preexisted ASC Topic 842¹⁴ is calculated in much the same way. 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.

When calculating the total volume of CEBA leases to apply the 12 USC 24(Tenth) limit of 10 percent, one subtracts the nonrecourse debt of a preexisting leveraged lease (before ASC Topic 842) that the national bank has incurred to finance the acquisition of the leased property.¹⁵ 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 not 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.¹⁶

Loan to a Leasing Company as Loans to the Underlying Lessees

Loans to third-party leasing companies 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.

¹⁴ Under ASC Topic 842, leveraged lease accounting is no longer permitted. Existing leveraged leases under ASC Topic 840 were permissible at the transition date. A lessor that has adopted ASC Topic 842 may continue to apply leveraged lease accounting to leases that preexisted the transition date. A lessor accounts for any leveraged lease modified on or after the effective date of ASC Topic 842 as a new finance or operating lease as of the effective date of the modification in accordance with the guidance in ASC Subtopic 842-10 and ASC Subtopic 842-30.

¹⁵ Refer to 12 CFR 23.10.

¹⁶ 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.

The 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. Examiners should contact assigned OCC legal counsel for assistance in determining whether loans and leases are attributable to a single entity, such as a third-party lessor, for legal lending limit purposes.

Binding Commitment and Legal Agreement

According to 12 CFR 23, subpart A, a national bank may purchase the leased property only after it has entered a legally binding agreement or a lease contract.¹⁷ 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 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 for Leases by Lessors

Lease accounting treatments vary depending on the type of lease and lessor. In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, "Leases (Topic 842)," which added ASC Topic 842 to supersede ASC Topic 840, "Leases." ASU 2018-10, "Codification Improvements to Topic 842, Leases"; ASU 2018-11, "Leases (Topic 842): Targeted Improvements"; ASU 2018-20, "Narrow-Scope Improvements for Lessors"; and ASU 2019-01, "Leases (Topic 842): Codification Improvements" provided further clarifications and amendments to ASC Topic 842.

Lessors record assets acquired for leasing purposes (including assets held for future leasing activities) at cost adjusted for applicable volume or trade discounts.¹⁸ If a significant lapse of time has occurred between the acquisition of the underlying asset and the commencement of

¹⁷ FSAs do not have this legal requirement, but they are encouraged to practice the same standard from a safety and soundness standpoint.

¹⁸ 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. For more information about the requirements for national banks to acquire personal property for future leasing, refer to the "Binding Commitment and Legal Agreement" section of this booklet.

the lease, **fair value** should be calculated based on the principles of ASC Topic 820, “Fair Value Measurement.”¹⁹ When an asset is leased, the lessor recognizes a **net investment in the lease** and derecognizes the asset or continues to recognize the asset net of depreciation on the balance sheet, depending on the type of lease. If the asset is not leased or otherwise disposed of within a reasonable time, the asset should be reviewed for impairment.

Under ASC Topic 842, at lease commencement, a lessor categorizes each lease into one of three types: sales-type, direct financing, or operating. A lease’s classification then drives the differences in accounting treatment under ASC Topic 842. The criteria for lease classification must be analyzed together with the principle of a sale in ASC 606, “Revenue from Contracts with Customers.” The appropriate classification depends on the facts and circumstances of each specific lease. The ensuing sections of this booklet discuss characteristics for categorizing leases as sales-type, direct financing, or operating. Appendix B of this booklet contains examples that demonstrate a bank lessor’s accounting classification and treatment of a sales-type lease, a direct financing lease, and an operating lease.

Sales-Type Lease

According to ASC Topic 842, a lease transaction is categorized as a sales-type lease for the lessor, if, at inception, the lease meets any of the following five criteria, indicating that control of the underlying asset has been effectively transferred to the lessee:

- The lessor will transfer ownership of the property to the lessee by the end of the lease term.
- The lessor grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term covers the major part of the remaining economic life of the underlying asset.²⁰

¹⁹ ASU 2019-01 clarifies that for lessors who are not manufacturers or dealers (i.e., banks), the determination of fair value is ordinarily the underlying asset’s cost, reflecting any volume or trade discounts that could apply, instead of fair value as defined in ASC Topic 820. If significant time lapses between the acquisition of the underlying asset and the lease commencement date, however, banks are required to apply the definition of fair value in ASC Topic 820.

²⁰ If the commencement date falls at or near the end of the economic life of the underlying asset, this criterion should not be used for the purpose of classifying the lease. In addition, although ASC Topic 842 does not specify a bright-line threshold for what would constitute the major part of economic life, lessors may continue to use the test of 75 percent of estimated economic life under ASC Topic 840.

- The present value²¹ of the sum of lease payments²² and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the leased asset's fair value.²³
- The underlying asset is of a specialized nature such that it is expected to have no alternative use to the lessor at the end of the lease term.

In accordance with ASC paragraph 842-10-25-3A, a lessor shall classify a lease with variable lease payments that do not depend on an index or a rate as an operating lease at lease commencement if classifying the lease as a sales-type or direct financing lease would result in the recognition of a selling loss (even if the lease otherwise meets the requirements of a sales-type or direct financing lease).

A sales-type lease that meets the ASC Topic 842 criterion is accounted for by the lessor as net investment in the lease, including (1) the **lease receivable** (present value of the lease payments not yet received and residual value guaranteed by either the lessee or a third party unrelated to the lessor discounted by the rate implicit in the lease),²⁴ and (2) present value of the **unguaranteed residual** discounted by the rate implicit in the lease.²⁵ The lessor recognizes any selling profit or loss from the sale at the inception of the lease unless the collectability of amounts due under the lease is not probable. **Initial direct costs** should be expensed at the inception of the lease if the fair value of the underlying asset is different from its carrying amount. If the fair value of the underlying asset equals its carrying amount (i.e.,

²¹ Under GAAP, a lessor should compute the present value using the interest rate implicit in the lease, while a lessee should compute the present value using the lessee's **incremental borrowing rate** unless the implicit rate is available and lower.

²² The fixed lease payments for classification purposes include unavoidable, "in-substance" fixed payments, if there is there is a minimum level that that must be paid by the lessee. An annual percentage increase included in a lease contract that is both fixed and unavoidable by the lessee is an example of an "in-substance" fixed lease payment. Lease payments include the following:

- Fixed lease payments for the lease term, net of any lease incentives provided to the lessee.
- Variable lease payments dependent on an index or rate (e.g., Consumer Price Index or Secured Overnight Financing Rate (SOFR)), measured using the index or rate at lease commencement.
- The exercise price of a purchase option, only if reasonably certain of exercise by the lessee.
- Payments for penalties for terminating the lease if the lessee is reasonably certain to exercise its option to terminate the lease.
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.

²³ Despite the absence of a bright-line threshold, the ASC Topic 840 test of 90 percent is still permissible under ASC Topic 842.

²⁴ If the residual is guaranteed after the lease commencement date, it is considered the same as an unguaranteed residual asset.

²⁵ If collectability of amounts due under the lease is not probable at lease inception, the lessor should not derecognize the leased asset nor recognize the net investment in the lease. Instead, the lessor should recognize lease payments received as a liability until the earlier of (1) the collectability of amounts due under the lease becomes probable, (2) the contract has been terminated and the lease payments received are nonrefundable, and (3) the lessor has repossessed the leased asset, has no further obligation under the lease, and the lease payments received are nonrefundable.

there is no selling profit or loss), the initial direct costs are deferred and recognized over the lease term as part of the net investment in the lease.

In a sales-type lease, the bank lessor should have no selling profit or loss, as the fair value of the underlying asset is usually its cost.²⁶ Initial direct costs for the bank lessor with no selling profit or loss, if any, are not expensed up front but capitalized as part of the net investment in the 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 carrying value of the property is different from the fair value of the underlying asset at the inception of the lease. This type of transaction is tantamount to a sale. A common sales-type lease is the agreement between an automobile dealer and a customer. In that circumstance, the lessor (dealer) is leasing the automobile in lieu of selling it.²⁷

Direct Financing Lease

Under ASC Topic 842, a lease is classified as either a direct financing lease or an operating lease if the lease does not meet any of the five criteria for a sales-type lease in which control of the underlying asset is transferred to the lessee.²⁸ A direct financing lease must meet both of the following two criteria; otherwise the lease must be classified as an operating lease:

- The present value of all future lease payments and any residual value guaranteed by the lessee or a third party at lease commencement equals or exceeds substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

²⁶ See footnote 19.

²⁷ Examiners might encounter titling trusts in leasing examinations, particularly auto leasing. A titling trust, a special-purpose entity (SPE) typically formed (and owned) by the lease originator or sponsoring entity, is commonly used in automobile leasing to avoid the administrative difficulty and expense associated with retitling leased vehicles. Upon the origination of the lease, the leased vehicle is titled in the name of the titling trust. Although the sponsor/originator is not named on the title, it possesses an undivided trust interest in the trust for all leases and related vehicles in the titling trust. The SPE trust is usually set up for tax reasons and should not impact the accounting just because beneficial interests are involved.

²⁸ In the case of a portfolio of leases, the classification analysis should be performed on a lease-by-lease basis even in the case when a residual value guarantee covers a portfolio of leased assets. This is because the variability around the expected residual values is usually not expected to be highly correlated, and it is not possible to determine the amount of the guaranteed residual value for each individual lease. Classification analysis may be performed on a pool basis under limited circumstances when the portfolio is homogeneous, the leases commence and end their term at the same time, the leased assets are physically similar to one another, and the variability around the expected residual values is expected to be highly correlated.

In a direct financing lease, the lessor records a net investment in the lease, including the lease receivable (present value of the lease payments not yet received and residual value guaranteed by either the lessee or a third party unrelated to the lessor), the unguaranteed residual asset discounted by the rate implicit in the lease similar to a sales-type lease, and any deferred initial direct costs, reduced by the amount of any selling profit. Selling profit and initial direct costs, if any, are deferred and reflected in the net investment in the lease. Alternatively, the lessor recognizes any selling loss at lease commencement.

For a bank lessor in a direct financing lease, the cost of the underlying asset is used as the fair value unless a significant gap exists between the timings of asset acquisition and lease commencement.²⁹ A bank lessor typically buys an asset and leases it to the lessee immediately, so there is no selling profit or loss for the bank lessor, and the bank's only source of revenue is interest. 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.

