# AK
# BANK
# CODE

Introduced: 2/9/70
Referred: Commerce and Judiciary

IN THE HOUSE

BY THE RULES COMMITTEE BY REQUEST OF THE GOVERNOR

HOUSE BILL NO. 643

IN THE LEGISLATURE OF THE STATE OF ALASKA

SIXTH LEGISLATURE - SECOND SESSION

A BILL

For an Act entitled: "An Act amending the Alaska Banking Code."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 06.05.005(3) is amended to read:

(3) authorize a state bank [UNTIL THE CLOSE OF THE NEXT REGULAR SESSION OF THE LEGISLATURE]

(A) to participate in a public agency created under the laws of this state or of the United States, for the purpose of affording advantages or safeguards to banks or to depositors and to comply with all requirements and conditions imposed upon such participants;

(B) to engage in any banking activity in which a bank subject to the jurisdiction of the federal government may be authorized by federal legislation to engage;

* Sec. 2. AS 06.05.015 is amended by adding a new subsection to read:

(11) charge off all debts owed to the bank in which interest due has been unpaid for a period of six months unless the debt principal is adequately secured and the bank is in process of collection.

* Sec. 3. AS 06.05.025 is amended to read:

AS 06.05.025. BANK EXAMINATIONS. (a) The department shall select one or more competent persons [A COMPETENT PERSON] to make a detailed examination of banks. A report [THE RESULT] of each [HIS] examination and findings shall be transmitted to the department. A copy of the report of examination shall be sent to the organization examined.

FORM SA-1B

# MEMORANDUM

State of Alaska

Jackson

TO: The Honorable Barry Jackson
Chairman, House Judiciary Committee
State Legislature
Juneau, Alaska

DATE: April 9, 1970

FROM: John K. Robertson, Director
Division of Banking, Securities,
Small Loans & Corporations

SUBJECT: H.B. 643
Amendments to the Alaska Banking Code

The following are brief summaries of each section of H.B. 643:

Sec. 1. AS.06.05.005 is amended by deleting certain language as it was originally adopted from the model banking code. This section is known as the "wild-card" statute and its purpose is to ensure a competitive balance between state and national banks. However, as it now stands, it is not as useful as it might be since it requires that any banking powers authorized by the department to maintain the competitive balance must be acted upon by the legislature by the close of the next session. It is suggested that time limit represented in "until the close of the next regular session of the legislature" be deleted. Of the six states having this type of statute, three have no time limit.

Sec. 2. AS.06.05.015 is amended by adding a new subsection defining bad debts. As we broaden the powers of state chartered banks, we must also concern ourselves with asset quality. Most other state banking codes, as well as the national banking law, contain statutory bad debt provisions.

Sec. 3. AS.06.05.025 is amended to clearly authorize the employment of an examination team and conduct whatever examinations are required in the discretion of the commissioner, including followup examinations for mergers or branch banks.

Sec. 4. AS.06.05.035 is amended to enable the department to charge and collect adequate examination and investigation fees.

Under the existing examination statutes (Sections .025 through .035), every examination or investigation performed results in a substantial loss to the department. Due to the increased examination responsibilities, and activities of the department, as well as the increasing number of new bank and branch applications, we feel that it is businesslike and appropriate to collect sufficient fees to offset the costs incurred.

Sec. 5. A new section covering leasehold and development loans is proposed. This section would permit banks to make loans, within certain limits, secured by first lien leaseholds. A leasehold loan is a type of real estate loan in which the borrower (lessee) is the holder, or owner of a leasehold estate, which is of sufficient qualility to warrant a lender accepting it as security for a loan. In other words, the borrower holds a long term lease, which together with the improvements provide security to the lender. Leasehold

loans normally apply to hotels, office buildings, warehouses, service stations, apartment houses, and other similar commercial development. This method of lending is now being used extensively throughout the nation and should be made available to our state chartered banks.

Sec. 6. AS.06.05.207 is rewritten to allow a bank to make second mortgage real estate loans. This will permit our banks to serve customers who have a substantial equity in real property and avoid a rewrite of the first mortgage loan. Due to the loan/value ratios and amortization rates established, we believe that the concept is sound and also believe that it will provide a definite advantage over national banks.

This section is rather lengthy due to rearranging existing language for clarification, however, nothing was deleted or added except the provision covering second mortgages.

Sec. 7. A new section is proposed, allowing state chartered banks to make loans secured by forest tracts. We believe this is particularly important to banks and their customers located in areas where there is a significant and economically marketable timber resource. National banks may make such loans and the more modern state banking codes contain such a provision.

Sec. 8. A new section permitting banks to invest in a bank service corporation is proposed. A bank service corporation normally provides computerized bookkeeping and record keeping services to other banks, businesses, and the public. Such an investment is subject to examination and regulations by the department. Bank service corporations are quite common throughout the nation.

Sec. 9. The new section proposed would permit banks to acquire and lease at the request of the customer, both real and personal property. This enables the bank to offer broader services to its customers, relieving them of capital investment and providing tax advantages. The bank's investment in real and personal property under lease arrangements combined with other investments under Sec.230 is limited to an amount not to exceed the shareholder's equity. National banks may engage in leasing and the more modern state banking codes contain such a provision.

Sec. 10. It is proposed that AS.06.05.235 be rewritten to provide clarification and a broader definition for domestic bank holding companies. The definition (AS.06.05.540(9)) as it now reads is very confusing and limits corporate ownership of bank stock to the controlling interest in one bank. We believe this is too restrictive and should be changed.

The proposed new section would require a company to register as a domestic bank holding company, if it owns 10% or more of an Alaska bank or banks. The term "company" includes a corporation, business trust, partnership, association, or other similar organizations. The language used in the proposed new section is sufficiently broad to recognize a registered bank holding company (Bank Holding Company Act of 1956, controlling two or more banks), provided there is compliance with the domestic qualifications under this section. We believe this type of organization is desirable if not vital to the smaller banks in this state for purposes of remaining competitive with the larger banks.

Sec. 11. This is a proposed new section covering various banking practices,

including issuing letters of credit, trade acceptances, banker's acceptances, and the sale of data processing services.

Due to the increasing involvement of Alaska in foreign trade and frequency of large commercial transactions between banks and their customers in this state, our own state banks should have such authorized capability.

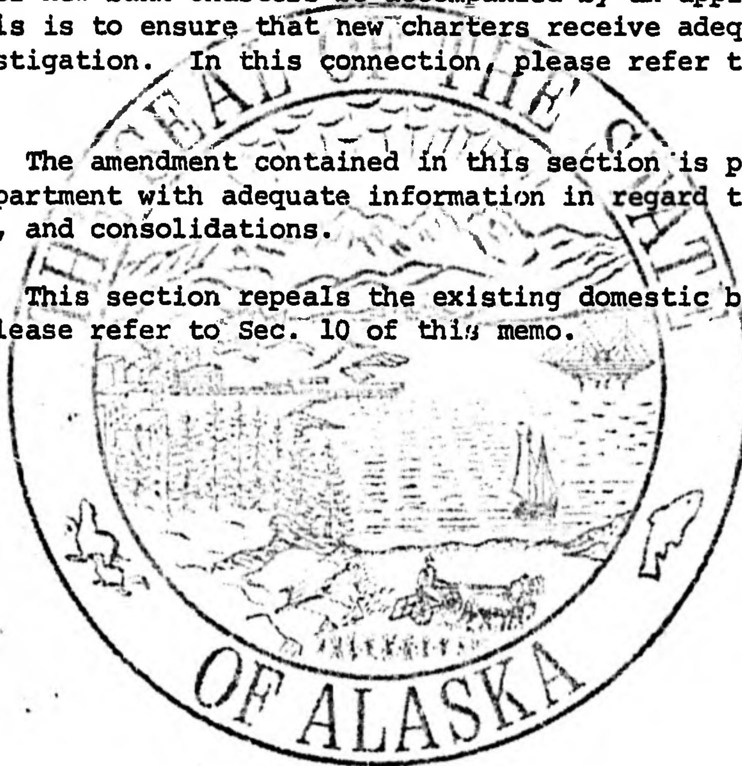
Authorizing the sale of data processing services should not be confused with the proposed bank service corporation legislation. This section permits the bank to offer the same services, but does not involve an investment in a separate corporate subsidiary.

Sec. 12. AS.06.05.345(a) is amended to reduce the par value of the capital stock from $10 to $1. We believe reducing the par value to $1 will allow a broader distribution of the capital stock, thus encouraging wider ownership of Alaska financial institutions.

Sec. 13. It is proposed that AS.06.05.365 be amended to provide that applications for new bank charters be accompanied by an application fee of $1,000. This is to ensure that new charters receive adequate feasibility study and investigation. In this connection, please refer to Sec. 3 and Sec. 4 of this memo.

Sec. 14. The amendment contained in this section is proposed in order to provide the department with adequate information in regard to bank conversions, mergers, and consolidations.

Sec. 15. This section repeals the existing domestic bank holding company definition. Please refer to Sec. 10 of this memo.



HOUSE JOURNAL

Judiciary Committee Report

on

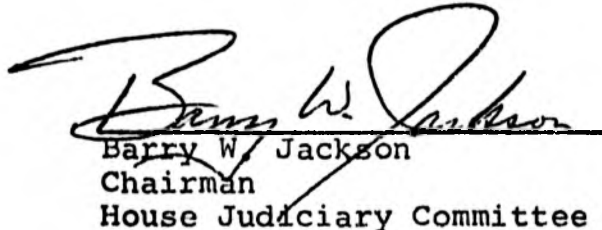
CS for HOUSE BILL NO. 643

The Judiciary Committee recommends passage of this bill in order to improve the competitive balance between state and national banks and to allow state chartered banks to make loans and extend services to customers not authorized at the present time.

The bill authorizes banks to make second mortgage real estate loans, loans secured by forest tracts, loans secured by a first lien on a leasehold of improved real estate, and land development loans. In recognition of Alaska's increasing involvement in foreign trade, banks are authorized to issue and confirm letters of credit and invest in trade and bank acceptances. The bill allows banks to invest in a bank service corporation, which normally provides computerized bookeeping and record keeping services to bank customers,and,when national banks are engaged in the same activity, to acquire and lease real and personal property to customers.

The provision of these additional services are subject to limitations designed to maintain asset quality, safeguard the interest of depositors, and prevent undue competition with other commercial enterprises. A new section defining bad debts further enhances asset quality.

Another section of the bill amends the Alaska Mutual Savings Bank Act to allow a savings bank to pay interest at a stated rate and issue certificates of deposit.



Barry W. Jackson
Chairman
House Judiciary Committee

**DRAFT**

4/29/70

# JUDICIARY COMMITTEE REPORT ON C.S. FOR H.B. 643

The Judiciary Committee recommends passage of this bill in order to improve the competitive balance between state and national banks and to ~~encourage~~ state chartered banks to ~~expand~~ services to customers.

~~The purpose of the bill is to amend the banking code so as to permit state banks to make loans and offer other services~~ not authorized at the present time.

The bill ~~incorporates a number of amendments which would broaden the range of services a bank may offer to its customers. It would~~ authorize banks to make second mortgage real estate loans, loans secured by forest tracts, loans secured by a first lien on a leasehold of improved real estate, and land development loans. In recognition of Alaska's increasing involvement in foreign trade, banks ~~would be~~ authorized to issue and confirm letters of credit and invest in trade and bank acceptances. The bill ~~would~~ allow banks to invest in a bank service corporation, which normally provides computerized bookkeeping and record keeping services to bank customers and to acquire and lease real and personal property when national banks are engaged in the same activity.

The provision of these additional services ~~would be~~ subject to limitations designed to maintain asset quality ~~and~~ safeguard the interest of depositors. A new section defining bad debts ~~would~~ further enhance asset quality.

Another section of the bill ~~would~~ amend the Alaska Mutual Savings Bank Act, ~~clarifying that~~ a savings bank ~~may~~ pay interest at a stated rate and issue certificates of deposit.

JKR/bb

FORM SA-2
100M 8-66

# STATE OF ALASKA
## Inter-Department Route Slip

TO:
DEPT.: Masonic Temple

ATTN.: Merle Masone

- [ ] Approval
- [ ] Signature
- [ ] Comment
- [ ] Contact Me
- [ ] Prepare Reply
- [ ] For Your File
- [ ] Note & Return
- [ ] Initial & Return
- [ ] Return As Requested
- [ ] Return For Approval
- [ ] Necessary Action
- [ ] Your Information

**Remarks:**

From:
Dept.: Commerce Date 4-24

By: John K. Roderton

FORM SA-18

File
HB 643

# MEMORANDUM

**State of Alaska**
DEPARTMENT OF COMMERCE

TO: Honorable Barry W. Jackson
House of Representatives
Capitol Building

DATE : April 24, 1970

FROM: John K. Robertson
Director
Division of Banking, Securities,
Small Loans and Corporations
Department of Commerce

SUBJECT: Leasing and Other Bank Services

Attached is information in regard to leasing and other bank services. Included in the information is a comparison of leasing rates quoted by major banks across the country to their commercial loan rates.

If you need additional copies of any of this information, we will be glad to provide it.

Attachment

| Bank | Leasing Rate | Commercial Loan Rate |
|---|---|---|
| Chase Manhattan Bank<br>New York | 10-15% | 8-1/2-11% |
| U. S. National Bank of Oregon<br>Portland | 9% | 8-1/2-10% |
| Bank of America<br>San Francisco | 10-1/2-13% | 8-1/2-12-3/4% |
| Seattle First National Bank<br>Seattle | 10-1/2-14% | 8-1/2-12% |

Rates quoted January, 1970.

Chapter 29

# LEASE FINANCING

*By KEITH G. CONE*[*]

The word "lease" has been used to define the terms and conditions under which the owner of either real or personal property (called the "lessor") makes such property available for use by another (called the "lessee"). The lessor often has to find financing for the property which is the subject of the lease. Consequently, the position of a bank in the community makes it susceptible to requests to finance the purchase of such property. In view of the fact that the financing of personal property for lease purposes is much more common than requests to finance real property, this chapter will be devoted to the discussion of personal property financing only.

## BANK ENTRY INTO THE FIELD

Financing of a purchase of personal property for leasing purposes was not generally done by banks prior to World War II. As a matter of fact, it was not until immediately after World War II that the first general indications that banks might become interested in such financing occurred. A small number of banks became interested in financing motor vehicles for leasing companies. However, as the leasing of automobiles grew in importance and volume, it appeared that there was also a tremendous market for leasing of all other types of equipment. It is possible to lease anything from the heaviest piece of equipment to the smallest. As a matter of fact, in the daily rental area, as contrasted to the term-leasing area, dishes, tablecloths, linens, and such are made available. However, this chapter will discuss only the financing of equipment for a specified term of months or years and will not be concerned with the financing of personal property used on a daily, weekly, or month-to-month rental basis.

Banks developed interest in lease financing slowly. It was not until the latter part of the 1950s that any appreciable number of banks entered into

* Senior Vice President, LaSalle National Bank, Chicago, Illinois.

the lease financing business as an aggressive part of development of instalment business. The banks' interest in leasing was increased as a result of the amendment of Regulation Q which made available much larger amounts of loanable funds than heretofore had been the case. Then, too, when the Comptroller of the Currency ruled, in March of 1963, that national banks could become lessors, it added another dimension to the business of lease financing.

