Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #953
February 2003
12 USC 24(7)
12 USC 24(10)

December 4, 2002

Re: Proposal to enter into residual purchase agreements

Dear Mr. **[ ]**:

This responds to your letter requesting the OCC's concurrence that **[*Bank*]**, **[*City, State*]** ("Bank") may enter into residual purchase agreements with other unrelated, third-party equipment lessors ("Proposed Activities"). For the reasons discussed below, we believe the Proposed Activities are permissible.

A. Background

The Bank engages in the leasing of personal property pursuant to 12 U.S.C. § 24(Tenth) and 12 C.F.R. Part 23 ("CEBA Leasing").[1] In the normal course of its CEBA Leasing, the Bank purchases equipment, relies upon its expertise to estimate the residual value of the equipment at the end of the lease term, and determines the lease payments it will receive. For each lease, the Bank then uses its reasonable estimate of the residual value in determining whether the lease qualifies as full-payout.

The Bank proposes to use the expertise it has developed in estimating the residual value of leased equipment to enter into the residual purchase agreements described below. Prior to entering into any agreement, the Bank will undertake its normal CEBA Leasing analysis, including review of the equipment to be leased. The same professionals who perform this analysis for the Bank's CEBA Leasing business will perform the analysis for the Proposed Activities. Furthermore, if any leased equipment suffers a loss – from theft or physical damage – during the term of the lease, the Bank's obligation under the residual purchase agreements will be extinguished.

[1] A permissible CEBA Lease must be of personal property, be a net, full-payout lease, and have a minimum term of 90 days.

The Bank proposes, for a fee, to enter into agreements with unrelated, third-party equipment lessors such that:

- at lease expiration, the lessor must either sell the off-lease equipment to the Bank for the pre-determined purchase price ("Purchase Price")[2] or appoint the Bank to serve as its exclusive agent to sell the equipment.[3] As the exclusive agent of the lessor, the Bank will arrange the sale of the equipment. Regardless of the sale price, the lessor will receive the Purchase Price, with the Bank entitled to any excess of the net sales proceeds over the Purchase Price as a commission;

- if a lease terminates early, the lessor must either sell the off-lease equipment to the Bank for the greater of its then fair market value ("FMV") or the pre-designated Purchase Price or appoint the Bank to serve as its exclusive agent to sell the equipment. As the exclusive agent of the lessor, the Bank will arrange the sale of the equipment. Again, regardless of the actual sale price, the lessor will receive the greater of the FMV or the Purchase Price, with the Bank entitled to any excess of the net sales proceeds over the FMV or Purchase Price as a commission.

The Bank proposes to enter into this residual purchase agreement both for CEBA Leases originated by unrelated, third-parties and for CEBA Leases originated and sold by the Bank. The Bank represents that all leases for which it will enter into this residual purchase agreement will meet the requirements for CEBA Leasing in Part 23. The Bank further represents that it will not be involved in the underlying lease negotiations between the third-party lessor and the lessee (except in those instance in which the Bank itself originates the CEBA Leases).

The Bank expects that its estimates of the Purchase Prices, essentially the off-lease equipment's residual values, would be accurate on a portfolio basis. For this reason, and because the Bank will receive fee income for entering into the residual purchase agreements, the Bank believes that the Proposed Activities would be profitable.

B. Discussion

The Supreme Court has held that the National Bank Act, in 12 U.S.C. § 24(Seventh), contains a broad grant of the power to engage in the "business of banking." Specifically, the Court has said that the business of banking "is not limited to the enumerated powers in Section 24(Seventh) and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated."[4] In exercising this discretion, the OCC is guided by several factors

---

[2] If the Bank is required to purchase the off-lease equipment pursuant to an agreement with the lessor, the Bank represents that it would dispose of the off-lease equipment within the period allowed by Part 23.

[3] The agreement between the Bank and the lessor would prohibit the lessor from selling or re-leasing the equipment or extending or renewing the subject lease.