Operating Lease

If a lease meets the criteria of neither a sales-type nor a direct financing lease, the lessor shall account for it as an operating lease. In an operating lease, the lessor retains control of the underlying asset, and, 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 lease term. In most operating leases, the term of the initial lease agreement is significantly shorter than the economic life of the property.³⁰

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 a straight-line basis or the lessor's normal depreciation policy or practice consistent with income recognition. 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.

Renewals, Extensions, and 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.

²⁹ See footnote 19.

³⁰ 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.

When a lease is terminated, the previously leased property becomes **off-lease property**.³¹ The remaining net lease receivable, if any, is removed, and the property recorded as an “other asset” at the lower of fair value or book value.³² 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 is reflected in income during the current period.

The maximum holding period for off-lease property is five years for national banks, beginning at the end of the original lease’s redemption period (if any), when the lessee does not redeem the property through payment in full earlier, unless the OCC specifically approves a longer holding period. Specifically, national banks are required to liquidate the off-lease property or re-lease it under a conforming lease as soon as practicable. Liquidation or re-lease must occur not later than five years from the date that the bank acquires the legal right to possession or control of the property. The OCC may extend the holding period for up to an additional five years, if the national bank provides a clearly convincing demonstration why any additional holding period is necessary.³³

During the holding period allowed for national banks under 12 CFR 32.4(c), a national bank may enter into a short-term bridge or interim lease pending the liquidation of off-lease property or the re-lease of the property under a conforming lease. A short-term bridge or interim lease must be a net lease but is not required to comply with subparts B or C of 12 CFR 32.³⁴

FSAs are not subject to a defined time limit for holding off-lease property. FSAs are required to liquidate or re-lease off-lease property on a net basis as soon as is practicable.³⁵

Common Control Arrangements

In March 2023, FASB issued ASU 2023-01, “Leases (Topic 842): Common Control Arrangements.” ASU 2023-01 provided a practical expedient only for private companies and

³¹ 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. Refer to 12 CFR 23.2(g).

³² Refer to the Federal Financial Institutions Examination Council’s “Instructions for Preparation of Consolidated Reports of Condition and Income” (call report instructions) for “Other Assets” (Schedule RC-F) for guidance on how to record off-lease property. Under 12 CFR 23.4(c), national banks are required to value off-lease property at the lower of current fair market value or book value promptly after the property becomes off-lease property. Under 12 CFR 160.41(c)(2)(iii), any property held by an FSA in anticipation of re-leasing must be reevaluated and recorded at the lower of fair market value or book value.

³³ A bank may request an extension not to exceed an additional five years, if (1) the bank has made a good-faith attempt to dispose of the real estate within the five-year period, or (2) disposal within the five-year period would be detrimental to the bank. Refer to 12 CFR 23.4(c) (national banks).

³⁴ Refer to 12 CFR 23.4(d) (national banks).

³⁵ Refer to 12 CFR 160.41(c)(2)(iii) (FSAs).

not-for-profit entities³⁶ that are not conduit bond obligors to use the written terms and conditions of a common control arrangement on an arrangement-by-arrangement basis to determine

1. whether a lease exists, and, if so,
2. the classification of and accounting for that lease.

The practical expedient in ASU 2023-01 allows a lessor or lessee to use the written terms and conditions of an agreement to account for common control leases without further assessing the legal enforceability of those terms. This is different than the original requirement of ASC 842, which requires *all* entities to consider legally enforceable terms and conditions, often involving judgmental factors beyond just the written agreement itself. The practical expedient can be applied only to written agreements (i.e., not verbal agreements) for private companies and certain not-for-profit entities.

This practical expedient is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted.

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 competition. For example, the traditional tax-driven operating leases have lost some prominence, 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). EFAs can be used to make secured financing loans with certain lease characteristics. A bank or bank's leasing operation could use an EFA when, for example, system limitations do not provide for 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.³⁷ For these and other reasons, EFAs are used instead of leases to reduce a bank's exposure or liability as a lessor of certain

³⁶ The practical expedient is available to entities that are not (1) public business entities, (2) not-for-profit conduit bond obligors, or (3) employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

³⁷ Another variation of the zero purchase option exists 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.

types of property or equipment. Some 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 leased property's value at the inception of the term. To book an EFA as a loan, the bank applies regular loan accounting policies and procedures, while the borrower generally accounts for the transaction by recording an asset and a liability on its balance sheet.

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 are viewed in essentially the same manner as other leases.

Under ASC Topic 842, sale-leaseback accounting applies to transactions that qualify for sales treatment whereby the parties have a contract based on the contract existence criteria outlined in ASC paragraphs 606-10-25-1 through 25-8, and the seller/lessee has transferred control of the leased asset to the buyer/lessor based on the guidance on satisfying performance obligations in ASC Topic 606. A transaction that does not transfer control is a "failed" sale (i.e., the seller has not sold the asset but has essentially mortgaged it) and thus is accounted for as a financing arrangement.

The criteria in ASC paragraphs 606-10-25-1 through 25-8 require that a contract with a related party have commercial substance (that is, the risk, timing, or amount of the bank's future cash flows is expected to change as a result of the contract). Related party contracts that lack commercial substance do not qualify as sale-leaseback transactions. Further, in determining the lease term, the parties must consider all relevant factors that create an economic incentive for the bank to extend the lease term beyond what may be stated in the contract. Factors to consider may include those specific to the contract, the leased asset, the market, and the bank. Examples of some of these factors are

- the expectation that leasehold improvements will have significant economic value at the end of the stated lease term.
- the importance of the leased asset and its location to the bank's operations.
- costs related to signing a new lease, such as costs of negotiating a new lease, identifying another location that is suitable for the bank, and relocation.

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.³⁸ 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.

The three primary categories of tax-exempt municipal leases are 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.³⁹

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.

The American Recovery and Reinvestment Act of 2009 introduced several incentives for municipal financing, including a de minimis exception to the disallowance of interest deductibility for new NBQ 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.⁴⁰

Conduits for 501(c)(3) Corporations

A bank can also provide tax-exempt lease financing to a nonprofit corporation with Internal Revenue Service (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 sublessor), which assigns its lease with the nonprofit corporation (the sublessee) 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.

³⁸ In addition to personal property leasing to municipalities, national banks may lease public facilities (i.e., real estate) to municipalities. For more information, refer to the "Leases for Public Facilities (National Banks)" section of this booklet.

³⁹ Examiners should be mindful that IRS laws, regulations, and rulings can change.

⁴⁰ Refer to Section 265 of the Internal Revenue Code (26 USC 265).

Terminal Rental Adjustment Clause 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.⁴¹

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.

Small-Dollar Lease

Small-dollar leases are a type of leasing that focuses on small- and middle-market borrowers. These leases are mostly sourced through independent third parties (e.g., manufacturers, resellers, dealers, and distributors), franchisors, or brokers. Therefore, small-dollar leases are often indirect leases. Common products offered as small or indirect leases include transportation (e.g., autos), personal communication (e.g., phones), and office products (e.g., copiers and computers), machine tools, material handling equipment, and, to a lesser extent, healthcare and construction equipment.⁴²

Risks Associated With Lease Financing

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank’s current or projected financial condition⁴³ and resilience.⁴⁴ The OCC has defined

⁴¹ 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.

⁴² Refer to the “Installment Lending” booklet of the *Comptroller’s Handbook* for more information about consumer indirect leases.

⁴³ Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

⁴⁴ Resilience recognizes the bank’s ability to withstand periods of stress.

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 and assess this interdependence. Examiners also should be alert to concentrations that can significantly elevate risk. Concentrations can accumulate within and across products, business lines, geographic areas, countries, and legal entities. 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.

Credit Risk

Credit risk is the risk to current or projected financial condition and resilience arising from an obligor’s failure to meet the terms of any contract with the bank or otherwise perform as agreed. The primary risk to a bank 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.⁴⁵ 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 financing (e.g., loans).

Interest Rate Risk

Interest rate risk (IRR) is the risk to current or projected financial condition and resilience arising from movements in interest rates. Like loans, leases are subject to 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

Liquidity risk is the risk to current or projected financial condition and resilience arising from an inability to meet obligations when they come due. An asset’s liquidity can be viewed in

⁴⁵ 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. Refer to the “Price Risk” section of this booklet for more information.

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 asset. Leases have high liquidity risk when 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

Operational risk is the risk to current or projected financial condition and resilience arising from inadequate or failed internal processes or systems, human errors or misconduct, or adverse external events.

Failing to develop proper risk management processes inclusive of internal controls, audit coverage, and credit risk review can lead to increased operational risk. Aggressive growth has the potential to stretch operational capacity and can cause problems in handling customer accounts and processing payments. Additionally, certain types of leases include complex structures, accounting rules, and reporting methods that add further operational risk to the leasing portfolio. Insufficient staffing or the failure to maintain staff with appropriate leasing expertise also introduces operational risk.

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. Operational risk in leases can stem from lease documentation failures and lapses in lease administration. Operational risk can also result from the 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 processes could result in the bank lessor's inability to collect the lease payments and regain control of the leased property if repossession becomes necessary.

A bank's use of third parties can result in heightened operational and other risks. A bank's use of third parties does not diminish or remove the bank's responsibility to offer lease financing activities in a safe and sound manner and in compliance with laws and regulations

Price Risk

Price risk is the risk to current or projected financial condition and resilience arising from changes in the value of either trading portfolios or other obligations that are entered into as part of distributing 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 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 activities 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 is the risk to current or projected financial condition and resilience arising from violations of laws or regulations, or from nonconformance with prescribed practices, internal bank policies and procedures, or ethical standards. Compliance risk in the form of litigation, settlements, or judgments affects leasing. Failure to comply with the statutory and regulatory requirements can expose a bank to regulatory actions and civil money penalties.⁴⁶ 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

Strategic risk is the risk to current or projected financial condition and resilience arising from adverse business decisions, poor implementation of business decisions, or lack of responsiveness to changes in the banking industry and operating environment. Strategic risk can arise when lease financing activities are not aligned with a bank's risk appetite or strategic plan. Strategic risk can also arise when a bank has insufficient personnel resources, infrastructure, and other resources necessary to maintain a sound and profitable operation. Engaging in new, modified, or expanded lease financing activities (collectively, new activities) without a risk management system that is commensurate with the associated risks can pose significant strategic risk.⁴⁷ 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.