A bank may become interested in lease financing in any one or more of several different ways. (1) A manufacturer, whether or not a customer of the bank, may request that the bank develop a plan to finance equipment which the manufacturer, as the lessor, leases to its customers. (2) The lessee, a customer of the bank, seeking to obtain a more favorable lease rate, may ask that the bank finance his lessor's purchase of the equipment. (3) A leasing company may ask the bank to develop a plan which it may use in developing its leasing business. (4) A customer of a national bank and in some states a state bank may request the bank to purchase equipment and lease it to the customer as a direct lessor transaction. The first three ways are clearly within the area of direct financing of the equipment for the use of the lessee, while (4) is in the nature of a service which makes equipment available to the lessee without the intervention of a third party as lessor. When a bank becomes the owner-lessor, it becomes subject to all the laws relating to ownership and leasing in the various states in which the property is used. Depreciation taken on the equipment, as well as the impact of tax credits given or taken, will have an important effect on the earnings of the bank. It is essential that expert advice be sought and followed by any bank desiring to direct-lease on a major scale.

## TYPES OF LEASES

### Maintenance or Service Leases

Inasmuch as the lease document is the basic instrument used to outline the terms, this chapter will briefly define the three basic types of leases. A maintenance lease is sometimes called a service lease and is used in all forms of leasing, although automobile leasing companies employ the maintenance lease more than do other types of equipment lessors. The lessor agrees to lease the described equipment to the lessee and, in addition, the lessor undertakes to provide certain described types of maintenance over the period of the lease. Such maintenance is determined through negotiation. In the case of automobiles, it usually requires the lessor to provide maintenance for mechanical problems, tires, battery replacements, and the like. Under this type of lease the lessee's responsibility is usually limited to paying the required rental each month for the term of the lease and

Leasing



providing the gasoline and oil necessary in the case of an automobile in order to keep it running and to return the equipment to the lessor at the end of the period in the lease in good condition, reasonable wear and tear excepted. Under this type of arrangement the lessor bears the responsibility for absorbing ordinary depreciation and is also subject to the fluctuations that may take place in the market value of the equipment at the time it is surrendered. Of importance to a bank is the fact that usually the amount allocated to the bank from rentals will not be of sufficient amount to retire the amount advanced. Therefore, the bank must look to the lessor for amounts outstanding at the conclusion of the lease.

**Finance Leases**

Another type of lease is known as a finance lease, although in various parts of the country other designations are used. Finance lease is a descriptive term for the instrument that is drawn up to make it the obligation of the lessee to pay the entire amount of the advance by the bank to the leasing company to finance this equipment. The lease then can be used as the basis for obtaining credit by the lessor because of the obligation of the lessee. Such a lease requires the lessee to make rental payments under the terms of the lease to an assignee of the lessor free from any defenses which the lessee might have against the lessor. There is also a provision comparable to a deficiency clause in a chattel mortgage or conditional sale contract. While the obligation of the lessee is not as unqualified as that of the maker of a note or mortgagor under a chattel mortgage, nevertheless, the effect is practically the same. In this type of lease the lessor assumes only the responsibility of providing the equipment for use by the lessee and for disposing of the equipment at the conclusion of the lease, subject, however, to certain taxes, such as the income tax, which are the responsibility of the lessor; other taxes are usually the responsibility of the lessee. The bank under this type of lease has the obligation of the lessee to pay the total amount it has advanced to the lessor as contrasted to the obligation of the lessee under a maintenance lease. This type of lease is responsible for the great growth of both automobile fleet leasing and equipment leasing to corporations.

**Net Lease**

A net lease is a variation of either the maintenance lease or the finance lease and is most often used in the motor vehicle type of finance lease. It usually establishes a term of sufficient duration to permit the retirement of the total advance made by the financing institution, although it may not always do so. The main thing is that no maintenance is required, whether or not the lease generates enough in lease payments to pay out the advance made by thhe financial institution.

## GENERAL CREDIT ASPECTS

Leasing is an attractive type of financing for banks. It offers banks another means for financing the needs of its customers in the community. However, it does not in any way permit deviation from the fundamental principles of credit upon which a bank predicates its loan policies. There has been a tendency to ascribe some type of magic to leasing. There is none. It must be approached and analyzed exactly in the same way as any other type of credit. The difference is in the application of the credit, in the documentation, and in the rights of the respective parties. Documents are of considerable importance. No bank should enter into lease financing without careful consideration and the opinion of competent counsel. Mention has been made concerning the use of the finance lease particularly in obtaining credit for use in the purchase of equipment. To a considerable degree, the same is present in other types of leasing such as the maintenance lease.

The bank in approaching the problem of credit granting must analyze the credit of the lessor as well as the credit of the lessee, even though the credit of the lessee may be of sufficient proportions to support the entire amount of the credit. The fact that the credit of the lessee is sufficient relates only to the possibility of obtaining repayment of the funds advanced. In the event that there is a problem on the part of the leasing company with its creditors, or the lessor does not have sufficient know-how, or has problems with the Internal Revenue Service, the lender faces a very real danger that his rights may be precluded because the leasing company did not protect itself and in the process protect the lender. Legal counsel should be consulted on this important question. In the event that the maintenance type of lease is used, there is an even greater reason why the credit of the lessor is important. Usually, in such types of leasing, the amount recovered under the terms of the lease is not sufficient to pay off the entire amount advanced. Consequently, the lender may be in the position of looking primarily at the sale of the equipment in order to pay off the remaining balance, a position it will not like, since it is axiomatic in banks that the collateral should not be the source from which repayment is obtained. The bank does not want to be in a position of having to look primarily to the market value of the property at the end of the lease for recovery of the remaining balance. The ability of the lessor to come up with any amounts needed to repay the advance is most important to the bank. Credit of the lessee is also important, but not to the same degree as in a finance lease. It is important to both the lessor and the bank which depend upon the credit of the lessee to fulfill the payment terms of the lease. Consequently, in appraising credit, the bank must have credit passers who are skilled in

analyzing the credits of both the lessor and the lessee and applying the results of that analysis to the type of lease involved.

This chapter has already discussed some of the aspects of a finance lease and its usage. It might be well to go into more detail since this instrument has become of such importance in the lease financing world. It originally was developed to enable a leasing company that had only nominal capital and could not support with its own statement the amounts needed to acquire equipment desired by the lessee; since the original need for such equipment appeared to be in the area of the larger corporations, the finance lease was an effective instrument for obtaining credit in far greater sums for the lessor than would have been the case under any other type of financing. There have been many developments in the instruments over a period of years, but basically it is still a fundamental requirement that the documents be of such nature as to, in effect, be an unqualified promise of the lessee to pay the sums required under the lease, free from any defenses against the lessor. Maturities in this type of lease range all the way from 3 to 15 or 20 years depending upon the nature of the equipment leased.

## ASSESSING THE MARKET

Ordinarily the leasing company rate is determined by the credit of the lessee, to which the leasing company adds its fee for servicing its requirements under the lease. There has been a considerable decrease in the rental rates charged companies because of the fact that interest rates available to leasing companies have steadily decreased. Over the past few years lessees have succeeded in establishing rates in connection with leasing of the equipment which are based on short- and long-term borrowing rates available to the lessee. This aspect of the present rate situation should be carefully analyzed to determine whether the rate and conditions are of such nature as to adequately compensate the lender for the risk and expense. A lease instrument is not a term loan document. As a result the lessor, and the bank as assignee in particular, do not have the same control and protection. Generally speaking, such type leasing should be available only to the better credits. Originally the finance lease was used primarily for large fleets of items of equipment. However, there is a large market for lease financing for smaller items and smaller but good companies as lessees. It is possible to obtain better rates primarily on an add-on basis of $4.00 to $7.00 per $100 per annum.

Maintenance leasing appeals to lessees who do not want to have the responsibility for maintaining the equipment in good repair. Their theory is that the lessor is in a better position to provide maintenance than is the lessee. This is particularly true in the case of accounting equipment of

which International Business Machines is the outstanding example. It leases its equipment through what is termed an operating lease. It agrees that in addition to making the equipment available it will also maintain it in good working order. The same principle applies to the lease of other types of equipment, particularly automotive equipment.

Leasing early became a favorite method of trucking companies for acquiring the use of equipment—for a local operation or in over-the-road operations. The maintenance leasing of automotive equipment, insofar as individuals were concerned, was used primarily by professional men who used the vehicles in their businesses and consequently felt that it was to their advantage to be able to exchange the vehicle from time to time and have it maintained in proper working order in the interim. In recent years, however, more and more individuals have turned to leasing rather than a conventional purchase.

It is important for a lender to determine whether a leasing company it finances has any great proportion in leases to individuals. The lender needs to understand that under a lease, the lessee does not have the same obligation to pay with respect to the amount advanced by the bank as that same individual would have under a conditional sales contract assigned to the bank.

We have already pointed out that the major characteristics of a maintenance lease are the requirements that the lessor provide the vehicle and provide the maintenance agreed upon in the lease. The obligation of the lessee is to make the payments in accordance with the terms of the lease and to surrender the car at the conclusion of the lease in good condition, reasonable wear and tear expected. So it may be seen that maintenance leasing is available and is used by both companies and individuals, professional and otherwise.

In the case of automotive leasing of passenger cars, the lease usually runs 24 months but, in some instances, it may be set up on a 36-month basis. Automotive equipment other than passenger cars often has a longer maturity, five years being the most common, but in some of the larger units seven years may be used as the lease term.

Ordinarily the bank advances to the lessor the cost of the equipment. Repayment quite often is calculated on the basis of a percent per month of the amount advanced during the term in which the lease is in effect. In some areas, it is 3 percent per month, in others it has been decreased to lesser amounts such as 2½ percent per month. It is recommended that in determining the repayment requirement, the bank pay considerable attention to the type of automotive equipment involved, its resale value, and the usages to which it will be put.

Rates vary in this type of leasing, quite often determined by the financial stability and position of the lessor rather than that of the lessee. Generally speaking, rates range from a 6 percent simple interest rate to add-on

rates of $6.00 per $100 per annum. Needless to say, the lower rates are commanded by the better companies particularly where large numbers of vehicles are involved.

Lease financing is generated through a number of different sources. Primarily, however, lease financing is generated through the leasing companies which apply to the bank for credit to finance their leasing activities, no matter what their nature may be. On the other hand, manufacturers are often a source of leasing business since they need a leasing plan and need it financed for the purpose of gaining wider distribution of the products they manufacture. Other sources are customers of the bank who come to the bank directly and ask that a lease be arranged for equipment which that customer wishes to lease. In other words, it seems that the sources of business are about the same as we might find in any other type of equipment sale and distribution.

## INSURING COLLECTION

The fact that the credit of the lessee as well as that of the lessor is most important has already been mentioned in this chapter. It might be well to repeat that there is no magic in leasing, that basic credit principles must be applied in any application for credit. The same exhaustive investigation and appraisal must be made in lease financing that is made in any other type of financing. Collection policies and practices must be tailored to the type of lease, the amount advanced, the quality of the lessee, and the obligation of the lessor.

It is suggested that the bank in setting up a collection procedure use the techniques which have been successfully applied to instalment credit collection with whatever allowances need to be made in the way of number of notices, letters, and telephone calls, as the circumstances require. It must be borne in mind that in the instance of corporations, collection procedures should be established which recognize that the problems of collecting from corporations are different than the problems of collecting from individuals.

It is imperative that auditing procedures be established in the same manner required in any instalment financing. Safeguards against double financing are in order in this type of financing as well as in other instalment financing. Verification procedures should be established through which may be determined from time to time whether the collateral that is on hand is in fact what it purports to be. It may be well to summarize this aspect by a few do's and don'ts:

1. It is essential that the bank have a complete and protective document approved by bank counsel.

2. In the case of a maintenance leasing company especially, it is essential that the company have a net worth that will support any exposure due to the

bank's advance being greater than the required repayment during the period in which the lease is in effect.

3. It is also imperative that the bank ascertain the ability and experience of the lessor, whether it be in maintenance leasing or finance leasing.

4. Be sure that the lessor knows how to figure his costs and expenses and to translate them into a profitable rate.

5. Review from time to time the progress that the lessor is making in his business.

6. Review his rates and costs from time to time also.

7. Make a thorough investigation of the lessee, both financially and performancewise.

8. It is safer to require the lessee to remit the lease payments directly to the bank, thus maintaining a better control of money.

9. Know your bank's costs in order to set a profitable rate for yourself.

10. Don't permit your competitor to dictate your bank's policies whether it be in rate, terms, advances, or otherwise.

11. Don't forget that the basic obligation of a lessee is not the same as the obligation of the maker of a note or the mortgagor on a chattel mortgage.

12. Don't permit the lessor to dictate your policies; control him, don't let him control you.

13. Finally, don't succumb to the feeling that there is magic in leasing and relax your basic credit requirements.

## CONCLUSION

It would appear that leasing has had its greatest period of development in the last five years. On the other hand, there is every indication that it will continue to grow and that it will continue to find acceptance among the users of equipment of all kinds. It would therefore appear that there is room in the future for more participation by banks in the field of leasing, remembering that it is merely another method of financing the needs of the people of the community in which the bank does business.

FORM SA-1B

Fil

# MEMORANDUM State of Alaska

TO: The Honorable Barry Jackson
Chairman, House Judiciary Committee
Alaska State Capital Building

DATE: April 30, 1970

FROM: John K. Robertson, Director
Division of Banking, Securities,
Small Loans & Corporations

SUBJECT: Committee Substitute for H.B. 643

The purpose of this bill is to improve the competitive balance between state and national banks and encourage state chartered banks to expand services to customers. The bill amends the Alaska Banking Code so as to permit state banks to make loans and offer other services not authorized at the present time.

The following are brief summaries of each section of Committee Substitute for H.B. 643:

Sec. 1. AS.06.05.005 is amended by deleting certain language as it was originally adopted from the Model Banking Code. This section is known as the "wild-card" statute and its purpose is to ensure a competitive balance between state and national banks. However, as it now stands, it is not as useful as it might be since it requires that any banking powers authorized by the Department to maintain the competitive balance must be acted upon by the legislature by the close of the next session. It is suggested that the time limit represented in "until the close of the next regular session of the legislature" be deleted. Of the six states having this type of statute, three have no time limit.

Sec. 2. At the present time, the banking code fails to define bad debts and AS.06.05.015 would be amended by including a provision that loans which have run six months beyond their due date without principal or interest payment are considered bad debts. Loans adequately secured and those in process of collection are excluded.

Sec. 3. AS.06.05.035 is amended to enable the Department to charge and collect examination fees, sufficient to cover the cost incurred in conducting the examination. In order to cover the costs of the examiner's salary, per diem, and travel, the rate was established at $125 per day, per examiner. It is not the intention of the Department to duplicate FDIC examinations, but simply participate as a member of their examination team. We will, of course, conduct our own independent examinations of the non-insured banks and finance companies. (National banks are assessed semi-annually for examinations at the rate of $100 plus $40 per million of total assets. State insured banks are not charged examination fees by FDIC since these banks already pay a fee for deposit insurance.) This section provides for a maximum annual examination fee of $3,750 or two examiners for fifteen days.

