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OFFICE OF FINANCIAL AND INSURANCE SERVICES  
DEPARTMENT OF CONSUMER & INDUSTRY SERVICES  
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**DATE:** June 23, 2005

**LETTER NO.:** 2005-CU-07

**TO:** The Board of Directors and Management of Michigan State-Chartered Credit Unions

**SUBJECT:** Member Leasing Activity

This letter clarifies Office of Financial and Insurance Services (OFIS) safety and soundness expectations regarding due diligence conducted by state-chartered credit unions prior to entering into a leasing program, including some of the risk characteristics which should be reviewed to analyze and differentiate proprietary leasing programs.

Section 401(2)(e) of the Michigan Credit Union Act allows credit unions to "Sell, convey, lease, or otherwise dispose of, or assign, pledge, or create a security interest in, all or part of its tangible personal property, including property obtained as a result of a default of an obligation owed to the domestic credit union." This power, as with all other powers granted to credit unions pursuant to the Michigan Credit Union Act, is accompanied by an expectation that credit union officials exercise due diligence in maintaining safe and sound credit union operations.

Several leasing programs are available for credit unions, each possessing distinct characteristics and unique structures. In deciding whether to participate in a leasing program, credit union officials must determine if the program is legal and appropriate. This determination requires a complete understanding and thorough analysis of lease transactions. Officials must document the analysis and the projected impact upon the institution.

The following are risks common to lease programs that must be considered by credit union officials:

**Credit Risk**

Leases are written to terminate at a specific point in time. Should a credit union allow a member to become delinquent, a significant deficiency balance may exist between the value of the automobile at collection and the scheduled residual value. Such deficiency balances must be collected from the lessee to be brought current. Insurance guaranteeing these residual values is effective only at the time of scheduled lease termination. Even if a lessee performs according to the contract, there is the risk that the financial condition of the insurer may be inadequate to pay a claim. Furthermore, some leasing programs are structured in such a way that the entity providing leasing services is the guarantor of residual values. The financial condition of the

leasing company must also be analyzed to determine its ability to honor any commitment made to the credit union. It is essential to engage competent individuals to assess the financial stability and condition of the entities providing the leasing program, any insurer or guarantor.

### **Transaction Risk**

If the property is damaged or stolen, primary insurance carried by the lessee may be insufficient to cover the unamortized balance of the lease. If appropriate insurance is not obtained by the credit union, the deficiency balance may represent a loss. Sound underwriting is essential. Officials must determine the credit union's responsibilities at lease termination, regardless of whether the lease goes full term or terminates early. Items such as vehicle disposal and collection of excess mileage and wear require specialized skills. Furthermore, insurance protection must be maintained on the vehicle for the period between the end of the lessee's obligation and the ultimate disposal of the vehicle.

If the credit union uses an outside party to assist in the acquisition of vehicles or other property and administration of leases, the credit union must have proof of rights and claims to the leased property. There is always the potential for fraud, such as the titling of a vehicle in the name of the outside party without a recorded security interest in the name of the participating credit union.

The accounting skills of credit union personnel must be sufficient to understand proper accounting treatment of fee amortization, income recognition, and principal recovery.

Appropriate information systems must be developed to monitor the portfolio performance relative to portfolio contribution to net income and Board approved risk limitations.

### **Interest Rate Risk**

Yields on the credit union's investment in a lease portfolio must be analyzed. Many programs charge a fee at the time of origination. The Board of Directors must consider the impact of fees paid by the credit union on the net yield when determining lease pricing.

### **Liquidity Risk**

The lease portfolio's impact on the balance sheet and the subsequent effect on liquidity must be managed. Appropriate limitations, outlining the Directorate's risk appetite and internal controls relative to this product should be defined by policy.

### **Compliance Risk**

An attorney should provide an opinion with respect to the legality of the leasing program. Compliance with all applicable regulations governing lease transactions must be maintained. In addition to providing credit union officials with a legal opinion, an attorney will be able to expand the level of understanding of lease transactions and communicate contractual requirements posing additional risk to the credit union. Credit union officials are warned against

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placing reliance on legal opinions provided to other credit unions since recourse will be available only to the credit union addressed in the original opinion.

**Reputational Risk**

The credit union will either be the sole owner, joint owner, and/or a secured party of the leased property, depending upon whether the lease transaction is direct or indirect. Officials must recognize the presence of potential contingent liabilities in the event of a lawsuit based upon the actions of the lessee. Action of parties contracted by the credit union to provide services relating to the lease portfolio may also expose the institution to negative public opinion and/or loss of member confidence.

**Strategic Risk**

Depending upon the transaction, leasing activity could represent a loan to a member, a purchase of an eligible member obligation, a commercial or member business loan, or perhaps some other scenario which has yet to be defined. Each of these conditions requires certain levels of expertise to effectively mitigate the respective risks. Management and staff must possess sufficient technical knowledge to effectively manage the inherent risks of leasing. Should officials decide to participate in a leasing program; documentation of all relevant due diligence activities must be available for review. The documentation should outline the products legality, cost effectiveness, business strategy, and the benefits to credit union members.

Sincerely,

Roger W. Little, Deputy Commissioner  
Credit Union Division