# Give Lease a Chance

## How An Overlooked, Unloved Asset Class Could Save Banking.

WHITE PAPER

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If you were ever picked last for a team sport at recess, you have a good idea how the lease finance industry feels these days. Despite outperforming every major asset class for the last five years, leases account for less than 1% of total assets for the average U.S. bank. In the immortal words of Rodney Dangerfield, lease finance can't get no respect.

Leasing is a common finance tool used by more than 90% of U.S. businesses which lease everything from printers and computers to manufacturing equipment and even the buildings they call headquarters. The U.S. leasing industry is massive, with more than $680 billion in commercial leasing volume annually[1].

Yet, despite significant demand for leasing by their commercial customers, many banks are reluctant to dedicate human resources or portfolio shelf space to it. The most recent data from the Federal Deposit Insurance Corp. (FDIC) shows that leased assets make up just 1.4% of an average bank's total loan portfolio, or a miniscule 0.73% of a bank's total assets.

| Lease Concentration % | Of Loan Portfolio | Of Total Assets |
|---|---|---|
| 2012 | 1.37 | 0.73 |
| 2011 | 1.37 | 0.74 |
| 2010 | 1.41 | 0.79 |
| 2009 | 1.50 | 0.86 |
| 2008 | 1.62 | 0.97 |

Source: FDIC

For most bankers, leasing is a four-letter word. Exactly why that is is debatable, although advance rate likely has something to do with it. Unlike typical real-estate-secured debt that requires a sizeable down payment, leases generally are 100% financings. And there are other differences. Instead of acting as lender, a lease requires the bank to serve as a lessor. Throw in the mix a new set of documents and agreements, sales tax filings, depreciation considerations and other servicing duties and you just killed any chance of getting a banker excited about leasing. While banks offer a number of reasons why they don't offer leasing, performance isn't one of them.

## A Shining Star

According to FDIC data, since 2007 leases have outperformed every single asset class in a typical bank portfolio, including loans for residential, commercial real estate, construction, home equity, credit cards and commercial and industrial (a.k.a. C&I). The numbers aren't close. Looking at two key performance

measures (noncurrent and net charge offs), leased assets far outperform any of the other asset categories. The numbers speak for themselves, as the two tables below illustrate.

| ***Noncurrent (%)*** | **2012** | **2011** | **2010** | **2009** | **2008** | **2007** |
|---|---|---|---|---|---|---|
| All RE Loans | 6.56 | 7.03 | 7.60 | 4.90 | 2.23 | 0.91 |
| Construction | 12.52 | 16.05 | 16.82 | 10.95 | 4.81 | 1.00 |
| Residential RE | 7.84 | 7.61 | 7.98 | 4.99 | 2.21 | 0.98 |
| HELOCs | 2.40 | 1.79 | 1.77 | 1.70 | 1.09 | 0.44 |
| Credit Cards | 1.63 | 2.05 | 3.14 | 3.48 | 2.38 | 1.93 |
| C&I | 1.16 | 1.89 | 3.05 | 2.25 | 0.81 | 0.63 |
| **Leases** | **0.42** | **0.73** | **1.40** | **1.15** | **0.57** | **0.43** |
| All Loans/Leases | 4.11 | 4.71 | 5.46 | 3.77 | 1.73 | 0.84 |

| ***Charge Offs (%)*** | **2012** | **2011** | **2010** | **2009** | **2008** | **2007** |
|---|---|---|---|---|---|---|
| All RE Loans | 1.08 | 1.47 | 2.11 | 1.44 | 0.73 | 0.10 |
| Construction | 1.95 | 3.76 | 5.35 | 3.28 | 1.12 | 0.08 |
| Residential RE | 1.32 | 1.55 | 2.17 | 1.59 | 0.92 | 0.13 |
| HELOCs | 1.97 | 2.20 | 3.12 | 2.37 | 1.54 | 0.24 |
| Credit Cards | 4.25 | 6.69 | 13.21 | 7.79 | 4.83 | 4.07 |
| C&I | 0.56 | 1.14 | 2.01 | 1.82 | 0.68 | 0.35 |
| **Leases** | **0.12** | **0.20** | **0.89** | **0.83** | **0.34** | **0.17** |
| All Loans/Leases | 1.17 | 1.83 | 2.88 | 1.94 | 0.99 | 0.45 |

**Source: FDIC**

Let's go back in time for some historical perspective. In 2007, it was hard to find an asset class that didn't outperform its historical average. Other than credit cards, no single asset class provided any significant concern for lenders in the U.S. It was a boom time. The economy was still upright, businesses were borrowing and developers were building as quickly as they could find (and ultimately overpay for) raw land. It wasn't until 2008 when lenders realized what possibly lay ahead for them.