Sec. 5. A new section covering leasehold and development loans is proposed. This section would permit banks to make loans secured by first lien leaseholds and within the limits prescribed for real estate loans in Sec. 207 of the banking code. A leasehold loan is a type of real estate loan in which the borrower (lessee) is the holder, or owner of a leasehold estate, which is of sufficient quality to warrant a lender accepting it as security for a loan. In other words, the borrower holds a long term lease which together with the improvements provides security to the lender. Leasehold loans normally apply to hotels, office buildings, warehouses, service stations, apartment houses, and other similar commercial development. This method of lending is now used extensively throughout the nation and should be made available to our state chartered banks. (See attached example of typical leasehold loans). National banks are permitted to make leasehold loans and the more modern state banking codes contain such a provision.

Also, included in this section is a provision allowing banks to make land development loans. In other words, a bank may make a loan on undeveloped real property, provided the proceeds of the loan are used to provide improvements, i.e., streets, water, sewer, fill, bulkheads, pilings, etc. The loans are made subject to the provisions of Sec. 207 in the banking code applying to other real estate loans. (Loan/Deposit ratio and amortization rate). The purpose of this provision is to encourage banks to become involved in developmental lending on industrial, commercial, and housing subdivisions. (National banks are permitted to make land development loans and the more modern state banking codes contain such a provision).

Sec. 6. This section appears rather lengthy due to the rearranging of existing language of Sec. 207 for clarification. However, nothing has been deleted or added except a provision covering second mortgages. AS.06.05.207 (Real Estate Loans) would be amended to permit our banks to serve customers who have a substantial equity in real property and avoid a rewrite of the first mortgage loan. The second mortgage loans are subject to the same loan/value ratio and amortization rates as prescribed for first mortgage loans. Due to the limitations established, we believe the concept is sound and will provide our state banks with a very useful tool in serving their customers.

Sec. 7. A new section is proposed, allowing state banks to make loans secured by forest tracts. We believe this is particularly important to banks and their customers located in areas where there is a significant and economically marketable timber resource. The total aggregate dollar amount of all such loans made by a bank may not exceed 50% of the bank's combined capital, surplus and undivided profits. National banks may make forest tract loans and the more modern state banking codes contain such a provision.

Sec. 8. A new section permitting a bank to join with one or more banks in a bank service corporation is proposed. The purpose of a bank service corporation is to provide banks with a joint method of acquiring larger computer equipment, capable of more sophisticated applications. A bank service corporation normally provides automated bookkeeping and record keeping services (payroll accounting, accounts receivable accounting, inventory records and etc.) to the bank's customers and to other banks. A bank's investment in a bank service corporation is limited to 10% of its total capital and surplus and to-

gether with its total investment in banking premises, furniture and fixtures, and investment under proposed Sec. 232 may not exceed the combined capital surplus and undivided profits. In other words, it is only stockholders equity invested in the bank service corporation. The bank service corporation would be subject to examination and regulation by the Department. Bank service corporations are quite common throughout the nation.

Sec. 9. A new section is proposed which would permit banks to acquire and lease at the request of the customer, both the real and personal property. This enables the bank to offer broader services to its customers, relieving them of capital investment and providing tax advantages. The bank's investment in real and personal property under lease arrangements, combined with other investments under Sec. 230 (Banking Premises and Equipment) and proposed Sec. 231 (Bank Service Corporations), is limited to an amount not to exceed the total capital, surplus and undivided profits of the bank. (In other words, the shareholders equity). Leasing agreements would also be subject to a bank's legal lending limit to one customer (15% of total capital, surplus and undivided profits, AS.06.05.205), i.e., a customer's lease agreement with the bank would be combined with his outstanding loans in order to determine the bank's legal lending limit to that customer.

National banks may engage in leasing and the more modern state banking codes contain such a provision. National bank leasing regulations and those of many other states are not as restrictive as the statute proposed here. In order to provide some idea of the volume of leasing now handled by banks, the Comptroller of The Currency has just reported that national banks alone are handling approximately $700 million in direct leases. <u>This section contains a special provision prohibiting state banks from engaging in this activity until a national bank in the state has actually done so</u>.

Sec. 10. Sec. 06.05.275 is a proposed new section covering various banking practices, including issuing letters of credit, investing in trade acceptances, issuing and investing in banker's acceptances, and the sale of data processing services.

Due to the increasing involvement of Alaska in foreign trade and the frequency of large commercial transactions between banks and their customers in this state, our own state banks should have such authorized capability.

Authorizing a bank to engage in the sale of computer time and the sale of data processing services, <u>involving its own equipment</u>, should not be confused with the proposed bank service corporation legislation (Sec. 231). This section permits a bank to offer the same service but does not involve an investment in a separate corporate subsidiary. This is an authorized activity for national banks and is a common practice by national banks in this state and by both state and national banks in other areas.

Sec. 11. AS.06.05.345 (a) is amended to reduce the par value of the capital stock from $10 to $1. It is believed reducing the par value to $1 will allow a broader distribution of the capital stock, thus, encouraging wider ownership of Alaska financial institutions.

Sec. 12. It is proposed that AS.06.05.365 be amended to provide that

applications for new bank charters be accompanied by an application fee of $1,000. This is to ensure that new charters receive adequate feasibility study and investigation. It is imperative that new applications for financial institutions receive careful attention in order to prevent weak and unqualified entries into the financial system, and to determine that the needs and convenience of the public are actually served.

Sec. 13. AS.06.05.462 would be amended in order to provide the Department with adequate information in regard to bank conversions, mergers, consolidations, as well as provide standards by which these may be approved or disapproved.

Sec. 14. AS.06.15.220 of the Alaska Mutual Savings Bank Act is amended to clarify that a savings bank may pay interest at a stated rate and issue certificates of deposit. A careful reading of the Mutual Savings Bank Act, particularly Sec. 220, subsections (a) and (b), will reveal the confusion which exists in regard to the payment of interest and the issue of certificates of deposit. The current statute places our savings banks in an awkward position resulting in a competitive disadvantage in comparison with commercial banks and S&L associations.

In lending on a leasehold, a lender normally is lending on the value of the buildings subjectto the ground rent that belongs to the lessor or fee owner. A simple case in fact would be as follows:

"A" railroad owns a parcel of land and leases it to "B" for 20 years with probably two ten-year options of renewal by "B". In turn,"B" wants to build a warehouse costing $400,000. "B" goes to his bank and requests a 75% loan, 15 years, in the amount of $300,000, and agrees to pledge his leasehold interest in the land subject to the ground lease to "A". "B" may be a user for the warehouse or he may in turn lease it to a credited tenant called "C". In either event the test of this type of loan depends on the following:

(1) The term of the ground lease to "A" from "B" must be for a longer term than that requested for the mortgage - preferably by five years.

(2) The ground lease must be firm and not cancellable except for non-payment of rent.

(3) The ground lease should be a triple net lease with lessee paying all expenses including taxes.

(4) The mortgagee should get consent in writing from the fee owner, "A" stating that in the event "B" should default on the lease, the mortgagee be given notice to cure such default prior to commencement of foreclosure.

(5) Leasehold loans normally apply to hotels, office buildings, warehouses, service stations, banks, apartment houses, and other improvements where the tenant may have a top rating such as AAA1, or the location is such that there is little doubt that the improvements will sustain an income which will support its valuation and retire the mortgage in full.

(6) In the State of California, it is quite common to make leasehold loans on residential property, however in the State of Washington it is very seldom done and of little consequence except on second home sites where the land is owned by the Indians and one may lease from them and build a house. These sites are normally waterfront tracts where the Indians are precluded from selling their land.

TYPICAL LEASEHOLD LOAN

FROM: LEASING STANDARDS AND PROCEDURES
Published by Thomas Publications, Ltd.

# INTRODUCTION TO LEASING

THE HISTORICAL roots of leasing go deep in time. As long as man has had machinery, he has leased it to others. But the great expansion of leasing, its coming of age as an important industry, has taken place since World War II.

When the war ended, American industry was faced with a shortage of capital and at the same time struggled with soaring market demands. In many cases it turned to leasing as a means of conserving capital while simultaneously accumulating the equipment and facilities it needed to manufacture and distribute its products.

The boom in leasing has continued to this day, and conservation of capital continues to be a motivating factor. Other factors, however, have entered the picture within the past ten years. Conservation of labor, protection against obsolescence, tax advantages, and the very human desire to conform to a popular trend, have all become important reasons for leasing.

## LEASING TODAY

Whatever the reasons may be, there is no question that leasing is on the increase. It is difficult to relate the accelerating pace of this increase to any other index or barometer of business activity. In general, this increase represents progress. There are, however, cases of companies going into leasing without real reasons, without awareness of the reasons why it may not be advantageous for them. One lessor has said, "In my years of leasing I have never been able to fully understand why a company leased or didn't lease. All I know is that once they decide they are going to lease, you can't talk them out of it; and once they have decided that they are not going to lease, the soundest arguments in the world won't convince them they should."

In this state of change, leasing stands today. The industry is booming, and the service it offers can greatly benefit a lessee. It can also be an unnecessary and expensive mistake. This manual is intended to help managers, and others in a position to consider leasing, to decide which situation fits their own organization. Should the decision be made to lease, there is information here to help them get the most for their leasing dollars.

## LEASING AND LABOR COSTS

The United States Departments of Commerce and Labor recently released figures on what pay hikes would mean to the average employee's paycheck by the year 1971. Recent agreements between management and labor have pushed the national pattern of wage and "fringe" benefit in-

creases up to around 6 per cent a year. The survey shows what has happened to pay levels in major industries in the past five years, and what they would be in 1971 with a rise of 6 per cent per year. The following are the figures:

**What Pay Hikes of 6 Per Cent Would Mean**

| | AVERAGE WAGES AND "FRINGES" (per hour) | | |
|---|---|---|---|
| | 1961 | 1966 | 1971 |
| Autos | $4.04 | $5.33 | $7.13 |
| Steel | $4.28 | $4.94 | $6.61 |
| Oil refining | $4.99 | $5.93 | $7.93 |
| Machinery | $3.36 | $4.01 | $5.37 |
| Transportation equipment (except autos) | $3.71 | $4.37 | $5.85 |
| Electrical equipment | $3.22 | $3.69 | $4.94 |
| Printing, publishing | $3.23 | $3.85 | $5.15 |
| Rubber | $3.04 | $3.58 | $4.79 |
| Textiles | $1.99 | $2.45 | $3.28 |
| Lumber, wood products | $2.07 | $2.50 | $3.35 |
| Food products | $2.74 | $3.50 | $4.68 |

NOTE: Figures are averages for all employes, including salaried workers.

Higher wage scales for employees who help manufacture the products they in turn buy, will ultimately bring about a higher cost for the products, thereby taking a significant portion of the added buying power from the higher take-home pay.

In an industry which has responded to higher labor costs by raising product prices, a strike or lay-off or other loss of wages deprives employees of purchasing power. This is obvious. It happens frequently and the economy survives. More than just one industry is affected, however, for the industry producing one product is the consumer of many other products, and that industry's workers are consumers of another vast range of products.

Such a situation, then, is not a healthy one for the economy as a whole. Nor is it healthy for the leasing industry, which has its own labor costs and is itself a consumer of the products of industry. In one respect, however, the leasing industry is unique. It is in a position to help correct one of the major weaknesses of our capitalistic system, its "inability to control spending."

## ECONOMY AND LEASING

In a most provocative article in the *Harvard Business Review,* Prof. Ferdinand F. Mauser of Wayne University discussed the role of leasing in the stabilization of the industrial economy through its potential influence on consumer and industrial spending.

"Stabilization," Prof. Mauser wrote, "involves getting at one symptom of business cycles, namely, fluctuation in the rates at which individuals, industry and government spend money. Fluctuations in spending reflect directly on production scheduling. Production must be steady, for this is the only means of assuring steady incomes for those who produce."

Prof. Mauser went on to point out that "Elimination of fluctuations in spending requires that businessmen must increasingly apply their marketing ingenuity to secure regularly committed amounts from each individual's income. The privilege of individuals doling out their incomes at any rate of speed or schedule they please will be a luxury which will have to be curtailed (not by fiat, but by persuasion) if we are to fully reap the material benefits of an automated world."

Relating leasing to this problem, Prof. Mauser's discussion is given to the change of attitude toward ownership of goods. He wrote, "In the new world of technological affluence, the principle of ownership of material possessions by individuals is fast becoming an anachronism," and "people in a busy, rapidly moving, affluent society increasingly realize that they are not interested in things per se, but rather in their use in a convenient and worry-free manner."

"If the goals of economic stability and full employment are to be achieved," Prof. Mauser continued, "marketing must be viewed as a social force. The public in general, and business leaders in particular, must better understand the place of marketing in the new society, for it is the force which will shape economic destiny by expanding and stabilizing consumption."

The situation lessors must face is a part of the larger problem of what Prof. Mauser called the "Age of Consumption." As he pointed out, "Methods for forcing consumption must be expanded and widely accepted as a permanent part of our social convention. The tempo of continuous consumption must be accelerated. Puritanical attitudes (mothered all these centuries by scarcity) that view excessive consumption as immoral must be discarded."

Changing attitudes is the challenge for the marketing profession. As attitudes change, and as consumers of all kinds move in the direction described by Prof. Mauser, the leasing industry — if it is ready — will have an opportunity unmatched in its history.

Just two or three years ago, any predictions that the American consumer would embrace leasing as a way of life would have been regarded as wildly futuristic. That was before the "credit card rush of 1967," which demonstrated that the middle class consumer was ready for bold changes in his style of living and buying.

Another trend that laid the ground work for a lease economy was the shift from goods to services. At the end of World War II, Americans spent 40% of their income for services, 60% for goods. Just ten years later, this had shifted to 50-50, and the proportion of income spent on services continues to rise.

Americans were also ignoring the precautions of their elders, who used a pay-as-you-go waste-not-want-not, policy to survive the depressions of the '30's. Between World War II and 1967, private debt doubled, rising to 1.3 trillion dollars. Americans are now in debt for 20% of every after-tax income dollar, three times the 1947 rate.

The new generation, obviously, has no doubt about its future earning power. It wants the good things of life, and it wants them now, paid for with tomorrow's dollars.

Eully half of all Americans are now under 26 years of age. A leased economy promises tomorrow's young married couples, who have an insatiable appetite for durable goods, the use of expensive household goods without the delay of accumulating down payments.

Have you gone to the apartment of a newly married young couple? They don't start out with a wedding gift cardtable and chair set to dine on. They have a beautiful "dinette suite," plus a complete line of appliances in the kitchen. Walk into their living room and you will find comfortable furniture, plus color TV. Walk into their bedroom and you will find another TV, plus beautiful bedroom furniture.

Parked outside or in the garage that comes with one of the rented apartments is a new car. The younger generation does not want to wait and save for the finer things in life, they want them now and they get them. How can they afford them? They charge everything with easy-to-obtain credit, and pay so much a month, because they want to enjoy it while they pay for it. This is really nothing but a leasing situation.

## WHAT'S SO NEW ABOUT LEASING?

In recent years, leasing has found its way into many areas of the economy. In other areas, it was there all the time, under other disguises. In addition to using leased telephones, most businessmen have used nothing but leased help all their hiring lives. Except for some high priced ballplayers, employees aren't paid five or ten years' salary on their first day on the job. Instead, employers pay for their help as it is delivered, a week or two at a time. Some even go beyond this, leasing individual blocks of employee time through a part-time help agency that leases workers and then re-leases them to employers in need of temporary extra help.

Clearly, the American consumer, like American industry before him, has been gradually discarding his love affair with property ownership. Ahead lies a new, unheard-of level of convenience, the convenience of use rather than ownership.