[4] *NationsBank of North Carolina, N.A. v. Variable Life Annuity Co*., 512 U.S. 251, 258-59, n.2 (1995).

reflected in case law and followed by OCC precedent: (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; (3) does the activity involve risks similar in nature to those already assumed by banks; and (4) whether the activity is expressly authorized by law for state-chartered banks.[5]

The Proposed Activities need not satisfy all four factors in order to be permissible as part of the business of banking. Rather, the OCC recognizes that one or more of the factors may predominate, depending on the specific facts and circumstances presented.[6] For the reasons discussed below, we believe that the Proposed Activities are part of the business of banking.

1. The Proposed Activities are the functional equivalent of and a logical outgrowth of recognized banking activities

The Proposed Activities are the functional equivalent of a recognized national banking activity – originating or purchasing loans, and specifically loans with balloon payments.[7] One example is an automobile loan with a balloon payment. Such a loan is an installment loan, secured by the automobile, with a large (or "balloon") payment equal to the estimated residual value of the automobile included in the final monthly installment. At the time of the final monthly payment, the borrower typically may choose (i) to sell the vehicle, pay the residual value, and keep the difference; (ii) to use the vehicle as a trade-in, paying the residual value as part of the transaction; (iii) to refinance the residual value as a used vehicle loan; or (iv) to return the vehicle to the lending bank.

When originating or purchasing a balloon loan, a national bank assumes the necessity of disposing of the collateral if, at the time of the final monthly payment, the borrower chooses to return the vehicle to the bank in lieu of the balloon payment ("residual disposal risk"). In addition, when estimating a residual value for the vehicle, the bank assumes the risk that the estimated residual value is set too high. If the estimated residual value is set too high and the borrower opts to return the collateral, the bank may receive an amount less than the estimated residual value when disposing of the returned vehicle ("residual value risk").

---

[5] The OCC recently codified these four principles in the electronic banking regulation. *See* 12 C.F.R. § 7.5001(c).

[6] *See* 67 F.R. 34855, 34994-95 (May 17, 2002); Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-453 (Dec. 24, 2001); *Merchants' Bank v. State Bank*, 77 U.S. 604, 608 (1871); *M&M Leasing Corp. v. Seattle First Nat'l Bank*, 536 F.2d 1377, 1382-83 (9th Cir. 1977), *cert. denied*, 436 U.S. 987 (1978); *American Ins. Assoc. v. Clarke*, 865 F.2d 278, 282 (D.C.Cir. 1988).

[7] National banks may originate and purchase such loans. Interpretive Letter No. 364, *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,534 (Jul. 9, 1986); Letter from Wallace S. Nathan, District Counsel (Dec. 2, 1985) (unpublished). *See* 12 C.F.R. § 5.34(e)(5)(v)(D) ("[p]urchasing … extensions of credit, or interests therein"); Corporate Decision No. 2001-27 (Sep. 27, 2001) (national bank may purchase loan participations).

The Proposed Activities represent a functionally equivalent activity. Before the Bank enters into a residual purchase agreement with an unrelated, third-party lessor to purchase, or act as exclusive agent for the sale of, off-lease equipment, it would establish the Purchase Price for the off-lease equipment. Establishing the Purchase Price for off-lease equipment is the functional equivalent of estimating the residual value of collateral in a balloon loan. In both instances, the Bank would be assigning the value at which it will accept the property – either the off-lease equipment or the balloon loan collateral. Then, by entering into a residual purchase agreement with a third-party equipment lessor, the Bank is agreeing to engage in an activity that is the equivalent of disposing of collateral returned in lieu of a balloon payment. The Bank would receive off-lease equipment (or, in the case of a balloon loan, returned collateral) that has been used for a period of time and would employ its expertise in disposing the equipment (or collateral).