⁴⁶ For more information about statutory and regulatory requirements, refer to the "Statutory and Regulatory Framework for Leasing" section of this booklet.

⁴⁷ For more information about strategic planning, refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook*. The OCC's guidance regarding new activities applies to new leasing activities. Refer to OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles."

Reputation Risk

Reputation risk is the risk to current or projected financial condition and resilience arising from negative public opinion. 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 and inefficient operations and property delivery could tarnish the bank's reputation. In the case of an operating lease in which the lessor is considered the owner of the property, the lender could be subject to lender or owner liability lawsuits.

A lease may be syndicated among the lessor and several debt participants because of the transaction size and risk characteristics. If a 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.⁴⁸ These transactions often involve professionals with specialized expertise and may involve the creation of special purpose entities and nonbank subsidiaries. If a bank enters into these transactions without sufficient due diligence, oversight, and internal controls, the bank could be exposed to significant reputation and compliance risks.

⁴⁸ Refer to the "Other Lease Financing Products and Alternatives" 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.

Risk Management

Each bank should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the bank's size, complexity, and risk profile. 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 "Corporate and Risk Governance" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

A bank's risk management for leasing activities should generally be similar to risk management for other types of lending products.

Policies

A bank should have adequate policies and procedures over lease financing activities. A sound leasing operation also typically has procedures for the periodic reviews of policies to determine consistency with changes in tax laws, accounting requirements, and market conditions, and update policies in a timely manner. Leasing policies typically address

- types of assets that the bank will and will not lease.
- minimum borrower eligibility.
- any targeted geographic footprints and restrictions.
- any industry focuses or restrictions.
- exposure limits and sub-limits.
- underwriting standards for leases.⁴⁹
- pricing.
- accounting and financial statement disclosure requirements, including proper classification of leases.
- compliance with laws and regulations.
- appraisal and valuation and residual requirements.
- asset monitoring requirements.
- documentation standards.
- concentration risk management.
- policy exceptions and underwriting variances.
- periodic review and risk rating requirements.
- off-lease property monitoring, accounting, and reporting.
- problem lease management and resolution.
- board and management responsibilities and duties.
- lease financing reporting requirements.
- credit review for lease financing activities.
- audit requirements and expectations.

⁴⁹ Refer to the "Underwriting Standards" section of this booklet for more information.

Personnel

Capable management and appropriate staffing are essential to effective risk management of lease financing activities. Retaining and recruiting competent leasing executives, line managers, risk management personnel, and back-office staff are important, as lease financing structures, regulatory requirements, and accounting standards can be complex. The skills and expertise of leasing management and staff should be commensurate with the complexity of the bank's leasing products and services. The skills within large or complex banks (and what a bank typically pays the personnel who have these skills) are generally greater and more varied than those in small or noncomplex banks. Mergers and acquisitions can also present complicated personnel challenges. Prudent merger plans typically include strategies for retaining the staff members essential to effective risk management.⁵⁰

It is important for leasing personnel to understand the statutory and regulatory requirements for leasing activities, the bank's risk appetite, risks associated with leasing, the different types of leases, and the proper accounting and reporting requirements. It is also important for personnel to stay current with changes in tax laws, accounting standards, customer demand, and other economic factors that could affect the bank's leasing program. Examiners should determine whether the personnel who structure and administer leases are qualified and have a working knowledge of applicable tax laws and regulations.

Sound leasing operations typically exhibit the following key characteristics regarding personnel:

- Personnel have appropriate experience with the assets acquired for leasing (specifically in the areas of market demand, purchasing, disposition, market value depreciation over time, and appraisal techniques).
- Personnel have knowledge and experience with structuring lease contracts and perfecting security interests in the leased property.
- Management and personnel compensation structures provide reasonable balance between lease or revenue production, lease quality, and portfolio administration.

Underwriting Standards

The underwriting considerations the bank applies 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 typically confirms that it reasonably expects 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. As with any lending activity, bank lessors develop specific underwriting guidelines or policies that set forth lease underwriting standards. Underwriting standards typically include

⁵⁰ Refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook* for more information about risk management during bank mergers.

- measurable criteria, such as a minimum fixed charge coverage ratio and permitted advance rates, to guide the leasing staff's transaction structuring and risk evaluations.
- credit analysis expectations.
- parameters for acceptable lease structures and repayment terms.
- valuation requirements.
- property and residual controls.
- guidelines for covenants.
- documentation standards.
- borrower equity and credit enhancement requirements.

Appropriate structuring of leases takes into account all relevant factors, such as lease amount, purpose, tenor, sources of repayment, repayment capacity, value of the leased property, rate, and residual risk.

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 traditional direct financing leases, similar to appropriate procedures for purchased loans.⁵¹

When structuring syndicated leases, the bank typically considers 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 syndicated leases depends largely on these factors, and even a slight change in the variables can affect profitability.

Financial and Repayment 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 typically computes 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 affects the rate of return.

For each lease, the bank lessor typically reviews the risks affecting collectability by

- assessing the lessee's creditworthiness. This would ordinarily include evaluating the lessee's
 - credit history as evidence of the lessee's willingness to repay the lease obligation as agreed.

⁵¹ For more information about structural weaknesses, refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*. For more information about risk management of loan purchase activities, refer to OCC Bulletin 2020-81, "Credit Risk: Risk Management of Loan Purchase Activities."

- income and financial resources to demonstrate its ability to meet the lease obligation according to the terms established.
- considering potential changes in tax benefits.
- assessing the value of the leased property periodically.

Syndicated lease transactions usually involve variable interest entities (VIE). Appropriate analysis generally includes assessing the financial capacity of all parties involved in the lease. If the lessee defaults, the lessor could have to repay any loan in the VIE provided by a third party in the transaction, even if nonrecourse, if the lessor exercises a buyback to reduce economic consequences and to recapture a part of its investment. Thus, the bank typically would not enter into a syndicated lease as the lessor, i.e., the equity participant in the VIE, unless the bank has the capacity to maintain the lease for a time in the event the lessee defaults.

The likelihood of nonappropriation is an important consideration when underwriting municipal leases. This assessment 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 similar property if the lease is canceled.⁵² In general, the agreement also should include evidence of appropriation for the first fiscal period.

For small-dollar leases, the underwriting metrics may be driven by scorecard models or computer-based applications. Underwriting models should be incorporated into the bank's model risk management processes.⁵³ Banks typically have size limits for including small and indirect leases in the computer-based underwriting versus the traditional underwriting method for the larger commercial loans.

Indirect exposure from third-party lease providers should also be subject to routine portfolio monitoring and annual reviews. Credit enhancement provided by the third party, if any, should be thoroughly reviewed and assessed, and properly reflected in the lessee's global cash flow and repayment capacity analysis.

Valuation and Residual Analysis

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

⁵² This also is referred to as the nonsubstitution clause.

⁵³ For more information, refer to OCC Bulletin 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management," and the "Model Risk Management" booklet of the *Comptroller's Handbook*.

At underwriting, leased property may be valued by appraisal, engineering estimates, brokers'/dealers' prices for similar used assets, and past recoveries on similar assets.⁵⁴ 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. In addition, it is also a sound banking practice that any valuation of the leased property be independent from the leasing function.

Effective asset valuation procedures mitigate risk over the course of a transaction and provide valuable information for structuring of new leases. The bank lessor evaluates the residuals on individual leases as part of the overall assessment of risk in the bank's portfolio. The bank reviews 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 should determine whether assumptions used in the model are reasonable.⁵⁵ Incorrect assumptions or changes in market conditions affecting the property could make it difficult for the bank to recover its investment. Projecting unreasonably high residuals can expose the bank to unwarranted risk during the lease term. Prudent risk management practices may include maintenance of reports relating to residual exposure, residual realization rates, historical residual realization rates, and residual concentrations by asset class, manufacturer, and 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 monitors properties for obsolescence or market value decline, which could assist in structuring profitable lease programs in the future. Finally, bank lessors should conduct annual impairment reviews under lease accounting standards.⁵⁶

Lease Documentation Standards

Lease financing documentation is similar to the documentation for any secured financing and typically includes

⁵⁴ For ongoing residual analysis and monitoring purposes, valuations should be periodically refreshed and not be based on the original invoice or purchase order at underwriting.

⁵⁵ For more information, refer to OCC Bulletin 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management," and the "Model Risk Management" booklet of the *Comptroller's Handbook*.

⁵⁶ Refer to ASC Topic 842 and ASC Topic 360.

- a lease financing agreement that details the lease obligation, including
 - payment amounts.
 - the lease term.
 - type of lease structure.
 - characteristics that qualify the lease for the designated tax and accounting classifications.
- 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.
- post-closing UCC searches evidencing the lessor’s first perfected security interest in the underlying leased property and that the leased property has not been double financed.
- 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).
- a clear title to the leased property to enable its repossession and liquidation if the lessee defaults.

A bank lessor’s lease documentation is an important control, regardless of whether the bank is originating the leases directly, purchasing them through a third party or a lease assignment, or in a pooled arrangement. Not only can the bank readily monitor the documents, but, in certain situations, possessing the actual lease documentation also can provide a distinct advantage in the perfection and recovery of leased property and the ability to take control of cash flow from leases.

Tax Considerations

Tax credit-driven leases often are complex transactions that typically warrant significant due diligence. Lessors whose returns depend substantially on tax benefits risk losing tax benefits if the lessee defaults or tax laws change. Some lessors 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.⁵⁷ 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 would evaluate its present and anticipated future tax position and future money rates. If a default occurs 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, it is prudent for a bank lessor to periodically review its exposure to changes in its tax position. When the exposure is caused by changes in tax laws, the bank would determine whether the borrower indemnifies the lessor against that risk.

⁵⁷ Refer to ASC Topic 740, “Income Taxes.”

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. Many banks engage counsel to assist in determining a lease's eligibility for tax benefits. In addition, IRS requirements may change periodically. Banks can structure lease contracts to protect the bank lessors' interests if tax laws change.

Interest Rate and Liquidity Risk Considerations

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.