The groundwork for a widespread consumers' switch from ownership to leasing has been done.

Leasing has acquired "class." The future "lease generation" has watched its heroes on TV as they leased a Mercedes in Switzerland and left it in Rome, leased a Riviera villa for the season, leased a hunting lodge in the Canadian wilds, or leased a full set of tableware and furniture for a society wedding.

A boardroom full of Madison Avenue advertising executives couldn't have prepared a more effective campaign to motivate the average consumer towards the acceptance of leasing as a way of obtaining today's goods with tomorrow's money.

It can easily be predicted that in the not too far distant future there is going to be a surge in consumer leasing. For a flat lease payment of, let us say, $48 a month over a five year period, our young people will receive a refrigerator, freezer, oven, range, color TV or some other comparable assortment of appliances. Their monthly payments will also include a maintenance man stopping by at regular intervals to make sure everything is in working order. At the end of the five year lease period, a truck will back up to their door and deliver the new appliances they will have arranged for, and the old appliances will be taken away. Every five years the old goes out and the new comes in. Our young married couple might even go so far as to include carpeting in the leasing package, as well as some fine furniture.

It could be projected that a good percentage of the younger generation will take advantage of some such lease arrangement, and probably quite a few of the older generation. What will this accomplish? It will accomplish what Professor Mauser said it would. The manufacturers of these appliances will be able to determine that a definite number of ovens, ranges, TV sets, freezers and so forth will be required at a particular date in the future. They can plan better than ever for wage demands, expenses, supplies, and-hopefully-profits.

As mentioned earlier, conservation of working capital is the prime reason why businesses, both large and small, lease. Members of the younger generation, in effect, are conserving or spreading out their "working capital," and in this way acquire more consumer goods. These same young people will soon be entering the business world and can very easily control trends and habits in acquiring equipment to run various industries.

In a recent survey of pre-college graduates, conducted by the Bank of America, young men were asked their preference as to employment after graduation. In 1963, 76% of those responding were interested in joining a large corporation for employment. In 1967, just four years later, the percentage preferring large companies went down to 55%, with an increase of 14% in preference for self-employment and 19% for partnerships.

Large businesses face the problem of limited working capital, and often can ease their financial burden through leasing. It can be assumed that the new one and two-man business enterprises favored by these young men will also turn to leasing, for working capital limitations will be just as severe for them, if not more severe, than for their larger counterparts.

We may never see the day when every businessman and every consumer will lease. However, if each of the manufacturers who serve these peoples needs could control 30% of his future production by leasing 30% of his products, it would be of tremendous help to him in charting the future.

Every industry which produces equipment used to make a profit or provide a service for another business could benefit through leasing its products. A lathe manufacturer, for example, may lease lathes to his customers on a monthly payment basis for the useful life of the equipment. His lease merchandising program may be set up by the manufacturer through his own leasing subsidiary, or by an independent lessor. At the end of the lease period, or sooner, new lathes or more efficient models would replace the currently leased lathes. As long as his product holds up and he provides good service, the manufacturer has a measure of control over his customers and his volume, giving his industry greater stability by being better able to program future production.

## AUTO LEASING

In the October 23, 1967, issue of *Newsweek* magazine, appeared an advertisement for Volvo automobiles. Volvo contends that their cars will last longer. This may be true, but American consumers and especially auto fleet users are never going to buy only Volvo automobiles. The ad read, "YOU DON'T BUY A NEW CAR, THE BANK BUYS A NEW CAR, BY THE TIME YOU BUY YOUR CAR BACK FROM THE BANK IT'S OLD."

How true this is in today's automobile financing market. It is estimated that about 70 per cent of all new cars are financed in one way or another. This estimate may be low. The majority of automobiles are financed over a 24 to 36-month period. By the time the last payment comes due, or before, a new car is ordered and financing starts all over again with the hope that the traded-in car will pay off the indebtedness or unpaid balance on the old car. This type of automobile financing situation is nothing but a "leasing of money" arrangement, a definite leasing situation. True leasing is actually another way of financing.

If a portion of any manufacturer's production can be controlled, it will stabilize his future production, profits, and labor demands. The manufacturer can project what his future needs and commitments will be. Leasing of his products, such as automobiles, can help to give the manufacturer this stabilizing factor. Leasing will assure spending for replacement of the products at regular intervals, which results in repeat sales.

Does the automobile industry realize this? Major auto manufacturers are now offering to leasing companies a guaranteed trade-in value on leased automobiles. This means that the lessor, or leasing company, knows exactly what the value of an automobile will be in 18 or 24 months. If he trades it in at this prearranged time the lessor will know the exact residual value of the leased car. It would be foolhardy for him to speculate or to anticipate the unknown value of a trade-in. If he doesn't trade and "buy new" he risks losses at a later date.

This arrangement between lessors and the auto industry has taken the guesswork out of one of the most difficult problems faced by the lessors. "What to do with trade-ins and what will they be worth?" This guaranteed trade-in value of leased cars helps to stabilize the automotive leasing industry, as well as the automobile manufacturing industry itself. It will help the automobile manufacturer to project and plan for the future demands of labor and to know the model, the color, and even the cost of the automobiles he must produce. The automobile leasing industry is growing at the rate of 15 to 20 percent each year, while the number of vehicles registered in the country increases 4½ percent annually. The trend in leasing speaks for itself.

## INDUSTRIAL TRENDS

Some of the factors that have made leasing more attractive to industry have originated within industry itself. These include programmed maintenance, absolescence of high priced equipment, and rapid changes in technology, that immediately require entirely new kinds of equipment.

Maintenance of industrial equipment, for example, has become a highly complex science in itself. The new technology of programmed maintenance, with periodic disassembly and inspection under the watchful eye of computers, beats old fashioned "wait until it breaks" maintenance costs by 15 to 75 percent. Such maintenance programs put the user in closer touch with the maker of the equipment, making leasing more feasible for both.

Material handling accounts for some 80% of all manufacturing cost today. As one way to cut this cost, mechanized material handling now approaches the "untouched by human hands" factory of science fiction. Computerized conveyor systems, heavy pallets floating on air cushions, and giant conveyor belts in place of interplant freight trains have successfully cut rising handling costs for

many hard pressed manufacturers. The manufacturer must first acquire the equipment. The solution . . . leasing.

## TRANSPORTATION USES LEASING

The transportation industry has used many types of leasing to prosper and to insure future growth. Some methods have been established by long tradition in the industry, others are new, imaginative and even daring. Union Tank Car Company, traditionally a lessor of tank cars, has been using new, specially engineered cars to diversify its business and get away from its dependency on oil companies as clients. The leasing device has helped Union Tank Car put into service expensive, specialized units to haul chemicals, liquified gases, dry cargo, and such other non-petroleum products as cement. The company leases its equipment out on long contracts, averaging 5 to 15 years, that help insulate the company against fluctuations in the business cycle. The practice is successful. The rate of growth of Union Tank Car has held at a fairly steady 8½ percent per year for the last twenty years.

In a transaction fairly typical of aircraft financing today, a group of banks recently purchased six DC-8 jets from Douglas Aircraft Corporation, and leased them to a major airline. The airline was not in a position to deduct from taxes the full amount of the 7 percent investment credit on the cost of these planes. The banks were, and shared their tax savings with the airline. The airline thus paid only 2 percent for its money, while the banks made 5.2% on their invested funds.

Aircraft lessors are using a new concept in private aircraft leasing called "block time." The customer contracts to use a minimum amount of mileage each month, in effect leasing time and mileage rather than the traditional "seats of the aircraft." For a minimum mileage contract of 5,000 miles, the lessor guarantees that a jet will be standing by at any airport in the United States ready to take-off to any other part of the country six hours after a telephone request.

## A 50 YEAR DREAM

As leasing becomes more widespread, it will have a positive effect on the economy so far reaching as to be almost revolutionary. Businessmen will recall the old days when people bought equipment rather than leasing it, and the resulting instability of production caused wildly swinging cycles of depression and widespread unemployment. Economist Mauser calls unemployment "the perpetual erosion which undermines the foundations of capitalism." Leasing has the potential to be a bulwark against that erosion.

## AN OLD AMERICAN CUSTOM

Leasing as a method for acquiring the use of goods goes back to the days of ancient Rome, when ship owners leased their vessels for trade in the Mediterranean. Leasing of real estate was a common practice in England centuries ago. Until just a few years ago, however, leasing of equipment by individuals, or by businessmen in most industries, was a rarity.

An outstanding exception has been the telephone. From its beginnings in 1877, Bell Telephone Company wisely decided to retain ownership rather than allow the phone to become a consumer-owned appliance. As a result, the company has always enjoyed all of the benefits accruing to a leasing company which are just now being discovered by American industry as a whole-production pegged to future use, assured full employment for its workers, and control of its markets.

It is surprising that leasing has taken so long to catch on in this country, because it could actually be described as a good old American custom. As far back as the early 1900's leaders in some key industries were using leasing to gain marketing advantages which most of them still retain.

## WHY BUY A BALL PARK?

A large leasing company once advertised "you don't have to own the ball park to enjoy the game." This principle of "use without ownership"

enables manufacturers to enjoy the benefits of the latest, most sophisticated eqiupment now, when it is needed, instead of waiting until they can afford to "buy the ball park."

It is ironic that today's typical businessman will take an arm's length look at equipment leasing, and many times not even consider it. This same businessman will lease an office, factory or warehouse. It is ironic because the equipment he buys to earn his profits will depreciate or become obsolete, yet the building that houses the purchased equipment will maintain or increase its value. It might be wise for this businessman to lease his equipment and own the building. The building is probably the better investment. Yet one out of every two businessmen buys equipment and leases buildings. Both equipment and building must be paid for somehow; why not own something that will retain its value, and lease something that won't.

## BANKS JUMP IN THE WATER

Held back by rulings that kept them out of the leasing business until early 1963, national banks are now allowed to form their own leasing departments. On March 18, 1963, the Comptroller of Currency issued a directive that allowed national banks to lease equipment to customers under some conditions.

By October, 1965, direct lease financing by some of the larger national banks that had formed their own leasing companies had reached a volume of 235 million dollars. California banks, especially the Pioneering Bank of America, contributed 44 percent of this volume.

The primary reason banks enter the leasing business is profit. As banks have watched the decline in their net return per dollar of assets, leasing provided the service they could offer customers which might counteract this trend. The actual rate of return for the bank will be about the same as on regular equipment financing, but there is additional income recovered from the residual value of the leased equipment or from renewal options. Residual values can easily double the rate of return. Additional economic benefits may be realized through accelerated depreciation of the equipment, and through the investment credit if it is retained by the bank and not passed on to the lessee.

Another reason banks enter the leasing business is so that they may provide an additional service for customers. Leasing is one more way to finance equipment acquisition, and a bank feels that financing such acquisition is a service that should be kept under its own roof.

A third reason is that leasing does not count as a part of the banks legal lending limit. Most large banks have adequate limits, but for smaller banks, this fact may be an advantage in attempting to meet the needs of desirable customers.

Banks slowly entered the field of equipment financing, by means of conditional sales contracts, in the 1930's. When they became aware of profits earned by independent finance companies, banks entered this field and it is now one of their more profitable services.

## MUNICIPAL LEASING

The days of pay-as-you-go are largely gone in City Hall, and many other public bodies have found themselves in the same situation. Many municipalities, indebted to their limit in long term obligations, are faced with pressing needs for more and better public facilities and equipment.

Some school boards, pioneering in a field where leasing has been slow to gain ground, have found they can get more for their money by leasing needed equipment. The needed equipment may vary from projectors, closed circuit television, food preparation appliances, and wood or metalworking machines, to typewriters or any other item necessary to carry on the daily activities of educating and serving their students. Schools find that when buying school buses, for example, they cannot purchase technical skill and help along with the equipment. If they lease the same buses, on the other hand, the lease contract covers the most highly professional maintenance available.

The lessor provides this service, which includes first-rate mechanics and maintenance facilities. Another factor is the cost that must be charged to administrative time. How much does it cost to own and administer a bus fleet? Does it involve one employee, or two, or three? At today's salary ranges, that can be $7,000, $14,000, or as much as $21,000 tied up in managing equipment, not education. This is a "cost of ownership" that may not appear on anyone's budget, but is nevertheless real.

## CONCLUSION

This manual covers only a few cases, selected to show the many opportunities leasing offers to business, industry and anyone who uses equipment of any kind to render a service or produce a profit. The reasons for leasing, as one solution to equipment financing problems, are almost as numerous as the areas in which leasing is at work today solving these problems. Whatever phase of leasing the reader wishes to explore, he'll be able to chart a prudent and profitable course by following the basic principles outlined in this manual.

FROM: COMMERCIAL FINANCING by Monroe R. Lazere

# 11

# Equipment Leasing

**Monroe R. Lazere**

## NATURE OF EQUIPMENT LEASING

Leasing is one of the oldest of legal relationships. Historically, it involved an arrangement in which an owner permitted another the right to use his property for a period of time pursuant to stipulated conditions. Familiarly, in real estate transactions it involves the granting of a right to use the realty for a period of months or years. Obviously such leases are for a substantially shorter term than the usable life of reality. However, in the case of ninety-nine year leases (or substantially equivalent terms) the realty becomes an integral part of the enterprise's operation. This discussion is limited to personal property and, even more specifically, to income-producing equipment for a business enterprise. Patently, such income-producing equipment has a usable life considerably less than that of realty. Obsolescence, depreciation, and ordinary wear and tear combine to reduce the usable life of the average piece of equipment to a limited number of years.

Indeed, this very fundamental fact gives rise to many of the unresolved problems concerning equipment leasing. The relationship between the usable life of the equipment, the dollar cost thereof, and the terms of the lease has been the major source of the debate on the legal and accounting treatment of leasing transactions.

The equipment leasing device really blossomed after World War II. In the 1950's it was in its infancy. In the 1960's the estimated annual volume of transactions was $600 million, and for the 1970's an annual volume of $7 billion appears to be a reasonable expectation

## Terminology

The newness of the concept of equipment leasing has also contributed a multiplicity of overlapping terms. At the extreme ends of the leasing spectrum the terminology is clear. A business enterprise may lease trucks for the movement of its merchandise over a period of several weeks. This short-term use of relatively long-lived equipment is clearly a "pure" lease, or "true" lease, or "operating" lease. In common parlance it is frequently called a "rental." At the other end of the spectrum is the situation in which a piece of equipment with a usable life of perhaps ten years is leased by a business enterprise for five years at a rental that enables the lessor to recover the cost of the equipment plus his compensation for the use of the funds over that period. At the end of the lease period, the lessee has the option of purchasing the equipment for one dollar. Under such an arrangement, the lessee has effectively acquired the use and title to the equipment over a period of time. Such a lease appears to differ only in form and not in substance from a purchase under a purchase money security agreement (or, before the advent of the Uniform Commercial Code, a conditional sales contract). Such a lease has been described as a "finance" or "financial" lease. Between the extremes of the spectrum, of course, lies a large twilight area of transactions with many variables.

### LEASES VS. INSTALLMENT PURCHASES

Understandably, the novelty of the device of equipment leasing has resulted in differences of opinion among financers regarding its proper function. To analyze leasing effectively one must recognize what it can and cannot do. Purchase money security agreements (in non-Code states, conditional sales contracts) are another means of acquiring equipment (as well as the use of the equipment) without an immediate full outlay of cash.