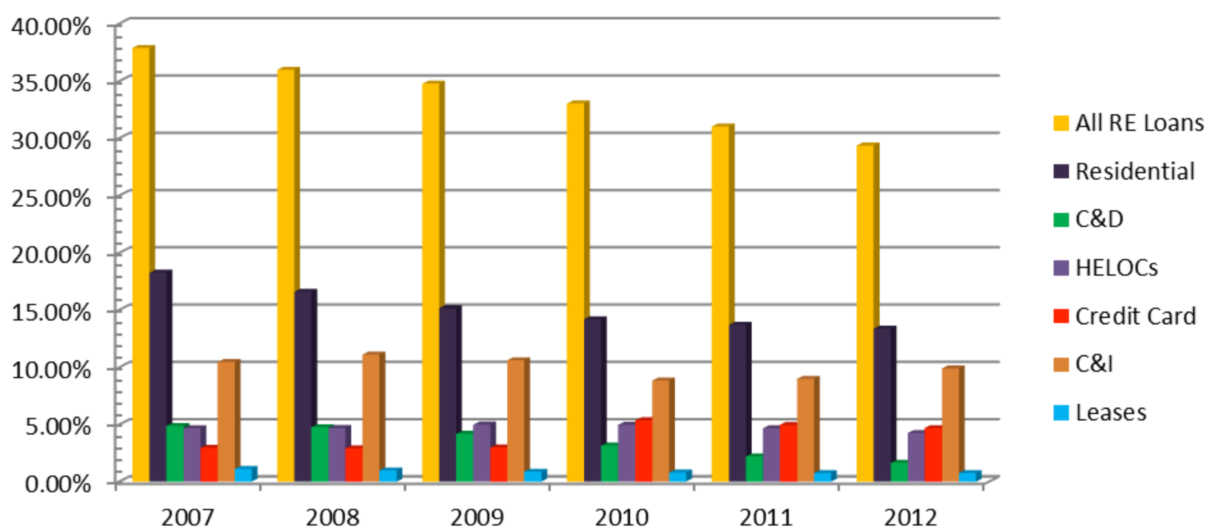
Fast forward 36 months to 2010 and you would be hard pressed to convince a lender to put money to work in any of the major assets classes, save one: leases. Year after year leases have outperformed every major asset class during a rugged six-year stretch. On average, leases are about four times less likely to be noncurrent or require a charge off than all other assets combined. In fact, leases are performing better now than their 2007 averages for both the noncurrent and charge-off categories.

Why leases outperform other assets is unclear. One theory is that leases have shorter terms (three to five years) than other debt facilities. Any troubled lease assets would have already worked through the collection process by now. And new lease transactions have since been underwritten with tougher credit standards.[2]

## Old Habits Die Hard

Not all of the 7,300 U.S. banks are missing the boat. Most money-center and larger regional banks understand the power of lease finance and either provide leasing services themselves or partner with a subsidiary or affiliate that does. For larger banks with more resources at their disposal, developing or acquiring leasing expertise is not as big a challenge as it is for smaller banks. More importantly, larger banks jump at the opportunity to enhance the customer experience and deepen relationships by providing a service traditionally supplied by commercial leasing companies and the captive finance arms of equipment manufacturers. They know their commercial customers are going to lease something for their businesses. Why make them look to other potential lenders – essentially forcing them into the arms of their competitors – when they can deliver a solution of their own?

Meanwhile, the remaining 6,000 community banks with assets under $1 billion shy away from leasing, opting instead to chase more traditional – albeit riskier – opportunities such as residential and commercial real estate loans. Instead of offering leasing, banks have allowed money-center banks, independent finance companies and other lessors to dominate the space. Despite the lessons learned from the 2008 credit disaster, community banks continue to rely on real estate to drive earnings. Unfortunately, those earnings are hard to come by these days.