To the extent that the leasing portfolio affects a bank's liquidity, management would assess any expected needs to liquidate portions of the portfolio to meet other funding requirements or take advantage of other opportunities. Examiners should 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 liquidity risk in addition to credit risk.⁵⁸

Control Systems

Control systems are the functions (such as internal and external audits, credit risk review, quality control, and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes and personnel. Control system reviews can detect mistakes caused by carelessness, errors in judgment, or unclear instructions, in addition to fraud or deliberate noncompliance with laws, regulations, and bank policies. Credit risk control systems help maintain credit risk exposure within parameters set by the board and senior management. Establishing and enforcing internal controls, operating limits, and other practices help maintain credit risk exposures within acceptable levels, and these systems collectively provide assurance that lease financing staff and others are working in accordance with specified policies and operating procedures.

Internal Audit

Leasing activities should be included in a bank's audit program.⁵⁹ Internal audit independently evaluates lease financing activities, including accounting systems, management reporting, and operations. Internal audit gives the board important information about the effectiveness of credit risk management activities, specifically whether existing internal controls are sufficient and working as intended. Internal audit does this by

⁵⁸ For more information, refer to the "Concentrations of Credit," "Interest Rate Risk," and "Liquidity" booklets of the *Comptroller's Handbook*.

⁵⁹ For more information, refer to the "Internal and External Audits" booklet of the *Comptroller's Handbook*.

- evaluating the reliability, adequacy, and effectiveness of accounting, operating, and administrative controls.
- determining whether internal controls result in timely and accurate recording of transactions and safeguarding of assets.
- determining whether the bank complies with laws and regulations and whether personnel adhere to established bank policies and processes.
- determining whether management is taking appropriate and timely steps to address current and prior control deficiencies and audit report recommendations.
- ensuring that audit activities are performed by a qualified person.

Lease financing audits typically focus on the categorization of various types of leases, volumes, growth, off-lease asset accounting, valuation, inspection, and controls. Most audit reviews include lease documentation file samples to review specific transactions for adherence to the bank's policies and processes. Many internal audit reviews also opine on the structuring of the lease, including prudent residual setting and valuation, off-lease asset disposal, control of property under lease, and off-lease asset management. Internal audit also typically reviews and reconciles management and board reports.

Credit Risk Review

A bank's credit risk review should include reviews of lease financing. Credit risk reviews typically review lease financing consistent with how they review other types of secured lending.

The credit risk review function is expected to be independent of a bank's internal audit function. Coordination of credit risk review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better use available resources, and enhance the bank's ability to comprehensively manage risk. Although coordination has advantages, an effective internal audit function maintains the ability to independently audit the credit risk review function.⁶⁰

Management Information Systems

Leasing activities should have accurate and complete management information systems (MIS) and reports to identify, measure, monitor, and control risk. Effective reports enable management and the board to monitor items such as lease payment status, collections, lease runoffs, residual positions, and concentrations within the leasing portfolio.

Third-Party Risk Management

The OCC expects a bank to practice effective risk management regardless of whether the bank performs the activity internally or through a third party. A bank's use of third parties

⁶⁰ For more information, refer to OCC Bulletin 2020-50, "Credit Risk: Interagency Guidance on Credit Risk Review Systems."

does not diminish or remove the bank's responsibility to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws and regulations. As part of sound risk management, banks analyze the risks associated with each third-party relationship and tailor risk management practices, commensurate with the bank's size, complexity, and risk profile and with the nature of the third-party relationship. Also as part of sound risk management, banks engage in more comprehensive and rigorous oversight and management of third-party relationships that support higher-risk activities, including critical activities.⁶¹

Common third-party relationships related to lease financing include guarantors or insurers of lease residuals, servicers, third-party lease providers, brokers, and valuation providers. Such third parties should be incorporated into the bank's third-party risk management processes.

To indicate meaningful support for the lease, lease residual guarantors and insurers should generally have credit standings and repayment capacities above that of the lessee. Effective third-party risk management includes credit analysis on the guarantors and insurers. Additionally, a bank's analysis of concentration risk and potential one-way counterparty credit risk is important, as correlation in credit risks typically exists between the lessee and its guarantors or insurers that have close relationship with the lessee.

When lease pools are serviced by a third party, it is important for bank management to 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 assumes control of the pools.

Third-party lease providers and brokers represent an indirect exposure that can add risk to an end-user (lessee) transaction. Practices such as limits on indirect leasing exposure and due diligence on the third party or broker aid in mitigating these risks.

Risk Rating Leases

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 lending, 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

⁶¹ For more information about third-party risk management, refer to OCC Bulletin 2023-17, "Third-Party Relationships: Interagency Guidance on Third-Party Relationships: Risk Management."

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 incurs 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 Credit Loss Allowances

A bank that has adopted the current expected credit loss (CECL)⁶² standard must determine allowances for credit losses (ACL) for sales-type and direct financing leases in accordance with ASC Subtopic 326-20, “Measured at Amortized Cost.” Operating lease receivables are excluded from the scope of ASC Subtopic 326-20 and should be evaluated for impairment under ASC Topic 842.

According to ASC Topic 842, 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 ACL. 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’s ACL methodology for financed lease receivables should accurately reflect 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 first separates 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.

OCC Bulletin 2023-11, “Current Expected Credit Losses: Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023),” ASC Subtopic 450-20, “Loss

⁶² Refer to ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326).”

Contingencies,” the call report instructions, and the “Allowances for Credit Losses” booklet of the *Comptroller’s Handbook* provide more information on the ACL.

Nonaccrual Status

Banks should follow the call report instructions when determining the accrual status for lease financing receivables. As a general rule, banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset if

- the asset is maintained on a cash basis because of deterioration in the financial condition of the borrower,
- payment in full of principal or interest is not expected, or
- principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.⁶³

The call report instructions provide one exception to the general rule:⁶⁴ Purchased credit-deteriorated assets need not be placed on nonaccrual status when the bank (1) reasonably estimates the timing and amounts of cash flows expected to be collected, and (2) did not acquire the asset primarily for the rewards of ownership of the underlying collateral.⁶⁵

As a general rule, a nonaccrual asset may be returned to accrual status when

- none of its principal and interest is due and unpaid and the bank expects repayment of the remaining contractual principal and interest,⁶⁶ or
- it otherwise becomes well secured and is in the process of collection.

The OCC’s *Bank Accounting Advisory Series* and the “Rating Credit Risk” booklet of the *Comptroller’s Handbook* provide more information for the recognition of nonaccrual loans and leases, including the appropriate treatment of cash payments for loans and leases on nonaccrual.

⁶³ An asset is “well secured” if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is “in the process of collection” if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

⁶⁴ For more information, refer to the “Nonaccrual Status” entry in the “Glossary” section of the call report instructions. This entry describes the general rule for the accrual of interest, as well as exceptions. The entry also describes criteria for returning a nonaccrual loan to accrual status.

⁶⁵ For more information, refer to the “Purchased Credit-Deteriorated Assets” entry in the “Glossary” section of the call report instructions.

⁶⁶ A modified troubled lease should have six months of performance before returning to accrual status. For more information, refer to ASU 2022-02, “Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures.”

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,” “Federal Branches and Agencies Supervision,” and “Large Bank 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. Examiners should consider work performed by internal and external auditors and other independent risk management, and other examiners reviewing related areas. Examiners should perform only those objectives and procedures relevant to the scope of the examination as determined by the following objectives. Seldom is every objective or step of the expanded procedures 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 to identify issues related to lease financing that require follow-up:
 - Supervisory strategy.
 - Scope memorandum.
 - Previous supervisory activity work papers.
 - Previous supervisory letters and reports of examination (ROE), and management’s responses.
 - Credit risk review reports.
 - Internal and external audit reports, work papers, and management’s responses. When possible, examiners should leverage the OCC’s reviews of internal and external audits conducted during the supervisory cycle when possible. Examiners assigned to the lease financing examination should ascertain the nature and extent of audit findings related to lease financing.
 - Customer complaints and litigation. Examiners should review customer complaint data from the OCC’s Customer Assistance Group, the bank, and the Consumer Financial Protection Bureau (when applicable). When possible, examiners should review and leverage complaint analysis already performed during the supervisory cycle to avoid duplication of effort.
2. Review the Uniform Bank Performance Report and applicable OCC reports or analytical tools.

3. Review the policies, procedures, and reports that management uses to supervise lease financing activities. Identify significant changes since the last examination. The following are examples of policies, procedures, and reports that examiners may review, depending on the scope of the examination:
 - Lease financing policies.
 - 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.
 - Latest valuation information for past-due and defaulted leases (e.g., appraisal, evaluation, or other valuation, as appropriate).
 - Current asset valuation reports, including reports of residual exposures, residual realization rates, historical residual realization results, residual concentrations.
 - Asset impairment review report.
 - Board or loan committee reports and minutes related to leasing activities.
 - A schedule of lease commitments that gives the name of the prospective lessee, date of commitment, expiration date, cost, and description of property to be leased.
 - A list of off-lease property that includes the book value, the date property came off lease, a description and location of property, the date of latest valuation, and the value.
 - Concentration reports.
 - Policy exceptions and underwriting variances.
 - Reports used to monitor lease compliance.
 - A list of lease participations purchased and sold, 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 parties involved in the bank's leasing activities and a description of the services performed.

In discussions with bank management, determine if there have been any significant changes (for example, in policies, processes, personnel, control systems, third-party relationships, products, services, delivery channels, volumes, markets, and geographies) since the previous examination of lease financing.

4. Based on an analysis of information obtained in the previous steps, as well as input from the examiner in charge (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).

Certain items are assessed across multiple risk areas. These items are marked with a ♦ symbol. Examiners should collaborate to avoid duplication of efforts. Examiners should avoid redundancy when documenting conclusions that apply to multiple risk areas. For example, examiners may cross-reference to comments in other parts of the examination procedures to avoid duplication.

Not all items within each examination procedure are relevant to every bank's lease financing activities. Examiners should consider each item relative to the scope of the examination and the bank's operations. Examiners' reviews should generally focus on those items that directly relate to the scope of the examination and key items that drive the conclusions for quantity of risks associated with lease financing.

Quantity of Credit Risk

Objective: To determine the quantity of credit risk associated with lease financing.⁶⁷

1. Assess the effect of lease financing-related underwriting factors on credit risk. Consider the following:
 - Changes in underwriting policies and standards.
 - Trends in the weighted average risk ratings of existing portfolios compared with new underwriting.
 - Volume, composition, trend, and performance of underwriting exceptions and overrides.
 - Trends and volumes of booked leases and approval rates.
 - Trends in lease origination metrics (e.g., credit score, leverage ratios, debt service and fixed charge ratios, advance rates, residual size) and the associated quantity of risk layering.