Several arguments favoring leasing over installment purchases appear in the literature. Since many of them almost fall of their own weight, their enumeration need not long detain us. Examples are: the formalities of leasing are less cumbersome, and leasing companies make decisions more rapidly than other lenders. The argument was also made that lessors know the equipment better than other lenders. While this last proposition may be accurate with respect to lessors specializing in particular equipment (e.g., automobiles or computers),

it surely does not apply to a leasing company handling a fuller range of equipment. Surely such a lessor would be no more familiar with the equipment than would a similarly broad-gauged installment sales financer.

## Obsolete Arguments for Leasing

Other arguments favoring leasing over installment sales financing were originally valid. The validity was lost, however, as the device became more familiar. In this category of arguments was one urging that in government cost-plus contracts the entire rental would be taken as "costs" even though the equipment would be retained by the contractor by exercising a nominal option at the end of the term. Government contracting officers have now eliminated this possibility. Also, it was urged that leasing could be utilized to avoid restrictions in departmental capital budgeting. Now such budgeting usually includes restrictions on finance leases as well. And finally, leasing was urged as a method of avoiding restrictions regarding capital expenditures found in long-term debt agreements. Such agreements are now usually broadened to apply the restrictions to finance leases.

Thus some early supporting arguments have been seriously diluted, even eliminated. Newer and perhaps more persuasive justifications have developed. It may therefore be appropriate to discuss some of the more serious theoretical arguments in close relationship to their chronological development. In such a chronology, 1962 represents a key year, for then the investment tax credit provisions became law. Thenceforth the theoretical and practical justifications for leasing underwent a profound change.

## Size of Down Payment

In the 1950's, however, leasing salesmen offered leasing as virtually a panacea for the company short of operating cash. They urged that the required down payment was less than in installment purchasing. Initially, this was true. The usual lessor required prepayment of one month's rental for each year of the lease term or 8½% of the total dollars involved. Under the pressure of such competition, however, the financers of equipment installment sales generally reduced their requirements from 25% to 10% of the purchase price. Hence the differential on this score became less dramatic.

## Size of Monthly Payments

Further, the lower monthly payments promised by the leasing salesmen seemed illusory. Where, as was usually the case, the lessor acquired the equipment for a particular lessee, he would obviously anticipate the full recovery of the cost of the equipment plus compensation for the use of funds during the lease period. Hence the lessee's option to purchase the equipment at the end of the lease period was usually nominal because the investment then remaining in the equipment was insubstantial. After 1962, as will later appear, it became economically feasible for the lessor to schedule monthly payments that would leave a more substantial investment in the residual portion at the end of the lease term.

## Tax Deductions

Another argument pressed by proponents of leasing was that the lease payments were deductible as an operating expense, thereby effecting a considerable tax savings for the lessee. It must be noted, however, that a purchaser of equipment may take depreciation and interest as tax deductible expense. Studies of comparative tables of parallel transactions (utilizing the same depreciation formula, cost of equipment, and interest charge) have been made. The conclusions thus reached clearly indicate that leasing does not increase or decrease the total tax savings. Leasing, however, does enable the lessee to distribute his tax savings more evenly over the term of the lease. The installment purchaser has higher tax savings earlier in the purchase period and lower in the later period. Further, as the lease term or purchase period increases, the annual differential on tax savings seems to become less.

## Creditworthiness of Lessee

A fourth argument utilized by the advocates of leasing was that leasing obligations were not required to be reflected on the lessee's balance sheet as debt. Hence leasing equipment (as opposed to purchasing it) would not affect existing credit lines with lenders and suppliers. Such lines are, of course, predicated in part upon the amount of debt incurred by the debtor. To the prospective user or lessee, this argument had great appeal. This is explored further on page 244. While the no-debt argument was advanced by the

sales department, the credit department of the financer was usually more circumspect. In practice, no financer considered advancing the cost of a specified piece of equipment for the lessee without being reasonably certain of the capacity of that lessee to repay the advance. Or, in the alternative, the financer had to feel that the equipment itself had sufficient liquidation value so that in the event of lessee's default, the lessor could recapture his investment through a sale of the equipment.

Since the lessor expects to be repaid—as does the financer under an installment sales contract—the credit standards should be the same for both devices. This obviously contradicts the popular notion that an applicant who is too weak financially to qualify for installment sales financing can solve the problem by seeking a lease. Patently, if a prospect does not qualify for purchase money security interest financing with, for example, a 10% down payment, there is nothing in a lease that improves his credit. Conversely, if the credit factors warrant approval for lease financing, they would also qualify for installment sales contract financing. In short, in this context, leasing must be deemed just another form of equipment financing and the same credit standards should be applied. All facts about a company's financial condition should be examined—its operations and its ability to meet its obligations, including its lease obligations.

## "TRUE" LEASE VS. DEBT

### Effect of Filing

It has also been argued that additional recognition of a lease as debt is found in the filing by lessors of financing statements under the Uniform Commercial Code or the recording of the lease with the proper agency in non-Code states. The method of perfecting security interests in equipment is described in Chapter 7. That discussion is equally applicable to leases. Such filings make leasing transactions matters of public knowledge. By this action the lessor, it has been urged, puts future creditors on notice that such leases are debts. Hence the argument that a lease is not fixed debt became considerably weaker. Certainly this conclusion would be valid in a "finance" lease, and the filing would therefore be a vital protection to the lessor.

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a safer method than relying upon an identification plaque that can be removed from the equipment. It can therefore reduce some potential identification disputes with trustees in bankruptcy, receivers, etc. Conceivably, therefore, the lessor of a "true" lease with limited non-cancelable payments and large reversionary interest might also wish to file a financing statement. Such filing would also protect his security interest in the event that a referee in bankruptcy subsequently were to hold his agreement to constitute an installment sales contract. A filing without prejudice (i.e., with appropriate language describing the transaction as a "true" lease) would then constitute an insurance policy with nominal premium. Hence the filing per se of a financing statement does not resolve the problems of whether the lease obligations are debt and to what extent.

## Legal Criteria

The legal criteria for classifying a lease run as follows: A true lease exists if the lessor's reversionary interest has a substantial economic value. On the other hand, if the exercise of a nominal monetary option enables the lessee to take title at the end of the lease term, then the lease may be considered a finance lease or quasi-purchase. Here the lessee would find it economically unsound to forego his option. In such case, the lessee has, during the lease term, virtually paid for the equipment plus the use of the funds employed in financing it.

The standards paraphrased above were set forth in many pre-Code statutes. In essence, they also represent the intent of Section 1-201(37) of the Uniform Commercial Code defining a "lease intended for security."

Obviously the determination of the facts and the development of conclusions making such standards operative will vary in each case. The relative novelty of the leasing format sometimes makes prediction of a court decision in a particular case uncertain. Because of a dearth of established authority, the decision may frequently turn on the predilections of the particular judge or referee and/or the matrix of circumstances from which the case arises. For example, if a large piece of leased equipment (with no financing statement filed therefor) lends an aura of affluence to the bankrupt, a persuasive creditor's attorney may convince the referee that the transaction is a purchase. Then the absence of a financing statement might throw the equipment into the general creditors' pot. This problem points up the advisability of filing a properly worded financing statement (without preju-

dice) covering a true lease. Lessee resistance to such a filing may develop because the possible balance sheet advantage (no debt) may then be lost.

## Accounting Treatment

The problem of whether leasing obligations should be treated on the balance sheet of the lessee as fixed debt has been examined by the accounting profession.

**A.I.C.P.A. Criteria.** In 1964 an opinion of the Accounting Principles Board of the American Institute of Certified Public Accountants set forth guidelines for the reporting of leases in the financial statements of lessees. In doing so it made no "distinctions between leases of real property and leases of personal property." It is not clear why such distinctions were not made. It is submitted that such distinctions can be made and probably would be very useful. In any event, Opinion No. 5 recommends that where a lease arrangement is in effect a purchase, then the accounting treatment should indicate the asset and liability involved. The Opinion is expressly applicable only to non-cancelable leases (or leases cancelable upon a remote contingency) and sets forth some criteria to determine whether the lease is actually a purchase. Any one of the following criteria would indicate that a lease is a purchase:

1. The property was especially acquired by the lessor for the lessee and is probably usable only by the lessee.
2. The lease term corresponds to the probable usable life of the property; and the lessee is obligated to pay costs such as taxes, insurance, and maintenance.
3. The lessee has guaranteed the lessor's obligations with respect to the property.
4. The lessee has treated the lease as a purchase for tax purposes.

The Opinion attempts to standardize the accounting treatment and apparently seeks to set more stringent standards than formerly prevailing. It is submitted, however, that many routine leasing transactions would fall outside the criteria established. For example, a lessor purchases a lathe having a ten-year life for a particular lessee and leases it to him for five years with a nominal purchase option at the end of the lease term. Although the property was purchased for the lessee it is usable by not only the lessee but others as well. The lease term does not correspond to the usable life of the property. The lessee has not guaranteed the lessor's obligations, nor has the

lessee treated the lease as a purchase for tax purposes. Nevertheless, here the initial term is "materially" less than the useful life of the equipment. Hence, under paragraph 10 of the Opinion it should be reported as a purchase. However, if the useful life were six years and the initial term five years, a grey area obviously would develop. Further, if the total lease payments are small in relation to the lessee's net worth, accountants reasonably might differ on the proper treatment. Some accountants would feel justified in not reflecting such lease obligations on the liability side of the balance sheet.

**Adequate Disclosure.** To the layman some distortion of the lessee's financial position seems to result. Indeed, such a possible buildup of equipment leases, unreflected on the balance sheet, presently constitutes a major attraction for leasing deals. Where, however, the lease obligations appear to the lessee's accountant to be material (in relation to net worth, for example) he may feel compelled to footnote them. Assume now that the lessee's accountant feels compelled to report in the footnotes of the balance sheet the type of lease above described. It seems highly unlikely that the average reader of the statement would be able to absorb the full import of such information. It has seriously been questioned, therefore, whether footnoted information of this nature is properly presented, for such presentation resembles the raw materials of a financial statement, rather than a finished product. It is in this twilight area that a very real and significant, albeit intangible, advantage exists for leasing deals.

**"Hell-or-High-Water" Clauses.** It should be noted that most leasing agreements contain what have become popularly known as "hell-or-high-water" clauses. As indicated by the colorful description, these clauses require the lessees to make the agreed payments to the lessor notwithstanding operational difficulties encountered in the equipment. It therefore frees the lessor of any warranties relating to the equipment, for the lessee must make payments come "hell or high water." Such a lease seems to resemble very closely the installment sale contract in which the lender's security interest is free of the manufacturer's warranties. Nevertheless, as above indicated, the lease obligations may not necessarily appear as balance-sheet debt.

**Lessee's Equity in Equipment.** Another difficulty arises in the accounting treatment which revolves around the condition that lease obligations may be reflected as a liability, provided the lessee is developing an "equity" of some kind. Apparently this need not neces-

sarily be an ownership equity. Presumably it can be a "use" equity. Understandably, accountants are reluctant to assign a value to this "equity" because such evaluation falls into the realm of economics rather than accounting. It may be asked why the total amount of the firm commitments for lease payments could not be capitalized as a "use equity." Here, the use of the cost figure appears reasonable. Whatever the merits of this issue may be, the net result of the present treatment is an absence of a reportable asset and corresponding liability. Consider the case of a ten-year, non-cancelable lease on equipment having a ten-year life. There are no options at the end of the lease term. Assume that it otherwise falls within the conditions of Opinion 5 described above. No equity seems to be accruing to the lessee, and therefore an accountant would feel justified in omitting the reporting of the lease liabilities. On the other hand, the same equipment on a ten-year installment sales contract would result in balance-sheet debt for the purchaser. The reason for the difference in treatment seems tenuous, but the lessee apparently gains an advantage over the purchaser. This advantage, however, could mislead the lessee's creditors. It could also encourage the lessee to over-extend himself.

## BANK LESSORS AND THE INVESTMENT TAX CREDIT

The year 1962 was pivotal for equipment leasing. In that year a ruling of the Comptroller of the Currency authorized national banks to purchase and lease capital assets. This, of course, encouraged national banks to enter the field and will probably also exert pressure on state banking authorities to grant similar powers to state banks. (This became an actuality for New York State in 1966.) The year 1962 brought another fundamental change to the leasing field. This was the amendment of the Internal Revenue Code to provide for the 7% investment tax credit. The tax credit could be taken by the lessor or passed on to the lessee. The accelerated depreciation (set forth in the Internal Revenue Code of 1954) could not be passed through to the lessee. The maximum of 7% (which constitutes an abatement of final tax otherwise computed) is available where the equipment has a usable life of eight years or more. It drops to 4.66% for an asset with a usable life of at least six but less than eight years and to 2.33% for an asset with a usable life of at least four but less than six years. These provisions were designed to encourage capital investment and thus stimulate the economy which was felt to be growing insufficiently at the time. The adminis-

tration's desired result was soon realized, and the impact of the provisions was dramatic. Commitments for the acquisition of capital equipment burgeoned substantially. Leasing and other devices for financing these orders all blossomed.

## Low-Profit, High-Investment Industries

For the equipment leasing field, two major new concepts resulted. The first centered around industries that were not particularly profitable and therefore could not take direct tax advantage of the investment tax credit and accelerated depreciation features. Among such industries were railroads, trucking operations, and some airlines. Lessors could utilize the new tax credit and the accelerated depreciation features of the old law and then pass on the saving to the lessees in the form of interest rates, reflected in very low downpayment requirements and low leasing payments. In this area leasing held a unique advantage as compared with other financing techniques. Since the equipment involved jet aircraft, railroad cars, trucks, etc., with large dollar value per unit, the total dollar volume of such transactions mounted rapidly and substantially. Since the leasing company effects substantial tax savings by these two tax devices, it can ease the burden on the lessee and still profit handsomely on its investment.

## Non-payout Lease

Another leasing development fostered by the dual tax advantages was the non-payout lease. This form of lease provides for a firm commitment by the lessee for a total amount which will not recover for the lessor the full cost of the equipment. Options to renew the lease or purchase at the then fair market value may then be available to the lessee. This method of leasing covers very select types of equipment such as jet aircraft and computers where manufacturer support is available to the lessor. This support may consist of the manufacturer's guarantee to cover any loss on the final disposition of the equipment up to an agreed percentage of original cost. The lessor's ability to utilize the accelerated depreciation for its tax purposes is here clearly established by the very non-payout structure of the arrangement. In setting up its deal, the lessor relies upon expert opinion regarding the future value of the equipment at key points of time.

Large leasing companies engaged in this activity are optimistic regarding the future outcome of their arrangements. Predictably,

the non-payout lease will flourish in the fields dealing with equipment that has developed or can very probably develop markets for second- and third-hand units. Such equipment would have some determinable market value for many years. The automobile is such an item of equipment, and the non-payout lease (including maintenance) developed early in that field, even before the advent of the investment tax credit. (It also flourished in the consumer area.) It seems quite likely that a parallel development is in the offing with respect to jet aircraft and computers. The anticipated wide demand for such equipment apparently has and will continue to create subsidiary markets for second- and third-hand units, thus assuring the lessor of their saleability. These markets eliminate the lessor's need for the above described manufacturers' support.