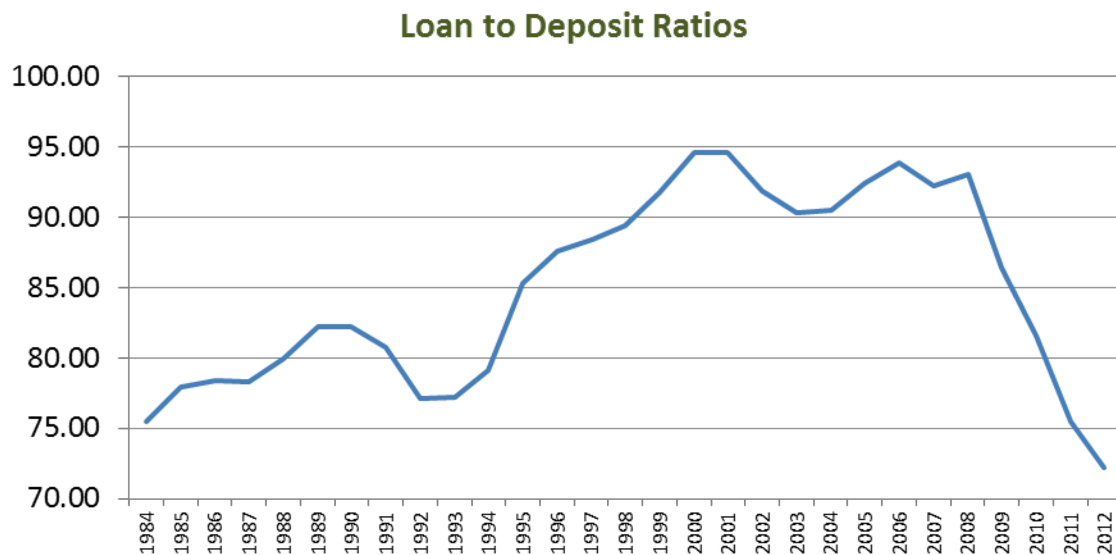



While down from traditional levels, real estate loans make up the lion's share of most banks' portfolios today. Other asset classes seem to have held their own during the downturn, notably credit cards and

C&I loans. Yet the best performer of the bunch (leasing) remains firmly at the back of the pack in terms of portfolio shelf space.

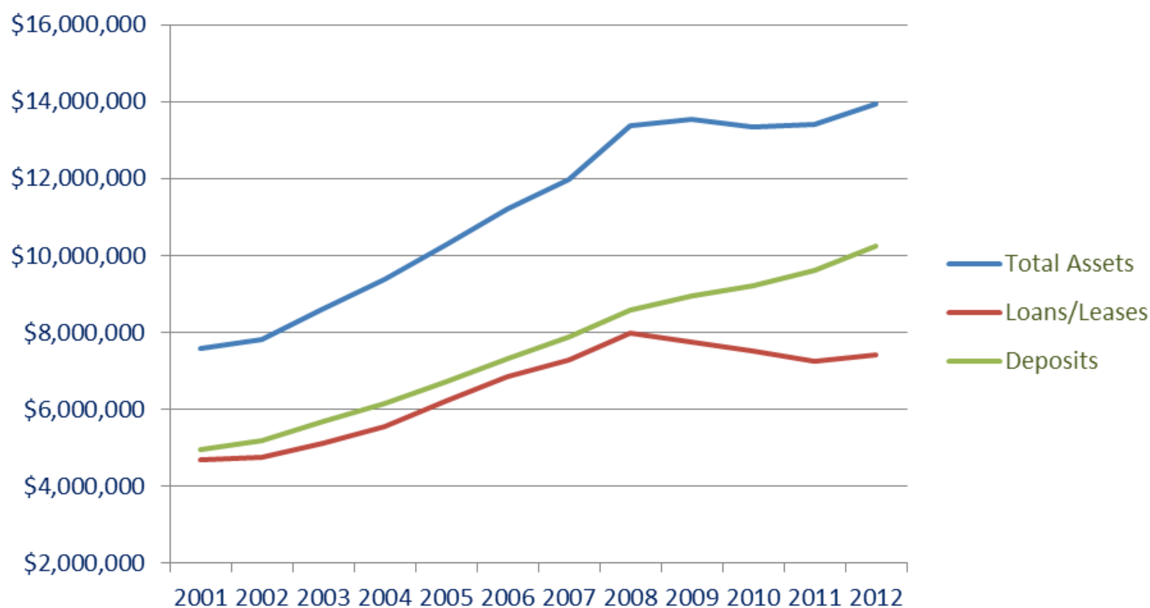
### What Demand?

For lenders in normal post-recession times, it would seem appropriate to reenter a beaten-down asset class as economic fundamentals and valuations begin to improve. Lenders can leverage low values and skittish times to improve the quality of their borrowers and the underlying assets being financed. Like a savvy investor, most bankers wait for good opportunities to put their money to work. Yet, as we have seen, these are not normal post-recessionary times. As banks continue to mend their beleaguered loan portfolios, they are dealing with a new issue: feeble loan demand. No one is borrowing. In fact, since the FDIC first started reporting consolidated loan-to-deposit (LTD) ratios in 1984, the banking industry has never seen LTDs this low – that's 28 years or 112 quarters.




*Source: FDIC Q1 2012 QBP Report*

With the upcoming election, healthcare reform and a myriad of economic variables percolating, businesses simply are not looking to incur additional debt. Small businesses are especially gun-shy, electing to hoard cash and wait until the recession is over. (Yes, the recession officially ended June 2009, but don't tell that to today's 14 million unemployed Americans.) To make matters worse, Americans are saving at a pace not seen since World War II, filling banks with mostly unwanted deposits.