Moreover, the Proposed Activities rely upon the core competencies developed by the Bank in originating and purchasing both balloon loans and CEBA Leases.[8] The Bank proposes to purchase equipment residuals after using the same expertise and the same analytical criteria the Bank applies when it originates or purchases a whole lease. The Bank would then dispose of these residuals in the same manner, with the same expertise, and subject to the same criteria in which it disposes of off-lease property from CEBA Leases its originates or purchases. The same professionals who perform CEBA Lease analysis and sales for the Bank today would undertake this analysis and sales activity.

2. The Proposed Activities involve risks similar in nature to those already assumed by the Bank

By originating or purchasing a balloon loan, the Bank would assume the residual value risk and, if the borrower opts to return the collateral in lieu of making the balloon payment, the

---

[8] The development of core competencies has important implications under the logical outgrowth analysis. As the OCC has observed:

> Among other things, the "logical outgrowth" test recognizes that the "business of banking" is defined not only by the services and products that banks provide, but also the core competencies that banks use to produce them….
>
> Clearly, "the business of banking is not static…." New York State Ass'n of Life Underwriters v. New York State Banking Dept., 632 N.E.2d 876, 880 (N.Y.1994). OCC recognizes that the evolution of "business of banking" is not restricted to lines of business reflecting only products banks have sold or functions banks have served previously. Rather, the "business of banking" must be – and is – sufficiently flexible to enable banks to develop and exploit their unique core competencies and optimize the return on those competencies by marketing products and services reflecting or using those competencies….

Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-453 (Dec. 24, 2001). In Interpretive Letter No. 743, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,108 (Oct. 17, 1996), the OCC concluded that providing mortgage reinsurance on mortgage loans originated or purchased by a bank was the functional equivalent to or a logical outgrowth of the lending business because, *inter alia*, it involved credit decisions based on core competencies developed in the lending business – the same underwriting criteria and comparable credit risks.

residual disposal risk. The Proposed Activities place the Bank in a comparable position, with a agreement to accept the off-lease equipment and the residual value risk. As described above, the Bank represents that the risk analysis and risk management that it would undertake in connection with the Proposed Activities in estimating the residual value, in assigning a Purchase Price, and ultimately in selling the off-lease equipment is identical to the risk analysis and risk management that the Bank currently undertakes in connection with its origination and acquisition of CEBA Leases.

Satisfactory risk analysis and management systems are an important part of identifying, measuring, and controlling risk. Therefore, the Bank may not commence the Proposed Activities unless and until the Bank has received the approval of its examiner-in-charge that the risk analysis and management systems for the Proposed Activities are satisfactory.[9]

C. Conclusion

For the reasons set forth above, the Proposed Activities are part of the business of banking and, therefore, are permissible for national banks.[10] If you have any questions, please contact Steven Key, Senior Attorney, at (202) 874-5300.

Sincerely,

Julie L. Williams

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

---

[9] Subject to the same requirement, we believe that the Bank may also engage in the Proposed Activities as a correspondent service. A national bank may offer correspondent services to its affiliates or any other financial institution. 12 C.F.R. § 7.5007. Because national banks assume the residual value risk of off-lease equipment and disposal of that equipment in connection with their personal property leasing activities, they may perform these services for other lessors. As described above, the Bank represents that it has developed an expertise in these activities. One rationale for authorizing a national bank to provide correspondent services is to permit the bank to pass on the benefits of its expertise in certain activities which are central to banking. Interpretive Letter No. 137, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,218 (Dec. 27, 1979); Letter from Peter Liebesman, Assistant Director, LASD (May 2, 1990) (unpublished). OCC precedents generally support the position that the Bank may engage in the Proposed Activities as a correspondent service. *See* Interpretive Letter No. 567, *reprinted in* [1991-1992 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 83,337 (Oct. 29, 1991) (disposal of off-lease property for other lessors); Letter from Peter Liebesman, Assistant Director, LASD (June 15, 1981) (unpublished).

[10] This letter does not address accounting and capital issues raised by the Proposed Activities. These issues will be addressed in later communications with the Bank.