2. Assess the effect of lease financing-related strategic factors on credit risk. Consider the following:
 - Risks associated with new activities or technologies, particularly those that are innovative or unproven. Consider both actual and planned new activities and technologies. ♦
 - Performance relative to stated operational risk appetite and other risk metrics. ♦
 - Level and criticality of reliance on manual processes. ♦
 - Trends in internal, external, and regulatory findings. ♦

⁶⁷ Refer to appendix C of this booklet for a quantity of risk matrix job aid.

- Effect of growth plans, portfolio and product mix, new products, delivery channels, third-party originations or acquisitions, syndications, concentrations, and securitizations.
3. Assess the effect of lease financing-related external factors on credit risk. Consider the following:
- Amount and significance of litigation, monetary penalties, remediations, customer complaints, and referrals from potential whistleblowers. ◆
 - Effect of economic conditions on banking and material credit portfolios.
 - Changes in the banking industry and competitive landscape.
 - Impact of geographic (including country) risks and environmental conditions on significant portfolios.
 - Effect of technological advancement on credit products, services, and delivery channels, and on significant leasing portfolios.
4. Assess the effect of lease financing-related credit factors on credit risk. Consider the following:
- Levels and trends of delinquencies, nonperforming, special mention and classified leases, off-lease assets, losses, weighted average risk ratings, forbearances, and reserves in both balance-sheet and off-balance-sheet accounts.
 - Trends in volume and quality of leasing and fee-based credit activities, including off-balance-sheet, syndication, and investment activities.
 - Changes in portfolio analytics, risk attributes, performance, loss forecasting, and stress testing.
 - Impact of credit mitigation or credit enhancement used to manage the level of on- or off-balance-sheet credit risk.
 - Volume of risk rating changes made by independent credit risk review, regulators, or audit.
5. Select a sample of leases to be reviewed. Selection of the sample should be consistent with the examination objectives and supervisory strategy. Refer to the “Sampling Methodologies” booklet of the *Comptroller’s Handbook*. Include the following leases and lease types in the sample consistent with the exam scope and strategy:
- New and large leases or new lease types.
 - Leases originated in new geographic regions.
 - Leases at or above the legal lending limit.
 - Leases to insiders of the bank or any affiliates.
 - Leases with high advance rates.
 - Leases with multiple renewals or extensions.
 - Leases for property types that are not typical of the bank’s leasing portfolio.
 - Special mention or classified leases.
 - Leases with significant policy or underwriting exceptions.

- Leases with existing or recent covenant violations.
 - Leases with modified repayment terms.
 - Off-lease assets.
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.
 - Insurance coverage.
 - Corporate resolution to lease or guarantee.

For syndicated 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. Review the bank's files (paper based or electronic, as applicable) on selected leases and transcribe or download the following information to 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 whether 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. Assess the quality and direction of underwriting practices for selected leases originated, renewed, or restructured since the previous examination.
- Midsize and community bank examiners generally use the National Credit Tool to perform the Credit Underwriting Assessment for each transaction sampled, unless the use of the tool is appropriately waived.
 - Conclusions from the individual transaction reviews should be used to support the assessment of the quality of underwriting practices and the direction of underwriting practices in the appropriate Credit Underwriting Assessment in Examiner View.
12. To evaluate the credit quality of each selected delinquent or defaulted lease, consider
- the duration of adverse operating trends and prospects for the future.

- the reasonableness of the latest valuation (e.g., appraisal, evaluation, or other valuation, as appropriate).
 - the status of any proposed sale or lease.
13. Assign regulatory risk rating and specific allowance allocation for each lease, if appropriate.
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, determine whether 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, 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.

Quantity of 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.
3. Assess the effect of lease financing-related repricing, basis, yield curve, and options risk factors. Consider the following:
 - Underwriting terms, such as lease term, residual valuation, pricing structure for the underlying property (e.g., fixed vs. variable interest rates), and the potential exposure to different pricing indexes.
 - Volume, tenor, and variety of different indexes tied to assets and liabilities (e.g., prime, Constant Maturity Treasury, and U.S. Treasury) that may change at different times or by different amounts.
 - Lagging effect of recent changes in interest rates on earnings.
 - Potential effect of implicit and explicit options embedded in leases.
 - IRR exposure from debt financing for syndicated leases.
 - Results of sensitivity analysis and portfolio stress testing.

Quantity of 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.

Quantity of Operational Risk

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

1. Assess the effect of lease financing-related structural factors on operational risk. Consider the following:
 - Level and criticality of reliance on manual processes. ◆
 - Volume, types, and complexity of lease financing transactions, on- and off-balance-sheet exposures, products and services offered, delivery methods employed, and models or other quantitative tools used by the bank.
 - Level and trend of operational errors, loss events, and near misses.
 - Software and hardware obsolescence, security, capacity, and operational resilience.
 - Volume, types, and concentrations of activities and operations that are outsourced, moved offshore, or performed by an affiliate.
 - Volume and severity of incidents and system outages.
2. Assess the effect of lease financing-related strategic factors on operational risk. Consider the following:
 - Risks associated with new activities or technologies, particularly those that are innovative or unproven. Consider both actual and planned new activities and technologies. ◆
 - Performance relative to stated operational risk appetite and other risk metrics.
 - Trends in internal, external, and regulatory findings. ◆
 - Effect of merger, acquisition, and divestiture strategies on a market, product, or geographic footprint.
 - Approach toward using insurance and contractual indemnifications within service level agreements and contracts with holding company, affiliates, and third-party relationships to mitigate operational loss.

- Complexity, velocity, and volume of conversions, integrations, and other system changes.
3. Assess the effect of lease financing-related external factors on operational risk. Consider the following:
 - Effect of external factors, including economic, industry, competitive, environmental, and market conditions; legislative and regulatory changes (domestic and international); and technological advancement.
 - Amount and significance of litigation, monetary penalties, remediations, customer complaints, and referrals from potential whistleblowers.
 - Effect of infrastructure threats on the bank’s ability to deliver timely support and service.
 - Ability of third parties to provide and maintain performance that meets the requirements of the bank and complies with applicable laws and regulations.
 - Volume of cybersecurity threats/attacks, data breaches, and fraud.

Quantity of 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 valuation (e.g., appraisal, evaluation, or other valuation, as appropriate) 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.

Quantity of Compliance Risk

Objective: To review the bank’s compliance with laws and regulations pertaining to lease financing.

1. Assess the bank’s compliance with the lending limits under 12 CFR 32. To determine lending exposure to one borrower, combine the lessee’s total obligations to the bank, including the present values⁶⁸ of the lease payments and residual values based on the “rate implicit in the lease” as defined in ASC Topic 842.
2. Determine whether financing arrangements comply with the restrictions on transactions with affiliates under 12 USC 371c and 371c-1 and 12 CFR 223 (Regulation W).

⁶⁸ 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.

3. Determine whether financing arrangements comply with the restrictions on insider lending under 12 USC 375a and 375b and 12 CFR 215 (Regulation O).
4. 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).
5. 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.
6. 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.
7. 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.
 - that all leases represent noncancelable obligations of the lessee.
8. 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.

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

1. Assess the effect of lease financing-related business activity factors on compliance risk. Consider the following:
 - Level and criticality of reliance on manual processes. ♦ Include discussion of the number of systems used for compliance risk management and the extent that disparate systems necessitate manual coordination across lines of business or functions.
 - Performance relative to stated compliance risk appetite and other risk metrics. ♦
 - Nature and extent of business activities, including rapid growth, expansion, new activities, unique products and services, innovative technology, delivery channels, third-party relationships, and significant merger and acquisition activity.
 - Level of competition and nature and extent of advertising and marketing activities.
2. Assess the effect of lease financing-related litigation and noncompliance factors on compliance risk. Consider the following:
 - 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 requirements for lease financing activities.
 - Amount and significance of litigation, monetary penalties, remediations, customer complaints, and referrals from potential whistleblowers. ♦
 - Trends in internal, external, and regulatory findings. ♦
 - Volume and significance of noncompliance and nonconformance with bank policies and procedures, laws, regulations, prescribed practices, and ethical standards.

Quantity of Strategic Risk

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

1. Assess the effect of lease financing-related strategic factors on strategic risk. Consider the following:
 - Risks associated with new activities or technologies, particularly those that are innovative or unproven. Consider both actual and planned new activities and technologies. ♦
 - Performance relative to stated risk appetite and other risk metrics. ♦
 - Trends in internal, external, and regulatory findings. ♦
 - The bank's market, including types and diversification of products and services, customers, and geographies.
 - Adequacy of strategic plans and consistency with the bank's risk appetite, financial objectives, capital plan, stress testing, and liquidity requirements. Include discussion of the nature and extent of actual or planned changes in the bank's mission, strategic objectives, core values, or risk appetite.
 - Effect of merger and acquisition plans and cost control initiatives.
 - Influence of the parent company, including foreign owners.

- Volume and significance of regulatory criticism or concerns that could impede the bank from executing strategic initiatives.
 - Adequacy of information technology infrastructure and systems to execute strategic plans and initiatives.
2. Assess the effect of lease financing-related external factors on strategic risk. Consider the following:
- Effect of external factors, including economic, industry, competitive, environmental, and market conditions; legislative and regulatory changes (domestic and international); and technological advancement. ◆
 - Amount and significance of litigation, monetary penalties, remediations, customer complaints, and referrals from potential whistleblowers. ◆

Quantity of Reputation Risk

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

1. Assess the effect of lease financing-related strategic factors on reputation risk. Consider the following:
- Risks associated with new activities or technologies, particularly those that are innovative or unproven. Consider both actual and planned new activities and technologies. ◆
 - Number and criticality of third-party relationships. ◆
 - The bank's core values, culture, and conduct of employees, contractors, or third parties.
 - Volume and types of assets and number of accounts under management or administration.
 - Business activities, geographies, or clients that generate exposure to reputation risk.
 - Merger and acquisition plans.
 - The volume of syndicated lease financing activity.
 - The volume of complex structured leasing transactions.
2. Assess the effect of lease financing-related external factors on reputation risk. Consider the following:
- Amount and significance of litigation, monetary penalties, remediations, customer complaints, and referrals from potential whistleblowers. ◆
 - The market's or public's perception of the bank or any third-party relationships as indicated by social media, negative news, and the quality of products, services, and business practices, including those perceived as unethical or deceptive.
 - Public enforcement actions, fines, or penalties for violations of laws, rules, and regulations, unsafe or unsound practices, or breaches of fiduciary duties.
 - Public rankings from customer satisfaction surveys.

