

INTERPRETIVE LETTER NO. 99-01 (March 19, 1999)

State bank may own and lease personal property to a municipality. The amount of the bank's permissible investment in the personal property subject to the lease is generally 20% of the unimpaired capital and surplus of the bank unless the lease is a general obligation of the municipality, in which case bank's investment is limited to the amount of bank's unimpaired capital and surplus or is limitless.

I am writing in response to your letter on behalf of * Bank inquiring about the ability of * Bank to lease personal property to municipalities, cities, and townships. You have asked the Office of Banks and Real Estate ("Agency") a number of questions regarding limitations and conditions that *Bank must observe if it offers these leases.

Illinois banks are specifically authorized under Section 5(14) of the Illinois Banking Act ("Act") to "acquire personal property to lease to a prospective lessee at the lessee's request in accordance with the provisions of Section 35.1 of the Act."¹ (205 ILCS 5/5(14)). Section 35.1 of the Act generally limits Bank's unamortized investment in the personal property that is leased, plus any existing indebtedness of the lessee for money borrowed from the bank, to 20% of the bank's unimpaired capital and surplus.

However, if the Bank structures the lease (and loans) to a particular municipality as a "general obligation" of the municipality², under Section 34(3) of the Act, the 20% limitation would not apply and the bank would be permitted to have total leases and loans with the municipality in the amount of the Bank's unimpaired capital and surplus. (205 ILCS 5/34(3)). If the lease (and loans) are structured as a general obligation of the municipality and the municipality is located in whole or in part in the same county as the Bank, under Section 35(4) of the Act, the Bank's unamortized investment in the property is not subject to any limits. (205 ILCS 5/35(4)). For purposes of Section 35(4), "bank" refers to the main banking premises or any branch of the bank.

Section 35.1 also prohibits the Bank from undertaking a lease that obligates the Bank to maintain, repair, or service the property, or that obligates the Bank to restore or replace the property or that places the risk of restoration or repair on the Bank in the case of loss, theft, destruction of or damage to the property (the Bank may accept liability for repairs etc. in the case of a willful act by the Bank). (205 ILCS 5/35.1(c)).

Provisions governing national banks leasing personal property are very similar to those applicable to Illinois State banks. Under 12 C.F.R. 23.3, a national bank may only enter into a personal property lease if it is a full-payout lease. Illinois statutes and regulations do not address whether these leases must be full-payout leases. However, the Agency suggests that as a prudent banking practice the Bank may wish to use either a full-payout lease or, if the lease provides a residual at the end, that the

¹ "Unamortized investment" refers to the bank's purchase price of the personal property to be leased less the amounts already remitted by the lessee under the lease. (205 ILCS 5/35.1(a)).

² Section 2 of the Act defines a general obligation as a "bond, note, debenture, security, or other instrument evidencing an obligation of the issuer that is supported by the full available resources of the issuer, the principal and interest of which is payable in whole or in part by taxation." (205 ILCS 5/2)(emphasis added).

residual should be adequately collateralized. In short, Bank should structure the municipal lease in the same way it structures other personal property leases.

The Office of the Comptroller of Currency ("OCC"), the regulator of national banks, recommends that a national bank should include a provision in all municipal leases that prohibits the municipality from leasing or purchasing similar property from another entity during the original lease term if the lease is cancelled. This provision is included because municipal leases generally include a termination or cancellation clause enabling the municipality to terminate the lease if the lease payment for the next fiscal year is not appropriated. The OCC also suggests that the lease agreement should also require that the municipality provide evidence of appropriation for the first fiscal period. To ensure the safety and soundness of the Bank, the Agency recommends that Bank include similar provisions in its municipal leases.

With respect to your question about provisions to ensure that the lease income is tax-free income to the Bank, the Agency suggests that you contact your tax adviser, the Internal Revenue Service or the Illinois Department of Revenue.

As to your question about how the leases should be reported on the call report, the Bank should follow the directions provided by its federal banking agency, the Federal Deposit Insurance Corporation.

Finally, the Agency suggests you require the municipality to obtain a letter from its counsel confirming that the municipality is legally able to enter into the personal property leases you are proposing.

We trust this letter responds to your inquiries. Should you have additional questions, please do not hesitate to contact us.