### Effect of Government Regulation of Economy

Current economic thought includes the regulation of the economy by monetary, fiscal, and tax policies of the Federal government. As indicated above, this theory gave rise to the legislation regarding the investment tax credit and the earlier accelerated depreciation provisions in order to stimulate an economy then considered sluggish. Conversely, when a rapidly expanding economy exhibits inflationary tendencies, these regulators may be reversed. The economic valves that were opened may then in effect be closed. Such a possibility could readily result in a repeal or suspension of the favorable tax provisions, and in such event, some of the above described competitive advantages may be lost permanently or temporarily. The temporary suspension of the investment tax credit during the latter months of 1966 and early 1967 is a case in point.

The survival of one by-product of the investment tax credit seems assured. By and large, as discussed above, the non-payout lease technique probably will continue to be a viable device.

## THE EQUIPMENT LEASE TRANSACTION

Let us follow through the practical application of a financial leasing transaction. XYZ Corporation is interested in a certain piece of equipment, perhaps a large piece of plastics machinery. The prospective lessee contacts a financer, giving it the specifications of the equipment, the vendor, the cost, and the length of time for which he wishes to lease it initially (see Fig. 11-1). The initial term is

TO: XYZ LEASING CORPORATION

**LEASE REQUEST**

**COMPANY**

Name of Company: XYZ Corporation
Address: 23 South Street, Newark, New Jersey
Type of Business: Manufactures Plastic Toys — Telephone Number: ______
Person to Contact: John Smith — Title: President
Form of Organization: Corporation ☒ Partnership ☐ Proprietorship ☐
State of Incorporation: New Jersey

**EQUIPMENT**

Seller's Name: XYZ Plastics Company — Address: First and Main, Wheeling, West Virginia
Manufacturer's Name: XYZ Automatic Tool Company — Address: Richmond, Indiana
Equipment Description (Attach Descriptive Literature, Sales Brochures, Specifications and terms if any)
Model #: 123AB 456 — Equipment: Plastics Molding Machine

(Continue on Separate Sheet)

Equipment is: ☒ New ☐ Used — If used, how old is the equipment: ______ Yrs.
The Equipment will be used for: Production of Plastic Toys
What Phase of Process: Molding of Raw Material
The Equipment is specially designed or built for intended use: ☒ Yes ☐ No
The Equipment is to be modified for particular use: ☐ Yes ☒ No
Cost of modification, if any: $______ Number of Shifts to be run: Three
Has your own purchase order been issued: ☐ Yes ☒ No (If Yes, Please Attach Copy)
Has an invoice been received: ☐ Yes ☒ No (If Yes, Please Attach Copy)
Has the Equipment been shipped to or received by you: ☐ Yes ☒ No
Cost: $ 85,000.00 — Sales Tax: $ None
Terms of Lease: Sixty Months — Desired Delivery Date: February 15, 19X6
Equipment to be located at: 123 North Street
Owner of premises: 123 North Realty Corp. (Name) — Same (Address)
Will Equipment be attached to realty? If so, how? No
Shipping instructions: Best Way

**CREDIT AND FINANCIAL**

Trade References: ______ Address: ______
______ Address: ______
______ Address: ______
Bank References: XYZ Bank — Address: ______
______ Address: ______
______ Address: ______

STATEMENT ATTACHED FOR FISCAL YEAR ENDING December 31, 19X5 Interim statement attached for ____ months period.
Other equipment presently leased ☐ Yes ☒ No — If so, total unpaid rent $______ Term ______

DATE:

We hereby request you to acquire the above Equipment and lease the same to us on the terms hereof and of any lease submitted to you herewith. This Lease Request includes the terms and conditions appearing on the reverse side hereof.

XYZ Corporation

By ______
Title:

Fig. 11–1. Lease Request

**TERMS AND CONDITIONS**

---

1. In consideration of your ordering or purchasing Equipment (of which no notice need be given to us) we agree that thereafter our offer to lease Equipment on the terms hereof and of any lease submitted to you herewith cannot be revoked. We agree to indemnify and save you harmless from any liability to seller and/or any other party arising from or in connection with this Lease Request and/or the purchase of Equipment and leasing thereof, and in case of dispute with seller or other party we will pay you on demand any amounts theretofore paid by you in respect of the purchase of Equipment (in which event we shall be subrogated to your claims, if any, against seller and/or any other party.)

2. All delivery, transportation, shipping, storage, installation and testing charges shall be paid by us.

3. We agree that all inquiries and communications directed to seller will be made through you.

4. We represent that execution, delivery and performance of this Lease Request and the lease have been duly authorized and will not violate any provision of law or our charter or by-laws or any indenture, loan or credit agreement or other instrument to which we are party or by which we or our property may be bound or affected; and that the financial statements submitted herewith have been prepared on the basis of generally accepted accounting principles, and are complete and correct and fairly present our financial condition as at the dates thereof.

Fig. 11–1. Lease Request—Continued

usually determined by the cost of the equipment, its usefulness to him, and its depreciable life, or any combination thereof.

## Credit Analysis

The financer thereupon makes a thorough credit analysis of the prospect. This includes reviewing balance sheets, profit-and-loss figures and trade and bank references. The financer also analyzes the prospect's need for the equipment and the liquidation value of equipment itself. In short, the procedure parallels that for an application for purchase money security interest financing.

## The Lease Agreement and Acquisition of Equipment

If satisfied, the financer prepares the lease agreement which is executed to ensure a commitment on the part of the lessee (see Fig.

DELIVERY-INSTALLATION AND ASSEMBLY CERTIFICATE

Dated February 21, 19X6

TO: XYZ LEASING CORPORATION

Gentlemen:

We hereby acknowledge complete and satisfactory delivery, assembly and installation of the equipment supplied by XYZ Plastics Company and described in the Equipment Lease Agreement, Number 12345, between us dated February 1, 19X6. We approve payment for said equipment.

XYZ Corporation
Company

By (title)

Fig. 11-2. Delivery Acceptance

11-3, page 253). Then the purchase order is accepted and the equipment ordered. In short, a commitment to lease is required from the prospective lessee before a commitment to purchase can be given by the prospective lessor. The prospect's purchase order is transposed to the leasing company's form of purchase order (see Fig. 11-4, page 260) and submitted to the particular manufacturer with instruction to bill the leasing company and ship to the lessee. Upon completion, the manufacturer ships the equipment.

## Acceptance of Delivery

Upon receipt and installation satisfactory to him, the lessee notifies the lessor thereof via a delivery acceptance form (see Fig. 11-2). The lessor-financer then pays the manufacturer, puts the lease on its books, and proceeds to bill the lessee on a monthly or other pre-determined basis.

## Expiration of Lease

At the end of the lease period, the lessee may elect to buy the equipment from the financer for a pre-determined percentage of the agreed cost or re-rent for an additional period at some other percentage. These percentages will vary, but they will usually be tailored to the desires of the lessee. He will normally have paid during the term of the lease the cost of the equipment purchased on his behalf plus the desired return on the lessor's investment. Hence, the usual lessor does not consider the options part of the necessary return on its investment. This can be left open in the initial stages of the transaction.

In sum, therefore, equipment leasing has several facets. Financers and leasing companies make the techniques available. As is so frequently true in other matters, a decision based on full consideration of related facts and problems constitutes the soundest and most successful course.

outlining the potential of service expansion to broadly define the bank's customers. A definition of markets might be as follows:

1. The general public—consumers. The "retail" market.
2. The business community.
3. The banking community.
4. Government, quasi-public, social, and institutional agencies.

While such a grouping may be a helpful beginning, it does not, by itself, supply us with ready knowledge of the present and changing needs of each group. It is only in terms of such knowledge that services are born. It is as true of rainy day umbrellas in bank lobbies as it is of computerized accounting services for small business.

## THE USES OF DIVERSITY IN BANK SERVICES

### Charting Changes and Establishing Marketing Programs for Them

In a rapidly moving society, the commercial banker must be a student of change. He must learn how and why needs change. He must understand the underlying social changes and the changing technologies as they relate to the demands for banking service. This kind of knowledge is perhaps banking's greatest challenge. In terms of the magnitude of many of our markets, it is no longer possible to simply guess at or generate a "feel" of things. New services are expensive to establish and promote. Industry has long ago proven that the risk of unprofitable products can be minimized by formal marketing approaches and techniques.

Commercial banks are more and more finding that the shortest route to this knowledge is the establishment of formal marketing programs, staffed where possible with professional personnel. Where this is not feasible, the bank may still establish such a program using outside professional services to refine specific services, define markets, and pretest market acceptance and pricing.

But establishing such a marketing program in the hands of an executive committee is no guarantee of success unless the bank executives themselves stand ready to translate such knowledge into programs and services. Too many banks in the past set up public relations departments because they didn't want to be "the only one on their block" without one. The main problem in marketing, as an American Bankers Association-sponsored study showed, is the failure of both management and department heads to understand and use it effectively.

The reason why banks should formalize their marketing programs is the same reason why the discount committee meets according to a regular schedule. It serves to commit the bank to a recognition of the place of such knowledge in its role as a service center as well as to regularly focus administrative attention on this area. Whether a bank is an originator, an

innovator, or imitator (and even the best will be all three), the important point is to insure that good intentions are not mere paving blocks to inaction.

A good way to start, for instance, is to appoint at least two officers—or an officer and a senior employee—to develop a marketing approach. A schedule should be drawn to provide a definite length of time each week with a specific subject to be discussed and acted upon. As a beginning, a list should be drawn of all financial services offered in the area by all types of financial institutions. This would include automobile financing companies, for instance. While such an approach may sound elemental, it will go a long way to determining just how full a line of services the bank offers.

It will also serve to formalize the bank's own fledgling marketing move and direct attention to what services and rates the bank can offer. To the extent that other institutions are successfully offering financial services the bank itself might offer, this can lead to healthy questions regarding bank policy and operations. While the development of new services may sound exciting, the expansion, modification, and refinement of old ones should not be forgotten. In many cases, new services are only sophisticated extensions of old services.

## THE CONSUMER PUBLIC

While primary market attention for most businesses is on the consuming aspect of individuals, commercial banks' interest is twofold: the general public is both a consumer of services and a saver. The broad rise in incomes following World War II has been followed by steady growth in savings of individuals. Indeed, it may well be that the effects of the past three recessions have been increasingly milder because of the cushion of savings which enables individuals to maintain spending levels even in the face of short-term unemployment.

This, in turn, has meant increased effectiveness in control of the business cycle through monetary and fiscal measures. If this assumption is borne out in the future, it will result in a still broader rise in income throughout the population as well as a rise in per capita income itself. As this happens and more reliance is placed on insurance and pension plans to safeguard against the circumstance of sickness, disability, unemployment, and old age, savings may not increase markedly from the present ratio of 8 percent of disposable income. In addition, discretionary income—that left over after cost of food, clothing, and shelter—may continue its long-term trend of rising faster than living expenses.

Based on a 1950 standard of living concept, discretionary income by 1975 may double what it was in 1964, rising from $234 billion to $462 billion. Living costs based on an increased population of 231 million will probably rise by only a fifth.

Discretionary income has been outpacing consumer credit in recent years and by all indications will be able to sustain an even greater expansion of consumer debt which reached $76.5 billion at the end of 1964.

Saving, spending, and borrowing—these are the aspects of the market. New savings will come from the heavy waves of new savers in the population, to a lesser extent from the increased dollar savings of existing savers as their incomes rise. The place of a school savings program becomes clearer seen in this light. It is one of the best investments any bank can make in its own future.

A growing population will be spending more, but individuals may not always be spending it on goods. The swing to buying services and leisure time pursuits has been noticeable. Consumer credit will expand, but what the character of the expansion will be, its magnitude, and what income levels it will touch are not entirely clear.

### Identifying the Saver-Spender-Borrower

Too often the banker has seen the general public as a separate borrower, or saver, or spender. This would rarely be the case with commercial accounts whose borrowing makes them depositors as well. Even where recognition has been made of the frequent identification of saver and borrower as the same person, service promotion has too often taken the line of impersonal appeal of generalized statement-stuffers rather than concrete programs incorporating this identification.

It is often easy to overlook this simple fact while searching for new markets for services. There are literally thousands of dollars of profits to be mined from within the bank itself, if only the effort is made to reach the bank's own customers. After all, what better place to start to sell than with those who are already buying one or more services?

One doesn't need a computer to solicit checking account customers for automatic savings plans or savings certificates. No involved marketing study is needed to go after the bank's larger depositors to sell trust services. And if we expect our business borrowers to maintain a compensating balance with us, would it be totally unrewarding to suggest to smaller borrowers while they are at the bank that they might open a modest savings account with part of the proceeds? Some recent loan-savings plans are already a step in this direction.

One of the benefits of machine accounting systems is that they will enable bankers to analyze their own operations and customers more easily and discover the different aspects and needs of the same customer at different times. There is nothing mysterious in this. The rural banker who anticipates heavy spring borrowing from his agricultural customers is only utilizing marketing knowledge learned from experience.

The big difference from that simple example and what banks now face

is the difficulty of acquiring that knowledge due to increase in numbers of bank users and the proliferation of services. That difficulty is now past us. From large city bank to small rural bank it can be quickly overcome with the use of sampling techniques and computer equipment, whether the bank's own, or nearby service center, or its correspondent.

## New Services Offer Insight into Consumer Needs

A glance at some of the new services that have been offered by banks in recent years can give us some insight into the divergent needs of bank customers. A partial list would include:

Open end mortgages. Utilizing a single credit instrument to finance home improvements, education, medical bills, and even autos.
Limited credit line plans. So-called instant credit.
Condominium loans.
College tuition loans.
Merchant charge plans.
Marine, aircraft, and mobile home financing.
Small business term loans.
Common investment funds for pensions of self-employed persons.
Loan-savings plans.
Savings incentive programs. Split rate plans, savings certificates bearing differing rate of interest for long-term savings.

The use of the open end mortgage is a good example of combining long- and short-term needs of a borrower into a single credit instrument. The rise in home ownership following World War II has created a broad market for such an instrument. But the mobility of the population, the turnover of homes, and the need for a national mortgage market which may not be able to cope with the ability of the local borrower to repay his short-term credit needs indicate that the open end mortgage may only be a stepping-stone to what is a sketch of the future.

If the trends indicated by the 1960 Census of Population are any guide, over 30 percent of the banks' 1960 local and regional markets will have moved away by 1970. Perhaps 55 to 60 percent will have changed their residences. The limitation of a credit instrument tied to residence is clearly seen. Of more importance is the credit worthiness of the individual himself based on his experience.

Such an approach suggests that an automated credit exchange linked with others in a national network might be in a more advantageous position to handle consumer credit than an individual bank. Such a network, through a single credit card, for instance, could handle the transactions of department stores, merchants, gas stations, restaurants, auto dealers, and utilities.

The equipment for such centers is already here, and the feasibility of

such a system can be demonstrated. New telephonic equipment, voice identification, memory units and on-line accounting equipment will require only supervisory personnel.

The question will not be whether such a system will evolve. Some such system will certainly evolve. It is already being suggested. The question is whether banks will operate it or whether they will be simply supplying funds to others.

Commercial banks now have a lead. According to Dr. Martin Greenberger of the Massachusetts Institute of Technology: "They already enjoy a confidential relationship with their customers. They have a good understanding of American industry and finance. They are knowledgeable in international affairs. They are accustomed to processing a large volume of information. And they are familiar with the ways of networks, through branch and correspondent banking and membership in the Federal Reserve System."