Quality of Risk Management

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

The conclusion on risk management considers all risks associated with lease financing.⁶⁹

Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies guide decisions, often set standards (on risk limits, for example), and should be consistent with the bank’s underlying mission, risk appetite, and core values. Policies should be reviewed periodically for effectiveness and approved by the board of directors or designated board committee.

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

1. Evaluate relevant policies to determine whether they provide appropriate guidance for managing the bank’s lease financing activities and are consistent with the bank’s mission, values, and risk appetite. Consider whether policies
 - are consistent with the bank’s strategic direction and risk appetite.
 - establish standards for reviewing lease financing applications.
 - establish prudent underwriting standards.
 - define types of leasing activities that the bank will consider, including any limits.
 - define minimum borrower eligibility and qualified property.
 - mandate compliance with lease regulations and lease accounting standards.
 - define policy exceptions and underwriting variances.
 - establish minimum standards for documentation.
 - establish credit administration procedures and clear separation of duties for leasing.
 - establish risk limits or positions, including concentration limits.
 - require periodic reevaluation of limits.
 - delineate prudent actions to be taken if the limits are exceeded.
 - establish standards for off-lease property and problem lease management.
 - set forth expectations for credit risk review, audit, and reporting.
2. 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 current market conditions.

⁶⁹ Appendix D, “Quality of Credit Risk Management Indicators,” provides a detailed matrix for assessing the quality of credit risk management.

3. Conclude whether the bank's lease financing policies are strong, satisfactory, insufficient, or weak. Examiner conclusions on the quality of lease financing underwriting policy standards should be used to complete the appropriate Credit Underwriting Assessment, as appropriate.

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 and help manage risk. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

Objective: To determine the adequacy of the bank's processes for lease financing activities.

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 whether
 - periodic property inventory reports are prepared by the lessee or trustee.
 - reports clearly indicate the condition and location of property.
 - the board receives for review at its regular meetings reports listing leases that are past due, classified, or receiving special attention.
 - the board receives 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 the property's misuse?
4. Review the bank's procedures for accepting bids for the purchase of the leased property at termination of the lease so that reasonable estimates of value are obtained. For a lease with no specific purchase options, renewals, 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 determine whether 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 ASC Topic 842 and ASC Subtopic 326-20 or ASC Subtopic 360-10, as applicable. Consider whether
- residual values are reviewed annually. Specifically,
 - the residual value in direct financing leases is part of the net investment in the lease evaluated under CECL (ASC Subtopic 326-20).
 - operating leases are assessed for impairment the same as property, plant, and equipment/long-lived assets (asset group) under ASC Subtopic 360-10.
 - residual write-downs are in accordance with generally accepted accounting principles (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 ASC Topic 842. 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 Internal Control Questionnaire (ICQ), if necessary, to make this determination.
 14. Assess the adequacy of operational tools to safeguard assets and ensure the integrity of accounting data and financial reports for lease financing.
 15. If the bank has third-party relationships that involve critical activities for lease financing activities, assess the adequacy of the bank’s third-party risk management. Refer to OCC Bulletin 2017-7, “Third-Party Relationships: Supplemental Examination Procedures,” and OCC Bulletin 2023-17, “Third-Party Relationships: Interagency Guidance on Third-Party Relationships: Risk Management.” Consider reviewing a sample of due diligence and ongoing monitoring documentation for critical lease financing third parties.

Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent, have clearly defined responsibilities, and be held accountable for their actions. They should understand the bank’s mission, risk appetite, core values, policies, and processes. Banks should design compensation programs to attract and retain personnel, align with strategy, and appropriately balance risk-taking and reward.

Objective: To determine management’s ability to supervise lease financing in a safe and sound manner.

1. Given the scope and complexity of the bank’s lease financing, assess the management structure and staffing. Consider the following:
 - The expertise, training, and number of staff members.
 - Whether reporting lines encourage open communication and limit the chances of conflicts of interest.
 - The level of staff turnover.
 - The 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 sufficient experience in lease financing. Consider
 - specialized lending experience.
 - tax and accounting experience.

3. 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 (1) provide employees with incentives that appropriately balance risk and reward; (2) are compatible with effective controls and risk management; and (3) are supported by strong corporate governance, including active and effective oversight by the bank's board of directors.⁷⁰

Control Systems

Control systems are the functions (such as internal and external audits and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes and personnel. Control functions should have clear reporting lines, adequate resources, and appropriate access and 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 credit risk review function in identifying risk in lease financing. Consider the following:⁷¹
 - Scope of reviews.
 - Frequency of reviews.
 - Qualifications of credit risk review personnel.
 - Independence of credit risk review function.
 - Identification and reporting of emerging risks in credit risk 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 audits.
 - Frequency of audits.
 - Qualifications of audit personnel.
 - Management and the board's responses to audit findings.

⁷⁰ Refer to OCC Bulletin 2010-24, "Interagency Guidance on Sound Incentive Compensation Policies."

⁷¹ For more information about credit risk review, refer to OCC Bulletin 2020-50.

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.
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.
 - quality of risk management.
 - aggregate level and direction of associated risks.
 - overall risk in lease financing.
 - violations of laws and regulations or deficient practices.

Summary of Risks Associated With Lease Financing

Risk category	Quantity of risk (Low, moderate, high)	Quality of risk management (Weak, insufficient, 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 the EIC with a brief conclusion regarding
 - the adequacy of the bank's policies or practices regarding leases.
 - how bank officers conform to established policies or practices.
 - findings and conclusions from the Credit Underwriting Assessment, if applicable.
 - adverse trends in the leasing department.

- internal control weaknesses.
 - 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 reports management and the board use to oversee lease financing.
 - corrective actions for deficient practices or violations.
 - other matters of significance.
3. If substantive safety and soundness concerns remain unresolved that may have a material adverse effect on the bank, further expand the scope of the examination by completing verification procedures.
 4. Discuss examination findings with management, including violations, deficient practices, and conclusions about risks and risk management practices. If necessary, obtain commitments for corrective action. Include the following subjects, if relevant:
 - Delinquent leases.
 - Violations of laws and regulations.
 - Deficient practices.
 - 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 or supervisory letter. If necessary, compose matters requiring attention and violation write-ups.
 6. Complete the applicable Credit Underwriting Assessment in Examiner View, if included in the examination scope.
 7. Update the OCC's supervisory information systems and any applicable ROE schedules or tables.
 8. Document recommendations for the supervisory strategy (e.g., what the OCC should do in the future to effectively supervise lease financing in the bank, including time periods, staffing, and workdays required).
 9. Update, organize, and reference work papers in accordance with OCC policy.
 10. Appropriately dispose of or secure any paper or electronic media that contain sensitive bank or customer information.

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, after reviewing the findings and conclusions of the core assessment, or after reviewing the conclusions from expanded procedures.

Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written lease financing policies?
2. Are lease financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

Records

3. Does the bank maintain relevant and appropriate information for each lease transaction based on bank policies and regulatory requirements?
4. Do bank records show that the acquisition and disposal of assets are approved and documented independent of any influence from personnel engaged in the disbursement and receipt of funds?
5. Does the bank determine whether total CEBA or general leases, as applicable, exceed 10 percent of consolidated bank assets?
6. Are the preparation and execution of subsidiary direct lease financing records performed or reviewed by persons who are independent of processes related to the receipt or disbursement of funds?
7. Are the subsidiary lease financing records regularly reconciled to the appropriate general ledger accounts consistent with controls to maintain independence of the process (e.g., separation of duties) and avoid misconduct?
8. Does the bank have a process to ensure that delinquent account collection requests and past-due notices match to the trial balances? Is this process consistent with controls to prevent and detect errors and misconduct?
9. Are the bank's processes for investigating and resolving inquiries about lease balances received supported by appropriate separation of duties (e.g., investigations are conducted by personnel who do not post transactions)?
10. Is documentation supporting recorded credit adjustments monitored and tested consistent with appropriate controls (e.g., controls to prevent or detect errors and misconduct)?

Interest and Rent

11. Are the preparation and posting of interest and rent records performed with appropriate controls (e.g., separation of duties or dual controls) and independent of processes involving the receipt or disbursement of funds?

Depreciation (Operating Leases)

12. Do processes for recording periodic depreciation records include controls to prevent errors or misconduct?
13. Do the bank's procedures require that depreciation expense be charged at least quarterly?
14. Does the bank regularly balance the subsidiary depreciation records to the appropriate general ledger with appropriate controls to prevent and detect errors and misconduct?

Property Acquired for Future Leasing Activity

15. Do the bank's procedures have appropriate controls to prevent and detect unauthorized use or disposal?
16. Is the addition, lease, or other disposal of property approved by bank personnel with the authority to do so? Are there controls to prevent and detect errors and misconduct?
17. Are records for additions, leases, and other disposals maintained under controls to prevent and detect errors and misconduct?
18. Are subsidiary property records balanced regularly to the appropriate general ledger accounts under controls to prevent and detect errors and misconduct?
19. Is the existence of property checked or tested, such as in a physical inventory? Are any differences between the property's characteristics and its description in property records investigated and appropriately resolved?
20. Does the bank maintain appropriate records, such as bills of sale, invoices, titles, or other information, to prove 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, insufficient, 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 whether yields on lease transactions are being accurately reported to the board of directors or its committee.
 - trace income and lease balances from the yield calculation to the general ledger.
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 or operating lease.
 - prepare and mail confirmation forms to lessees. 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 syndicated lease transactions and verify the outstanding balance of the 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.⁷²
- 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 in procedure #3
- obtain or prepare a listing of unpaid monthly rentals and reconcile to the general ledger and verify 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 in procedure #3
- 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 syndicated leases selected in procedure #3, determine
- the monthly payments to loan participants and whether 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.

⁷² 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 #3 and #7 for syndicated 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 avoid becoming 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 in procedure #3,
- 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).⁷³
- 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.