*Source: FDIC Q1 2012 QBP Report*

## An Alternative to Real Estate

Recent times have not been kind to bankers. Having survived the worst recession in a generation, increased federal regulations and an enormous PR maelstrom courtesy of Too Big To Fail, bankers would sell their souls to get back to good, old fashioned banking. Unfortunately, there's not much banking to be done. With low loan demand, a frugal bond market and swelling deposits, bankers have to find new ways to deploy capital and reignite earnings that have been absent for far too long.

One alternative is leasing, an asset class that simply has gone unnoticed for too long among the majority of banks in the U.S. Judging from its recent performance, leasing appears to have earned at least a consideration.

Like other asset opportunities, leasing is not as simple as it looks. It requires a skilled team of professionals who are experienced at designing, pricing, servicing and executing an appropriate strategy. That strategy must fit into the fabric and brand of the bank as well as the clientele whom it serves. Lease finance can be provided for any sector, be it transportation, energy, medical, technology, manufacturing or professional services, to name a few. While the debt facility is unique to others a bank might originate, leases are nothing more than specialized C&I loans.

Prior to entering the leasing business, bank management must carefully discern the potential risks and rewards for such a program. First and foremost, banks should design credit policies and risk management programs to ensure the safety and soundness of the institution are protected at all times. Moreover, the organization has to embrace the unique structuring that leasing requires. Lenders, calling officers, credit managers and servicing administrators have to recognize the distinctive nature of the lease facility and be able to work with customers in a variety of situations. Like other credit facilities, leases come with alternatives and nuances that offer significant flexibility for the lessees (borrowers) that bankers will have to become familiar with before hitting the street.

Finally, just because a bank is offering leasing doesn't mean the customers will barge through the door. Like banking, the commercial leasing space is crowded and competitive. In order to compete for the best assets, banks will have to differentiate themselves from the other providers – just like they do with traditional banking products.

## Summary

The banking industry is facing a difficult and challenging environment. Low loan demand, increased regulations, a weak bond market and lowly earnings are forcing lenders to rethink how they service their existing customers and attract new ones. Moreover, the real estate collapse illustrates the need for portfolio diversification and new sources of revenue. Since it's clear that the economy will not rebound as quickly as predicted, lenders are looking for new, safer ways to deploy their stockpile of deposits without lowering credit standards.

Leasing is a viable alternative. Historically, leased assets have far outperformed other asset classes. And while competitive, the leasing industry has fewer players than the crowded banking industry. By offering leasing, banks deliver financing solutions that 90% of their customers currently utilize through other sources, including other banks. Executed properly, leasing can deepen relationships, increase customer loyalty and improve earnings.

And, just like the last player picked at recess, leasing just might turn out to be the star of the team.

[1] *Equipment Leasing Finance Association (ELFA)*

[2] *Community Banks and the Equipment Finance Industry: A Growing Opportunity, 2011 (S.A. Wheeler)*

# About the Author

Tom Grady serves as Vice President, Capital Markets for K2 Capital Group where he is responsible for developing and managing partnerships with money center, regional and community banking institutions across the country. Prior to his current role, he has worked with companies in a variety of industries, primarily in banking and finance, asset management, higher education, medical and publishing. Grady holds a bachelor's degree in English from Saint Louis University and a master's of business administration degree in Marketing and Finance from the Freeman School of Business at Tulane University. He can be reached at (952) 224-2479 or tgrady@k2capitalgroup.com.

# About K2 Capital Group | www.k2capitalgroup.com

**K2 Capital Group** is a national provider of leasing solutions to the healthcare industry. Headquartered in Minneapolis, K2 Capital delivers direct and private-label financing solutions to medical and technology manufacturers across the nation. K2 Capital specializes in delivering customized financing programs and alternatives which most commercial banks are not able to deliver.

K2 Capital's experienced leasing professionals have developed long-standing relationships with some of the world's largest and most respected hospitals and medical equipment manufacturers. Its private-label vendor leasing programs offer creative, competitive and professionally administered financing solutions for the vendors' customers. K2 Capital delivers a turnkey, seamless financing alternative for the vendors' sales force and ultimately their customers. In addition to its private-label leasing programs, K2 Capital offers financing solutions directly to major medical institutions.

K2 Capital Group funds its leases with a wide variety of financing sources including partnerships with commercial banks. K2 Capital retains the servicing rights and ownership of the residuals. It secures permanent financing by assigning the stream of payments and a first-security interest in the equipment to a bank lender. Banks provide funding to K2 Capital based on the present value of the lease payments at a discount rate, which is determined by the lender based on the credit quality of the lessee. The individual lease streams are discounted with the banks on a non-recourse basis.