Such a system need no more eliminate competition or erase the identification of existing institutions than credit bureaus and clearing houses now operated by a group of banks

As a matter of fact, by reducing the time of bank personnel in record keeping, credit processing, and accounting, and expanding their own knowledge of credit and customer activities, it will place them in a better position to assume the role of financial advisor as well as to devise new means to meet changing needs and social conditions.

Widening the commercial banks' service role will also call for projecting a new image of banking through education of the public and business. Insurance companies, for example, have long since discovered this. They do not sell insurance. They offer themselves as financial counselors. They have devised a multitude of insurance plans so that a combination of them may fit the needs of individual families with varying circumstances. The image the insurance companies have succeeded in creating is that of guardian of the family hearth and security. The insurance agent is more and more achieving a role somewhere midway between the lawyer and family doctor.

Yet, banks have the broadest means of devising appropriate financial programs and the instruments needed to carry them out. They are in the best of all positions to offer valuable and neutral advice. Commercial banks will in the future have to learn to sell more than specific services. Oil companies not only sell gasoline. They sell car care, and courtesy, and weave an air of expertise about the station attendant designed to inspire faith on the part of the motorist.

Electronic data processing will make it possible for the bank to assemble profiles of its customers and to achieve greater selectivity in selling specific services. Banks will be able to select officers of corporations who do

not have personal accounts with banks, or accounts of a certain level of dollar balances who may be prospects for the trust department.

### Mass and Class

One need in the expansion of commercial bank services is a shifting from the mass market approach too frequently used, the one service for everybody concept. Consumer goods manufacturers long ago learned that markets are actually "fractured," composed of groups or segments of the public differing in their demands and needs by geography, incomes, and social backgrounds.

Retail distributors recognize this when they distribute their products according to line and price in those markets where the products are designed to appeal. To cite an obvious example, a distributor of Italian food products would not spend equal amounts of selling time in Italian and Chinese neighborhoods.

While this has been generally recognized in dealing with commercial and industrial customers and prospects, as well as in the trust department, the same techniques can be used in dealing with the general public, particularly in urban areas where most of the commercial banking business is concentrated. The following is only one example.

### The Prestige Market

The general rise in income levels has resulted in an enormous increase in the upper group of the income range. By 1963, *Sales Management* magazine estimated that over 10 million households in the United States had incomes of $10,000 or more, a 70 percent increase since 1959. This was nearly 18 percent of the total of 56 million families.

It is this higher income group—centered in cities and suburbs—that has given rise to an increasing demand not for goods alone but for personal services and leisure activities of all kinds. It is within this group that urban banking may well find a receptive market for a development of a prestige banking service such as is found still in Europe today in which the bank functions as bookkeeper, accountant, and business manager for the personal financial affairs of individuals.

Equally valuable is the fact that many persons of means are also the same business leaders whose corporations the bank has been attempting to attract. What better way to demonstrate the ability of the bank to service the needs of companies than through the owners and chief executives themselves?

Payment for such services has traditionally been achieved through the return on balances maintained with the bank. Using automated accounting, the commercial bank may well find this kind of service not only profitable but the experience may also prepare the bank to expand the

service on a straight fee basis where the widened market may not produce adequate compensating balances.

## BANKING AND THE BUSINESS COMMUNITY

The business community is the bank's "natural" market. It is one that the commercial banker knows best and has lived with longest. With the technological breakthrough of the past decade, commercial banking stands at a point where knowledge and ability to perform are limited only by imagination.

The commercial banker enjoys a unique position. He sits in the center of the world of commerce and industry, and from time immemorial he has been regarded as a knowledgeable advisor. Unfortunately, since the end of World War II when industry here and abroad faced the tremendous challenge in rebuilding a civilian economy, this role has not brought with it the easy flow of demand deposits that banks had previously enjoyed. Companies were understandably pressed for cash and pressed for means of utilizing cash flow and the securities markets to finance their expansion. With commercial banks no longer able to engage in the securities business, their means of attracting compensating balances turned increasingly to generating new services and financing methods to enlarge their usefulness.

A sample list of new services developed by commercial banks over the past few years shows the trend:

Clearinghouse plans to settle interline freight bills.
Lease financing of chain store furnishings and equipment.
Construction equipment financing.
Merchant charge plans.
Establishment and investment in Small Business Investment Corporations to meet the capital needs of small business.
Mutual or common trust investment funds for small fiduciaries.
Accounts receivables financing.
Payroll accounting services.
Business and farm management trust services.

### The Technological Breakthrough . . . and Break-even

There is no doubt that the new data-processing equipment and corresponding systems form the foundation of the revolution in business and industry, including banking. If more and more banks find that they cannot build without this foundation, they may also find that they have prepared themselves to move onto the wider stage of business service centers by selling computer services to their customers.

This is not to suggest that there is a clear, easy road to profits. But researched, and sold properly, banks will find that fees from such services will build a hedge against the increasing cost squeeze. The "but" is a big one because of the costliness of misjudgment. Markets and fees should be

carefully evaluated. Banks should concentrate on broad markets where the same service can be sold to a number of customers. Services that have already been attempted by some banks are tenant billing for building owners, and professional billing for doctors and dentists.

Another new service that has been developed by banks is an automated payroll accounting system for business. Because volume and calculations are no obstacle to electronic data-processing equipment, the plan can be merchandised to a large number of companies both large and small. It virtually eliminates payroll accounting on their part, reducing routine operating expenses. And since it can provide firms with detailed cost reports by department, product line, or contract, it should prove useful in increasing their overall business efficiency.

From employee and payroll information transmitted by the employer, the plan provides these reports to the company:

1. Payroll register or journal with details of hours, earnings, automatic overtime computations, deductions, and total earnings and deductions to date.
2. Employee ledgers covering each employee, delivered to the company every six months, or more often, if required.
3. Payroll checks. The check portion can be substituted for a receipt for cash payment or for a deposit slip to be credited to the employee's account at any office of the bank. Alternatively, stuffed cash pay envelopes can be delivered to the company.
4. Summaries by department, product line, or contracts.
5. Automatically prepared federal and state quarterly reports on earnings and withheld taxes including FICA information. These reports can also be filed for employers.
6. Annual W-2 statements for each employee.

While there may be some payroll accounts that may prove too costly to handle except on a negotiated fee basis, nearly all firms will make up the market for this service. Payroll accounting is a good example of the kinds of services that will prove profitable to develop. Banks should be careful not to develop a service that is locked in to only one customer need—such as automated inventory control for a single department store. Or a service that does not really meet all the customer's needs.

It is also necessary to design the service in such a way that costly time-consuming steps are eliminated. This may even mean a change in the user's operational habits. In the payroll accounting system, for instance, the preparation of individual employee ledgers is done only once every six months, or no more than quarterly in order to reduce the machine time costs of the service.

The important factor is the fee. Services should not be tied to a compensating balance unless the bank has made a thorough analysis of the return on such balances and what the true costs of the services are.

In the long run, this is the ideal time to move away from compensating

balances to a fee method of payment. As banks learn to utilize their electronic equipment to determine their true costs, they will be able to determine more adequately than at present the balances necessary to support the services they render and the fees to charge in the absence of such balances.

### For Sale: EDP Services

Research has already indicated the kinds of markets that commercial banks can tap for computer services. Even smaller banks, for instance, can process payrolls for medium-sized companies and some local governmental agencies. They can also handle municipal, hospital, and central school accounting. In this field, banks should remember that they are selling a service: the customers come first, not their own internal bank processing.

More specialized services were outlined at a National Automation Conference of the American Bankers Association. The services range from ones designed for urban markets to those for rural areas.

1. *Automobile Dealer Accounting.* The monthly preparation of journals, general ledgers, and sales and expense reports.
2. *P .l Estate Multiple Listing.* Providing data on homes and apartment buildings for sale in a metropolitan area to realty brokers. The bank would regularly print for participating realtors the location, style, selling price, number of rooms, taxes, plot size, and other facts on homes in an urban area.
3. *Financial Planning Services.* The market is primarily for small and medium-sized companies. Services would include: analysis of alternate financing plans; corporate portfolio analysis; calculation of minimum tax liability; pension plan development and fringe benefits cost.
4. *Farmer Credit Plan.* Farmers would be given a line of short-term credit at the bank. Merchants and wholesalers would sell goods based on the farmer's credit and be paid by the bank. One deterrent to this plan is that many merchants give free credit. Fee income would be negligible, with revenue realized from short-term interest rates.

### Industrial Development

Commercial banks are certainly not new to industrial development in their areas. What is new is the intensive pursuit of this activity as a formal program within the bank with one or more persons assigned on a full-time basis, much as the railroads and utilities carry on this activity.

United States industry is still very much on the move. If a bank is located in an area where new development has taken place, the bank can accelerate and aid the process through cooperative efforts, dissemination of information, solicitation, and direct contact. Contact with realtors, for instance, may reveal advance information about the interest of a company. Information may come from a present customer, or a correspondent. A sign of welcome and an offer to obtain information on a confidential basis

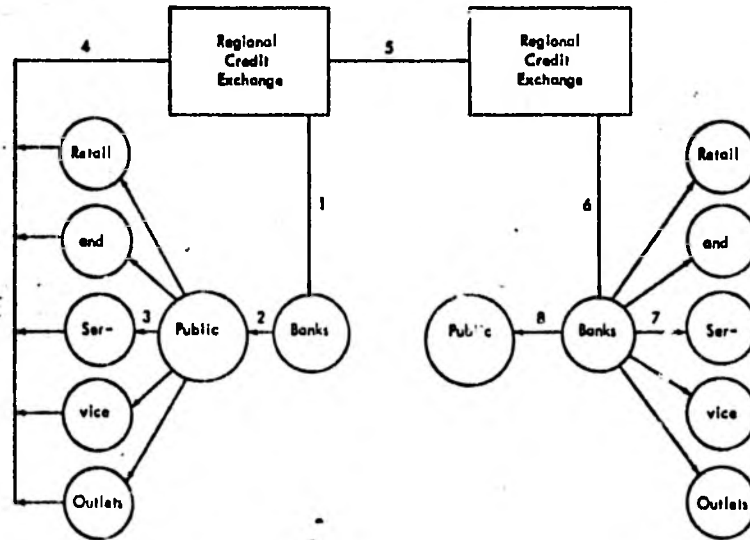
may go a long way not only toward creating a favorable attitude in locating a plant but also in securing the new account.

Industrial development is very much a part of business development and can be used to implement the sales efforts of branch managers or officers in a call program.

The collection of data pertinent to the area may or may not be necessary, depending on the availability and dissemination of local industrial development groups or the chamber of commerce. The bank may find it useful, however, to prepare periodic comments on business conditions and a simple index of business activity useful to prospective employers.

## CORRESPONDENT BANKING

Correspondent relationships between banks were born out of the need to collect drafts and checks drawn on out-of-town banks which their business customers deposited with them. Out of that simple need has come the multitude of services—spurred on by par clearance and the Federal




Simplified diagrammatic sketch showing how a network of regional credit exchanges might work in consumer transactions. (1) Bank receives credit advice on individual from exchange preparatory to a loan to consumer. (2) Using this advance, or credit devices such as credit cards or voice identification, consumer makes purchase through retail and service outlets. (3) Transaction data from outlets is transmitted to exchanges. (4) Exchanges would either forward transactions applicable to customers of individual bank when the bank is a member of the exchange, or through a network arrangement, transmit data to another exchange (5) which in turn would transmit data to member bank (6) for adjustment of individual accounts (7) and (8).

**FIG. 74–1.** Hypothetical operating sketch for a network of regional credit exchanges.

Reserve System's free check collection service—that are now grouped under correspondent banking. Services which run from asset allocation studies through loan participation and personnel searches to year-end stockholder reporting.

The future will not diminish private banking's correspondent relationships. If anything, what has been sketched for the years ahead indicates a further drawing together and strengthening of those bonds. One of the most valuable things to be derived, for instance, will be, increasingly, the knowledge and experience of "lead" banks, whether they are large or small, in developing and extending new services to the various publics.

In the evolution of some such national credit exchange network, it is unlikely that, given the measure of competition between banks, any single system will be established. Undoubtedly, credit exchanges will be set up by one or more banks in a commercial center tied to banks in other cities throughout a state or a geographic region and linked to other regional or center exchanges for operational convenience. Debits arising from this operation could well be settled through the use of balances such as with the system already in use. As such, therefore, it will be a bold expansion of the correspondent banking system and should instill new vigor into a unique American institution.

HB-643

AMERICAN BANKER April 14, 1970

# Direct Lease Financing At NBs Up to $693.8 Mil.

WASHINGTON.—Direct lease financing operations of the country's national banks climbed to $693.8 million as of Dec. 31, 1969, compared with $646.7 million last June 30 and $541.9 million at the end of 1968, Comptroller of the Currency William B. Camp said.

During the first six months of 1969, the number of national banks engaged in direct lease financing increased from 303 to 341; by the end of the year the total stood at 353.

Direct lease financing involves bank purchase of equipment—such as computers, vehicles, machinery and the like—and its lease to other users on a fee basis. The dollar totals reported by the banks engaged in this service reflect the leasing contracts outstanding.

Fifteen California banks reported $276,598,000 in direct lease financing outstanding at the end of 1969, while 10 New York banks reported $113,547,000 and 27 Illinois banks reported $68,853,000 in outstanding leases. Various amounts of direct lease financing were reported by national banks in all but seven states in the country.

Totals disclosed reflect a continuation of the trend toward both increased volume of direct lease financing and a rising number of banks engaged in the service since the Comptroller first requested such information as part of call report data.

## LEGAL NOTICES

GRENADA COMPUTING CO.—NOTICE IS HEREBY GIVEN, in accordance with and pursuant to the provisions of Article 8 of the Partnership Law of the State of New York that a Certificate of Limited Partnership was filed February 10, 1970 in the office of the County Clerk of New York County in the State of New York, which Certificate reads as follows: I. The name of the partnership is GRENADA COMPUTING CO. II. The character of the business to be conducted by the partnership, within or without the State of New York, is a computer services business for the transformation of documents into computer readable form by means of, but not limited to, the process of key punching and/or optical character recognition and such other business or businesses as may be consented to in writing by those Partners whose contributions to the capital of the partnership, as of the time of such consent, shall aggregate at least 90% of the then capital of the partnership. III. The location of the principal place of business of the partnership shall be 7316 Wisconsin Avenue, Bethesda, Maryland 20014 and the location of its principal office in the State of New York shall be c/o Rosenman Colin K[illegible]

JKR

JOHN K. ROBERTSON
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II

# The Case for Bank Holding Companies

The arguments in support of bank holding companies may be classified into four broad categories: (1) improved operating results of individual banks; (2) strengthened capital structure of banks, thereby adding to depositor safety and reducing supervisory problems; (3) additional banking services to the communities served by subsidiaries of these companies; and (4) better allocation of bank credit. In the terminology of the Bank Holding Company Act of 1956 the first two arguments relate to the "banking factors," while the last two relate to the "convenience and needs" of the community. Each argument is considered below.