⁷³ FSAs do not need to conform to this requirement. Refer to 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		FSAs	
	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). Refer to 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: Sales-Type Lease

The following is a bank lessor's description of a sales-type lease on office equipment:

Monthly lease payments payable on first day of month	\$200
Estimated residual value at lease end	\$4,000
Residual value (guaranteed by the lessee) at lease end	\$2,000
Present value of lease payments and lessee guaranteed residual value discounted at the implicit interest rate of 9.85 percent	\$9,325
Economic life of the property	72 months
Lease term	48 months
Lessor's cost of the leased property	\$10,000
Fair value of the leased property at lease inception ⁷⁴	\$10,000

The bank purchases the office equipment and leases it to the lessee on the same day. The lease does not transfer ownership or title to the lessee by the end of the lease term. The expected residual value of the property at lease end is \$4,000, and the lessee guarantees part of the residual value through a \$2,000 balloon payment at the end of the lease. The lease also grants the lessee an option to purchase the equipment at the end of the lease at a price that is the lower of \$3,000 or the fair market value of the equipment at lease end. The underlying asset is specialized for the lessee's industry and is of no alternative use to the bank at the end of the lease. Further, collection of all the lease payments and residual value guarantee are reasonably predictable. The rate implicit in the lease is 9.85 percent.

The lease meets two of the five criteria set forth in ASC Topic 842 for a sales-type lease, as follows:

- The present value of all lease payments, including the \$2,000 residual value guaranteed by the lessee, is \$9,325, or 93 percent of the asset's \$10,000 cost to the bank, which equals or exceeds what constitutes substantially all the fair value of the underlying asset.
- The underlying asset is a specialized asset for the lessee and is of no alternative use to the lessor.

Meeting any one of the five criteria would qualify this lease as a sales-type lease. Therefore, this lease would be classified as a sales-type lease.

⁷⁴ For a bank lessor, the fair value of the underlying asset is usually the cost of the asset if no significant period of time has elapsed between asset acquisition and lease commencement. If the lessor is a manufacturer or dealer instead or if a significant period of time has elapsed, the fair value would be calculated based on the sum of lease receivable and the present value of unguaranteed residual value discounted at the rate implicit in the lease.

The journal entries on the books of the lessor to record the sales-type lease are as follows:

To record the purchase of the office equipment:

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

To record the net investment in the sales-type lease and derecognize the underlying asset:

Net investment in the lease	\$10,000 ⁷⁵
Office equipment	\$10,000 ⁷⁶

The following entries are recorded monthly:

To record the lease payment, interest income, and net investment at the end of the first month:⁷⁷

Cash	\$200
Interest income	\$80 ⁷⁸
Net investment in the lease	\$120 ⁷⁹

⁷⁵ Net investment in lease is the fair value of the leased asset including the lease receivable of \$9,325 and the \$675 present value of the \$1,000 unguaranteed residual discounted at the rate implicit in the lease, net of any deferred selling profit.

⁷⁶ Cost of goods sold.

⁷⁷ This entry is recorded monthly. Interest income decreases over time, as the outstanding net investment in the lease decreases.

⁷⁸ $(\$10,000 - \$200) \times 9.85 \text{ percent}/12 = \80 (\$10,000 initial investment subtracted by the first lease payment at the beginning of the lease term, multiplied by the implicit interest rate). Total interest income includes the interest on the lease receivable, accretion of the unguaranteed residual asset, and amortization of deferred selling profit, if any.

⁷⁹ \$120 (\$200 monthly payment less \$80 interest income) is to reduce the net investment in the lease.

Example 2: Direct Financing Lease

The following is a bank lessor's description of a direct financing lease on office equipment:

Monthly lease payments payable on first day of month	\$200
Estimated residual value (unguaranteed by the lessee) at lease end	\$3,000
Residual value (guaranteed by a third party) at lease end	\$2,000
Present value of lease payments and any residual guarantee from lessee discounted at the implicit interest rate of 9.85 percent	\$7,973
Present value of lease payments (including third party guaranteed residual value) discounted at the implicit interest rate of 9.85 percent	\$9,325
Economic life of the property	72 months
Lease term	48 months
Lessor's cost of the leased property	\$10,000
Fair value of the leased property at lease inception	\$10,000 ⁸⁰

The bank purchases the office equipment and leases it to the lessee on the same day. The lease does not transfer ownership or title to the lessee by the end of the lease term, nor does it contain a bargain purchase agreement. The expected residual value of the property at lease end is \$3,000, but the lessee does not guarantee the residual value. The bank obtains a guarantee of the residual value up to \$2,000 from an unrelated third party at lease commencement. The underlying asset is not specialized and can be of alternative use to the bank at the end of the lease. Further, collection of all the lease payments and residual value guarantee are reasonably predictable. The rate implicit in the lease is 9.85 percent.

The lease does not meet any of the five criteria set forth in ASC Topic 842 for a sales-type lease, because

- the lease does not transfer ownership or title to the lessee.
- the lease does not provide the lessee with a **bargain purchase option** at lease end.
- the lease term is for 67 percent of the estimated economic life of the equipment, which does not constitute a major part of the economic life under ASC Topic 842.
- the \$7,973 present value of all the lease payments from the lessee, or 80 percent of the fair value of the asset, does not equal or exceed substantially all the fair value of the property.
- the underlying asset is not specialized.

The lease instead meets the two criteria set forth for a direct financing lease, in that

- the present value of all lease payments, including the \$2,000 residual value guaranteed by a third party, is \$9,325, or 93 percent of the asset's fair value, which meets the ASC Topic 842 requirement that it equals or exceeds substantially all the fair value of the underlying asset.

⁸⁰ As with a sales-type lease, the fair value of the underlying asset is typically the cost if the lessor is a bank.

- the collection of the lease payments and the third-party residual guarantee are reasonably predictable.

Therefore, this lease would be classified as a direct financing lease.

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 net investment in the direct financing lease and derecognize the underlying asset:

Net investment in the lease	\$10,000 ⁸¹
Office equipment	\$10,000 ⁸²

The following entries are recorded monthly:

To record the lease payment, interest income, and net investment at the end of the first month:⁸³

Cash	\$200
Interest income	\$80 ⁸⁴
Net investment in the lease	\$120 ⁸⁵

⁸¹ Net investment in the lease is the fair value of the leased asset including the lease receivable of \$9,325 and the \$675 present value of the \$1,000 unguaranteed residual discounted at the rate implicit in the lease, net of any deferred selling profit.

⁸² Carrying amount of the underlying asset.

⁸³ This entry is recorded monthly. Interest income decreases over time, as the outstanding net investment in the lease decreases.

⁸⁴ $(\$10,000 - \$200) \times 9.85 \text{ percent}/12 = \80 (\$10,000 initial investment subtracted by the first lease payment at the beginning of the lease term, multiplied by the implicit interest rate). Total interest income includes the interest on the lease receivable, accretion of the unguaranteed residual asset, and amortization of deferred selling profit, if any.

⁸⁵ \$120 (\$200 monthly payment less \$80 interest income) is to reduce the net investment in the lease.

Example 3: Operating Lease

The following is a bank lessor's description of an operating lease on office equipment:

Monthly lease payments payable on first day of month	\$200
Estimated residual value (unguaranteed) at lease end	\$3,000
Present value of lease payments and any residual guarantee discounted at the implicit interest rate of 9.85 percent	\$7,973
Economic life of the property	72 months
Lease term	48 months
Lessor's cost of the leased property	\$10,000
Fair value of the leased property at lease inception	\$10,000 ⁸⁶

The bank purchases the office equipment and leases it to the lessee on the same day. The lease does not transfer ownership or title to the lessee by end of the lease term, nor does it contain a bargain purchase agreement. The expected residual value of the property at lease end is \$3,000, which is not guaranteed by the lessee nor by a third party. The underlying asset is not specialized and can be of alternative use to the bank at the end of the lease. Further, collection of all the lease payments is reasonably predictable. The rate implicit in the lease is 9.85 percent.

The lease does not meet any of the five criteria set forth in ASC Topic 842 for a sales-type lease, in that

- the lease does not transfer ownership or title to the lessee.
- the lease does not provide the lessee with a bargain purchase option at lease end.
- the lease term is for 67 percent of the estimated economic life of the equipment, which does not constitute a major part of the economic life under ASC Topic 842.
- the \$7,973 present value of all the lease payments from the lessee, or 80 percent of the fair value of the asset, does not equal or exceed substantially all the fair value of the property.
- the underlying asset is not specialized.

Further, the lease fails to meet one of the two additional criteria for a direct financing lease:

- The lessor does not have a third-party guarantee on the residual value, and present value of the lease payments is \$7,973, or 80 percent of the asset's fair value, which does not equal or exceed substantially all the fair value of the underlying asset.

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

⁸⁶ As with a sales-type lease, the fair value of the underlying asset is typically the cost if the lessor is a bank.

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	\$200
Rental Income	\$200

To record the monthly depreciation:

Depreciation expense	\$145.83 ⁸⁷
Accumulated depreciation	\$145.83

⁸⁷ Carrying value of the leased asset (\$10,000) less estimated residual value (\$3,000) divided by the total number of months in the lease (48).

