November 26, 1996

Cary C. Boyden, Esq.
Pillsbury Madison & Sutro
400 Capitol Mall, Suite 1700
Sacramento, CA 95814

Re: Residual Value Insurance (Your Letter of August 30, 1996)

Dear Mr. Boyden:

You have asked whether a new type of residual value insurance may be used to meet the full payout requirement of Interpretive Ruling and Policy Statement (IRPS) 83-3, which governs federal credit union (FCU) leasing of personal property. Under the IRPS, FCUs may engage in personal property leasing, provided that a number of specific requirements are met. One requirement is that leases must be "full payout, with a maximum limit of 25 percent residual value to be relied upon for the full payout requirement." The IRPS states, "Any reliance beyond the 25 percent is permissible if guaranteed."

The preamble to the IRPS explains full payout and residual value as follows:

The full payout requirement means that over the term of the lease, the lessor must recoup its entire investment in the leased property plus the cost of the financing. The lessor's return will come from the monthly payments made by the lessee, estimated tax benefits . . . and the estimated residual value of the property. The residual value of the property is determined at the outset of the lease. It is the value of the property at lease end that will be relied upon by the FCU to meet the full payout requirement. . . . [T]he NCUA Board has determined that FCUs shall place a maximum limit of 25 percent of the original cost of the leased item on residual value estimates to be relied upon to meet the full payout requirement. Higher estimates will be allowed if the residual value is guaranteed by a financially capable party. The guarantor may be the manufacturer, the lessee or a third party who is not an affiliate of the FCU. In all cases, the residual value relied upon must be reasonable in light of the circumstances. This policy is adopted so that FCUs will not place excessive reliance on residual values that may be somewhat speculative and may, therefore, subject FCUs to increased risk.

You state that "the approach of certain residual value insurance policies has changed so that the insured amount is not tied necessarily to the proceeds of disposition from the vehicle, but rather is based on the higher of what would be the wholesale proceeds or the vehicle's 'clean wholesale' condition."

Under the IRPS, the residual value is "the value of the property at lease end." We believe that this should be interpreted as the proceeds from disposition of the vehicle. To the extent that the new type of residual value insurance is not based on this definition of residual value, it does not satisfy the full payout requirement of the IRPS. Please be advised, however, that we are aware that the limit may be too low for high-end automobiles, which may be worth well over 25% of their original value at the end of a lease. Accordingly, as party of an upcoming regulatory relief project involving a number of IRPS, staff plans to recommend that the NCUA Board request public comment on any changes that need to be made to the leasing rules.

Sincerely,

Michael J. McKenna
Acting Associate General Counsel

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