## IMPROVED OPERATING RESULTS

In virtually all applications from bank holding companies for additional acquisitions, it is argued that the operating efficiency of the acquired bank will improve as a result of affiliation. Bank holding company groups, by their very nature, have more possibilities for organizing the production of banking services than independent banks. The latter must produce banking services themselves or "buy" them from correspondents. Banks in a holding company group, however, may produce their own services or may buy them from nonaffiliated correspondents, from the lead bank [12] of the holding company group, from the holding company, or from a nonbanking subsidiary of the holding company. This greater flexibility may enable bank holding companies to use more efficient operating techniques.

For example, it may be more efficient to have the lead bank of a holding company or a nonbanking subsidiary provide computer services to all banks in a bank group than to have the same number of independent banks purchase such services from correspondents or produce the services for themselves.[13] In other words, to the extent that economies of vertical integration exist in banking, a holding company can take advantage of them. Economies of scale are not the relevant consideration here, for if economies of scale exist in the production of banking services, they will exist for the large correspondent bank as well as for the lead bank

[12] Refers to the dominant bank in the group.

[13] The services that a bank might purchase from its holding company or another affiliate—or which a nonaffiliated bank might buy from its correspondent—include check clearing and collection services, investment advice, foreign banking services, purchases of equipment and supplies, employees benefit programs, and many others. For a comprehensive list of services offered by correspondent banks, see U.S. Congress, House, Banking and Currency Committee, 88th Cong., 2d sess., *Correspondent Relations: A Survey of Banker Opinion* (Oct. 21, 1964), pp. 25-25.

of a holding company or a nonbanking subsidiary.

Another potential source of differences in operating efficiency, which is closely related to basic organizational structure, is in the quality of management. One of the major arguments in support of the holding company arrangement is that the holding company can acquire and train, for its affiliates, managers who are superior to the managers of comparable independent banks. This argument may be valid even though large city banks offer training programs to the managements of their small correspondents, because, it is argued, bank holding company systems are able to attract more talented individuals to the banking industry. They are able to do this because such a system can presumably offer greater challenges and opportunities for advancement to capable young men than can the typical independent bank.

Bank holding companies may also contribute to greater labor mobility within the banking industry and thus foster a more efficient allocation of labor resources, particularly management resources. The holding company can allocate its labor resources in a way that maximizes its profits, although not necessarily the profits of a particular subsidiary bank. Thus, while an independent bank is unlikely to suggest the transfer of one of its capable officers to one of its correspondent banks in order to overcome a management problem at the latter, a holding company would effect such a transfer between subsidiaries if the holding company would benefit. Further, common pension plans within a holding company system can assist in overcoming some of the institutional barriers to labor mobility that currently exist in this country.

The above arguments support a position that subsidiary banks are able to operate more efficiently than comparable independent banks. However, improved operating results may also come from larger revenues. There are strong arguments to support a position that holding company subsidiaries are able to earn a greater return on assets. One is that the superior management capabilities of holding companies enable the subsidiary banks to earn a greater return on their investments through better investment management. Another is that subsidiary banks are able to commit a greater proportion of their assets to a high-yielding asset —loans. (This argument is examined in the discussion of bank credit, beginning on page 8.) Thus, the higher loans/assets ratio and the greater return on investments that subsidiaries can presumably achieve enable them to earn a larger return on assets than can comparable independent banks.

## STRENGTHENED CAPITAL STRUCTURE

The second category of arguments in favor of bank holding companies is that they strengthen a bank's capital structure. A bank's capital may be increased by the sale of stock and/or the retention of earnings. Banking tradition and the pressures of bank examiners cause banks to maintain relatively conservative capital/deposits, capital/assets, and other capital ratios. Consequently, if a bank is to continue to meet the expanding credit and service demands of its community, it must continually increase its capital. The problem of maintaining capital ratios is particularly acute for banks located in rapidly growing areas.

For additions to capital, the independent bank must rely upon the sale of its own stock and/or upon its own retained earnings. Because no active market exists for the stock of

small banks, these banks may have difficulty in securing sufficient capital from stock sales; and as a result, banking services in the community may suffer. Most independent banks are not able to import equity capital from other regions of the nation because, for all but the largest ones, the market for a bank's stock is largely confined to the bank's service area.

Economists who have analyzed bank holding companies have consistently concluded that the subsidiaries of bank holding companies have significant advantages over independent banks in acquiring new capital.[14] The reason is that the stocks of most bank holding companies are traded in active national or regional markets. Thus, if the subsidiary banks are in need of additional capital, the holding company can acquire it by selling its own stock in these markets. It can also be said that holding companies are able to achieve a better allocation of equity capital than independent banks. Through stock sales the holding company is better able to acquire capital from capital-surplus areas and transfer this capital to banks that are located in areas characterized by a shortage of capital.

In addition, holding companies are capable of achieving a more satisfactory distribution of the retained earnings of banks. Under independent banking one might find some banks, especially those in slow-growth areas, building their capital ratios to levels in excess of that which is considered necessary, while other banks in rapidly growing areas may find their capital positions impaired because retained earnings are currently inadequate. The holding company, however, has the ability to allocate the aggregate retained earnings of the bank group in accordance with the needs of the individual banks.[15]

## ADDITIONAL BANKING SERVICES TO THE COMMUNITY

The quantity and quality of banking services are somewhat related to the operating results of banks. A more efficient banking organization can offer banking services at a lower price or can offer additional or better services at the same price. However, holding companies also assert that they can provide some services to a community through their subsidiaries that a comparable independent bank cannot provide —services such specialized business loans, special checking accounts, trust services, consumer credit, and so forth, that require highly specialized knowledge. A holding company subsidiary has the advantage of being able to draw upon specialized managerial talents from any of the banks in its bank group. While correspondent banks can assist in the provision of specialized services, it is argued that the holding company arrangement results in closer cooperation among affiliated banks than would be the case with independent correspondent banks. Moreover, the ability to supply specialized banking services still depends to a large extent upon the capabilities of management at the individual bank; and holding companies declare that they are able, for reasons cited above, to supply their banks with better management.

[14] See for example, W. Ralph Lamb, *Group Banking* (1961), pp. 148-51.

[15] The extent to which a bank holding company can achieve a more rational allocation of equity capital is dependent upon the degree of autonomy possessed by the directors and managements of the subsidiary banks. In order to achieve the optimum distribution of equity capital (or of bank credit), the managements of the subsidiary banks must desire to maximize the profits of the *holding company*, not necessarily their own bank's profits. The "carrot approach" to instilling this desire is to grant options on the stock of the holding company to the managements of the subsidiary banks.

## BETTER ALLOCATION OF BANK CREDIT

The potential supply of bank credit available to a given community depends in large part upon the income and the wealth of economic units in the community. The availability of bank loans to economic units in the community, however, is largely determined by the types of assets bankers choose to hold. If a bank has relatively large amounts of U.S. Government securities and "due from" balances in its asset structure, it is clear that large amounts of potential bank credit are being transferred away from this community. If there is little loan demand, this is desirable in terms of the optimum allocation of bank credit; but if potential bank credit is being transferred out of the community because the bank's management lacks the ability to make some specialized types of loans or because of restrictions imposed by the bank's lending limit, then the best allocation of bank credit is not being achieved. Holding companies assert that because they can provide management with the requisite skills and can overcome at least some of the limitations imposed by lending limits at individual banks, their banks can more adequately meet the credit needs of the community.

### Benefits to the Community

The basic nature of the holding company form of banking organization permits component banks to commit a greater proportion of potential bank credit to the communities in which the subsidiary banks are located. Bank holding companies are generally comprised of banks located in different communities or in different sections of large metropolitan areas. Consequently, the combined portfolios of all of the subsidiaries of the holding company are more diversified than the portfolio of a single bank and, therefore, less risk would be associated with the holding company portfolio. Moreover, each individual subsidiary bank can assume that, should difficulties arise, assistance would be available from its coaffiliates. For these reasons, the risk associated with a given level of loans would be less for a subsidiary bank than it would for a comparable independent bank; hence, with risk preference being equal, a subsidiary bank would have a higher loans/assets ratio than a comparable independent bank.

Correspondent banking operations in the United States supplement to some extent the capacity of unit banks or limited-branch banks to adequately meet the credit needs of their communities. Traditional banking practices call for the maintenance of deposit balances by small outlying banks (country banks) in large banks located in metropolitan areas (city banks). Part of the balance is maintained in order to facilitate the performance of the check-clearing service that the city bank renders to the country bank. The remaining or excess balance is maintained to compensate the city bank for other services that it renders to the country bank. Hence, the "cost" of these correspondent services to the country bank is the return that would have been earned on the excess balance if these funds had been used to purchase earning assets. This excess balance may be reasonably assumed to be required by the city bank and, therefore, should not be considered excess reserves. Were these excess balances not required, a high percentage of such funds would likely be channeled into local loans and into the purchase of local municipal bonds. Consequently, the "cost" to the outlying community of this correspondent banking arrangement is the loss of potential local bank credit.[10]

[10] If country banks paid fees for correspondent services, the outlying community would gain. The country bank's profit would be unaffected, because the fee paid for the correspondent services is presumably equal to the income that the bank could derive by shifting its excess correspondent balances into earning assets. But the community served by the country bank would have additional credit resources available to it. For a discussion of the fee system and banker reaction to it, see U.S. Congress, House, Banking and Currency Committee, 88th Cong., 2d sess., *Correspondent Relations: A Survey of Banker Opinion* (Oct. 21, 1964), especially p. 63.

How would bank credit be allocated under the holding company form of banking organization? One of the long-standing arguments against bank holding companies is that they drain money capital from rural and suburban areas, the beneficiary being the big city.[17] In rebuttal, the supporters of bank holding companies stress the independence of the directors of the subsidiary banks.[18] Presumably these directors are local leaders who strive to and are able to protect their community's interests. A good case can be developed to support both arguments. However, if the holding company acts to maximize its profits, the loanable funds would be channeled into those areas where the highest net return (after allowance for risk) is available. Such an allocation of bank loans means that potential bank credit would be transferred from communities with relatively little loan demand to communities with high loan demand.

### Greater Credit Mobility

Credit mobility is required to meet the credit needs of many communities because (1) some communities will be capital-surplus areas while others will be capital-deficit areas; and (2) some borrowers in a given community will have credit needs that exceed the lending limits of the local banks. Two important arrangements that the banking system in the United States has used to achieve mobility are participation loans and the sale of loan paper from one bank to another and from banks to other financial intermediaries. These arrangements have not been fully available to the subsidiaries of a bank holding company because of certain provisions in the original 1956 Act. Under the original Act the sale of loan paper and the granting of a loan by one banking subsidiary to another bank in the same holding company were prohibited. Because of these restrictions, loan participations between banks in the same group had to be arranged at the time the loan was made. Such restrictions did not, however, apply to transactions between an independent country bank and its city correspondent. Critics of the original Act argued that these restrictions prevented, in some degree, the realization of one of the significant advantages of bank holding companies—greater interregional mobility of bank credit.

Though the provisions of the original Act appeared to place subsidiaries of bank holding companies at a disadvantage to independent banks in terms of making loan participations and of buying and selling loan paper,[19] strong arguments remained in support of a position that greater credit mobility could be achieved via a holding company arrangement than via independent banks linked by conventional correspondent relationships.[20]

The extent to which loan participations are employed clearly depends upon the willingness of small banks to request participation by their city correspondent and upon the willingness of the latter to do so. Small independent banks are often reluctant to seek participations from the large correspondent banks for fear that the customer will be lost to the large bank. This fear is apparently often justified, for in a survey of city correspondents, the large banks

[17] See for example, Governor J. L. Robertson's dissent in the Denver U.S. Bancorporation case. *Federal Reserve Bulletin*, Nov. 1963, p. 1529.

[18] Marcus Nadler and Jules I. Bogen, *The Bank Holding Company* (1959), p. 22.

[19] The restrictions were not so damaging to holding companies as it may at first appear. Although it was not legal for, say, Subsidiary Bank A to purchase loan paper from Subsidiary Bank B (if A and B are subsidiaries of the same holding company), Bank A could increase Bank B's liquidity by making a direct loan to one of Bank B's customers. This loan would enable the customer to repay his loan at Bank B. The final result would be the same as if Bank A had purchased an equivalent amount of loan paper directly from Bank B.

[20] The superiority of the holding company arrangement in providing for credit mobility was one of the major arguments used in the application of Morgan New York State Corporation to become a bank holding company. See *Federal Reserve Bulletin*, May 1962, pp. 567-82.

In a separate statement accompanying the Board's denial of the application, Governor G. W. Mitchell questioned the Applicant's assertions that the proposed holding company could allocate credit more efficiently than would be the case under the existing correspondent banking network (see p. 582).

were asked how many times they would carry overlines of the same borrower before expecting the borrower to establish a direct relationship with them. Typical replies were "2 or 3 years" and "no set number of times, but we do feel that the local bank should assist us in obtaining a direct relationship if the borrower has permanently outgrown the lending limit of his local bank."[21]

A holding company subsidiary is less likely to be reluctant to seek loan participation from the lead bank of its group because the holding company would probably prohibit one of its banks from pirating the account of a customer of another of its subsidiary banks. Also, in securing loan participation the small independent bank is in a relatively poor bargaining position with respect to, say, the large money-market banks. A subsidiary of a bank group, given that the banks in the group have substantial interbank balances with a money-market bank, would be in a much better position to bargain for loan participations.

In addition to arranging loan participations, local banks can meet the excess credit demand of the community by selling their existing loan paper to other commercial banks or other financial intermediaries. Despite the prohibition that was placed on the sale of loans to holding company subsidiaries, the holding company arrangement probably enabled a subsidiary bank to dispose of loan paper more easily than a comparable independent bank because the latter could not generate the volume of loans needed to interest institutional buyers of loan paper, such as, life insurance companies and savings and loan associations. The bank holding company, however, can make arrangements with these institutions to purchase the loan paper of all of the subsidiaries in the bank group and thus assure the institution of a steady flow in reasonably large volume. The ability of the holding company to standardize credit procedures further aids in facilitating such transactions.

[21] "Participation Loans," *Banking*, Jan. 1958, p. 49.

### Effects of the Amended Act

The restrictions upon loan participations and upon the sale of loan paper between banking subsidiaries of the same holding company were based on section 6 of the original Bank Holding Company Act. This section was repealed by the 1966 amendment; but section 23A of the Federal Reserve Act was amended so that its restrictions on banking affiliates were also applied to the subsidiaries of bank holding companies.[22] These restrictions state that a banking affiliate may not loan or otherwise extend credit to another affiliate or to the holding company if the total amount of loans or extensions of credit to the other affiliate exceeds 10 per cent of the lending affiliate's capital and surplus or if the total amount of loans or extensions of credit to all affiliates (including the holding company) exceeds 20 per cent of the lending affiliate's capital and surplus. (Under the original Act, loans from one banking subsidiary to another or to the holding company, that is, "cross-stream" and "upstream" loans, were prohibited.) However, because the purchase of loan paper without recourse is not considered an extension of credit, it appears that no significant restrictions now exist on the purchase of loan paper by one subsidiary from another or on loan participations between subsidiaries.

The extent to which the restrictions of the original Act prevented holding companies from achieving their desired allocation of bank credit is not known; but whatever the extent, these barriers now appear to have been substantially eliminated.

[22] Under section 23A, a banking affiliate includes any corporation of which a member bank owns or controls more than 50 per cent of the voting shares. In the amended section 23A, affiliate now includes, with respect to any insured bank, any bank holding company of which such bank is a subsidiary as defined by the 1956 Bank Holding Company Act, and any other subsidiary of this bank holding company.