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 supporting infrastructure.	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 supporting infrastructure. 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 moderate. 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	Insufficient	Weak
There is a clear, sound leasing credit culture. Board and management's appetite for risk is well communicated.	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 may not be well communicated throughout the bank. Risk appetite may be inconsistent with strategic goals or not uniformly communicated throughout the bank.	The leasing credit culture is absent or materially flawed. Risk appetite may not be well communicated.
Leasing initiatives are consistent with a conservative risk appetite and promote an appropriate balance between risk taking and strategic objectives. Risk management of new leasing activities is robust (e.g., 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. Risk management of new leasing activities is satisfactory.	Leasing initiatives are consistent with a moderate to liberal risk appetite. Anxiety for income may lead to some higher-risk transactions that may not be well managed. There is an imbalance between risk taking and growth and earnings objectives. Moderate weaknesses in risk management of new leasing activities may be present.	Leasing initiatives are liberal and encourage risk-taking. Anxiety for income dominates planning activities. The bank engages in new leasing activities 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 modest improvement may be needed in one or more areas. Leasing staff generally possesses the expertise to administer assumed risks; however, additional expertise may be necessary in one or more areas. Responsibilities and accountability may warrant some clarification. In general, appropriate remedial or corrective action is taken when necessary.	Management requires strengthening in one or more key areas. Responsibilities and accountability likely require some clarification or do not reflect the bank's current structure. Management may take remedial or corrective actions to address root causes of problems, but these actions are not always effective or timely.	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	Diversification management is adequate, but certain aspects may need improvement. Lease concentrations are identified and reported, but limits and other action triggers may be	Diversification strategies need improvement in one or more areas. Management has set concentration limits, but these limits may not be reasonable, are outdated, or may not adequately address the	Diversification management is passive or deficient. Management may not identify concentrations, or takes little or no action to reduce, limit, or mitigate the associated risk. Limits may be

Strong	Satisfactory	Insufficient	Weak
exposures. Management effectively identifies and understands correlated risk exposures and their potential impact.	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.	primary exposures at the bank. Management may identify when the bank exceeds these limits but does not always take appropriate or timely actions to reduce or mitigate risk when limits are exceeded. Correlated exposures are not well understood or clearly identified.	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.	Some imbalances exist between lease management and personnel compensation structures. Lease or revenue production, lease quality, and portfolio administration are not well balanced.	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.
Lease staffing levels and expertise are appropriate for the size and complexity of the activities. 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 activities. Staff turnover is moderate and may result in some temporary gaps in portfolio management. Training initiatives are adequate.	Lease staffing levels need improvement in some areas. High turnover may result in significant gaps in some areas. Management and the board do not respond to these needs in a timely manner. Training initiatives may be present but are likely inconsistent.	Lease staffing levels and expertise are deficient. Turnover is high. Management does not provide sufficient resources for staff training. Training does not take place or is deficient.
Lease financing policies effectively establish and communicate portfolio objectives, risk limits, 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 require improvement in some areas. They may not be sufficiently clear or are too general to adequately communicate portfolio objectives, risk appetite, and underwriting and risk-selection standards. Policies may be outdated or do not reflect the bank's risk appetite.	Lease financing policies are deficient in one or more ways and need 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, aggregation or trend analysis lacks rigor and cannot determine	Staff identifies, approves, and reports significant policy, underwriting, and risk-selection exceptions in many but not all cases, including risk exposures associated with off-balance-sheet activities. Aggregation or trend analysis may not be adequate to determine	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-

Strong	Satisfactory	Insufficient	Weak
	the effect on portfolio quality.	the effect on portfolio quality.	balance-sheet activities are not 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 may not appropriately identify key risks in many cases. Moderate errors may be evident, key risks may be overlooked, or analyses may not be consistently timely. Post-underwriting analysis may be deficient in some areas and need strengthening.	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 lease review and identification systems are accurate and timely. Credit risk is effectively stratified for both problem and pass-rated leases. Systems serve as effective early warning tools and support risk-based pricing, allowance for credit losses, and capital allocations.	Risk rating and problem lease review and identification systems are adequate. Problem and emerging problem leases 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, allowance for credit losses, and capital allocations.	Risk rating and problem lease review and identification systems need improvement in some key areas. Problem leases may not be consistently identified in a timely manner. The graduation of pass ratings is insufficient to stratify risk in pass-rated credits for early warning or other purposes (lease pricing, allowance for credit losses, capital allocation).	Risk rating and problem lease review and identification systems are deficient. Problem leases 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 administration issues within the leasing portfolio in some cases.	Special mention ratings indicate management is not properly administering the leasing portfolio.
Management and board reporting provides accurate, timely, and complete portfolio information. Management and the board receive comprehensive reports to analyze and understand the bank's credit risk profile, including off-balance-sheet activities. Management reporting facilitates exception reporting, and MIS infrastructure can support ad hoc queries in a timely manner.	Management and board reporting may require minor improvement in one or more areas, but management and the board generally receive appropriate reports to analyze and understand the bank's credit risk profile. Management reporting facilitates exception reporting, and MIS infrastructure can support ad hoc queries in a timely manner.	Management and board reporting requires improvement in some key areas. Reports may be incomplete or are not consistently produced in a timely fashion. As a result, management and the board may not be receiving complete information to fully analyze and understand the bank's credit risk profile. MIS infrastructure may not support ad hoc queries in a timely manner.	Management and board reporting is deficient, lacks key information, is not timely, or is not reliable due to significant inaccuracies. As a result, management and the board are not receiving accurate or sufficient information to analyze and understand the bank's credit risk profile. The bank lacks exception reporting, and MIS infrastructure does not support ad hoc queries.

Appendix E: Glossary

12 USC 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.

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: Leasing 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 leases under 12 USC 24(Seventh) for national banks.

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. Also known as “rate implicit in the lease.”

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 syndicated 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: A agreement that allows one party to use another’s property for a stated period of time in exchange for consideration.

Lease receivable: Present value of 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 discounted by the rate implicit in the lease.

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 net investment in the lease is recorded by the lessor in loans and lease financing receivables (net of unearned income) and is composed of the following:

- The lease receivable, which includes the present value of the future lease payments and the guaranteed residual asset value.
- The present value of the unguaranteed residual asset value.

To calculate the present value of the net investment in the lease, the lessor uses the implicit rate, which is the percentage that, when applied to the aggregate value of the lease receivable and unguaranteed residual value, causes the present value of all the payments to equal the fair value of the underlying asset. The fair value of the underlying asset used in the calculation is reduced for any related investment tax credits retained and expected to be realized by the lessor and any deferred initial direct costs of the lessor.

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 to the VIE. Such a trustee is most common in syndicated leases involving many parties.

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

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. 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.

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

ACL	allowance for credit losses
ALLL	allowance for loan and lease losses
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BQ	bank qualified
CEBA	Competitive Equality Banking Act of 1987
CECL	current expected credit losses
CFR	Code of Federal Regulations
EFA	equipment finance agreement
EIC	examiner-in-charge
FAQ	frequently asked question
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 systems
NBQ	non-bank qualified
OCC	Office of the Comptroller of the Currency
ROE	report of examination
TRAC	terminal rental adjustment clause
UCC	Uniform Commercial Code
USC	U.S. Code
VIE	variable interest entity

References

Listed references apply to all OCC-supervised banks unless otherwise noted.

Laws

12 USC 24(Seventh) and (Tenth), “Corporate Powers of Associations” (national banks)
12 USC 84, “Lending Limits” (national banks)
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(c), “Loans and Investments” (FSAs)
12 USC 1464(u), “Limits on Loans to One Borrower” (FSAs)
15 USC 1667, “Consumer Leases – Definitions”
26 USC 48, “Energy Credit”
26 USC 265, “Expenses and Interest Relating to Tax-Exempt Income”
American Recovery and Reinvestment Act of 2009
Competitive Equality Banking Act of 1987
Tax Reform Act of 1986

Regulations

12 CFR 23, “Leasing” (national banks)
12 CFR 32, “Lending Limits”
12 CFR 101, “Covered Savings Associations”
12 CFR 160.41, “Leasing” (FSAs)
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)”
12 CFR 1013, “Consumer Leasing (Regulation M)”

Court Cases

Merchants National Bank v. Wehrmann, 202 U.S. 295 (1906)
M&M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377 (9th Cir. 1977), *cert. denied* 436 U.S. 956 (1978)

Comptroller’s Handbook

Examination Process

“Bank Supervision Processes”
“Community Bank Supervision”
“Large Bank Supervision”

“Federal Branches and Agencies Supervision”
“Sampling Methodologies”

Safety and Soundness, Asset Quality

“Allowances for Credit Losses”
“Allowance for Loan and Lease Losses”
“Concentrations of Credit”
“Installment Lending”
“Rating Credit Risk”

Safety and Soundness, Management

“Corporate and Risk Governance”
“Internal and External Audits”
“Model Risk Management”

Safety and Soundness, Liquidity

“Liquidity”

Safety and Soundness, Sensitivity to Market Risk

“Interest Rate Risk”

Consumer Compliance

“Other Consumer Protection Laws and Regulations”

OCC Issuances

Bank Accounting Advisory Series, Topic 3, “Leases”

Interpretive Letter No. 770

Interpretive Letter No. 806

Interpretive Letter No. 847

OCC Bulletin 2001-37, “Policy Statement on Allowance for Loan and Lease Losses
Methodologies and Documentation for Banks and Savings Institutions”

OCC Bulletin 2006-47, “Guidance and Frequently Asked Questions (FAQs) on the ALLL”

OCC Bulletin 2007-1, “Complex Structured Finance Transactions: Notice of Final
Interagency Statement”

OCC Bulletin 2010-24, “Interagency Guidance on Sound Incentive Compensation Policies”

OCC Bulletin 2011-12, “Sound Practices for Model Risk Management: Supervisory
Guidance on Model Risk Management”

OCC Bulletin 2017-7, “Third-Party Relationships: Supplemental Examination Procedures”

OCC Bulletin 2017-43, “New, Modified, or Expanded Bank Products and Services: Risk
Management Principles”

OCC Bulletin 2020-50, “Credit Risk: Interagency Guidance on Credit Risk Review Systems”

OCC Bulletin 2020-81, “Credit Risk: Risk Management of Loan Purchase Activities”

OCC Bulletin 2023-11, “Current Expected Credit Losses: Interagency Policy Statement on
Allowances for Credit Losses (Revised April 2023)”

OCC Bulletin 2023-17, “Third-Party Relationships: Interagency Guidance on Risk Management”

Other

FASB Accounting Standards Codification

- ASC Subtopic 326-20, “Financial Instruments – Credit Losses”
- ASC Topic 360, “Property, Plant, and Equipment”
- ASC Subtopic 450-20, “Loss Contingencies”
- ASC Topic 606, “Revenue Recognition”
- ASC Topic 740, “Provision for Income Taxes”
- ASC Topic 820, “Fair Value Measurement”
- ASC Topic 842, “Leases”

FASB Accounting Standards Update

- ASU 2016-02, “Leases (Topic 842)”
- ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326)”
- ASU 2018-10, “Codification Improvements to Topic 842, Leases”
- ASU 2018-11, “Leases (Topic 842): Targeted Improvements”
- ASU 2018-20, “Leases (Topic 842): Narrow-Scope Improvements for Lessors”
- ASU 2019-01, “Leases (Topic 842): Codification Improvements”
- ASU 2022-02, “Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures”
- ASU 2023-01, “Leases (Topic 842): Common Control Arrangements.”

Federal Financial Institutions Examination Council

- “Instructions for Preparation of Consolidated Reports of Condition and Income” (call report instructions)