Rise of the Banks in Equipment Finance
Establishing a Sustainable Engine for Growth

EQUIPMENT LEASING & FINANCE
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Purpose of the Study

Over the last ten years the commercial banking industry has experienced both record profits and record losses. Today, the industry operates in an environment that most bankers view as stable and improving with enhanced portfolio quality and the hope and expectation for continued revenue growth, albeit at a relatively slow pace. During this period leasing activities of commercial banks have increased as a percentage of total new business volumes (NBV) generated by the leasing industry and now exceed 55% of NBV. Most recently, many banks have reenergized their equipment finance activities while others have entered this market for the first time. National players, regionals, and some community banks now view equipment finance as a major growth area versus their historic focus on various retail and commercial products, including mortgages, debit and credit cards, and "free" checking. Equipment finance has become a high priority opportunity for many banks, and they are investing accordingly.

However, while more banks are intensifying their focus on equipment finance, the "how and why" of their approaches differ significantly. Regarding the way in which they enter or are growing this business, some banks have taken the acquisition route, buying one or more Independents, many in the desire to quickly gain asset and revenue growth. Other banks have deliberately avoided that approach, instead pursuing the "lift out" of experienced leasing teams or seasoned individuals from Independents or other banks (when a large number of employees move to a new player this shift is commonly termed a "lift out"). They view the acquisition route with some suspicion, characterizing it as both overly costly and fraught with potential frustration related to integrating the newly acquired (and often newly enriched) management team into the established and more staid bank culture. Increasingly, however, banks will consider either option if the opportunity offers the desired likelihood for growth.

The primary strategic approaches guiding the entrance or expansion of banks into leasing also differ. Some banks have entered the market from a defensive stance to avoid competitors encroaching on their customers, while others have established leasing as a "lead" product. Some more banks are positioning one or more parts of their leasing groups as largely stand-alone businesses that can put the bank's excess deposits and liquidity to work by creating a regional or national franchise. In fact, bank managements that "get it" now see leasing as a multi-pronged line of business, one that can potentially offer a lead product, provide a cross-sell opportunity to enrich existing relationships, and/or offer a new stand-alone regional or national expansion franchise. At the same time this growth initiative also raises complex organizational issues for management to address.

Where does this heightened focus leave the banks' competitors, the Captives and, in particularly, the Independents, many of whom suffered from funding shortages and risk-related issues during the recent downturn? Can Independents grow or even survive with the banks making a major push, or are they doomed to become increasingly marginalized, fighting over the scraps that banks leave behind? And, is this major push by the banks a systemic change that will impact the industry long term, or, conversely, will banks abandon the equipment finance market or reduce their exposure to it as quickly as they seem to have embraced it?

This report will examine these and related questions aimed at understanding how and why the banks have grown in the equipment finance space. We will also present a perspective on the likely future operating scenario for the banks and their competitors. During prior down cycles banks have exited businesses based upon poor performance, internal strategic decisions and regulatory, compliance, or accounting concerns. One focus of this report centers on providing a perspective concerning whether, to borrow the title of a recent business book, "this

time is different" with more banks now committed to this business long term and continuing to build off present strengths.

Financial Institutions Consulting (FIC) wrote this report with the interests and concerns of the industry's key stakeholders in mind. Bankers need to consider the factors that resulted in their current strong performance as well as the sustainability of that position. Independents, having survived the funding challenges of the recent past, continue to assess how they can compete against a reinvigorated banking sector while, similarly, Captives want to determine whether and how their financing role may be changing. Third-party vendors and outsourcers to the equipment finance industry view the banking sector as a major client opportunity and will want to evaluate the segments to which they should give the highest priority. The pace of change is quickening within the banking industry and, as this report will detail, the shifting dynamics of the leasing industry represent a significant positive area of change that can continue to benefit banks.

Executive Summary

In recent years the commercial banking industry has increased its investment in and marketing focus on equipment finance and leasing. Industry media now regularly report a bank's acquisition of another Independent or the announcement that a bank that had previously lacked a leasing capability has decided to establish that specialty business. The current operating environment for banks features low interest rates, in many cases an overabundance of deposits and capital that banks are struggling to put to work to generate strong returns, and limited opportunity in some of the areas in which banks have traditionally have been able to pursue growth. Numerous businesses that were once high priority for banks for various reasons now have reduced attractiveness. These include debit and credit cards, consumer and commercial mortgage lending, and checking-related overdraft fees.

At more banks the retail side of the house, once considered a stable moneymaker, is being rethought as branch transaction volumes drop and branch profitability declines.

Overall, banks face limited areas in which to grow on the consumer side, particularly in light of increased regulatory requirements and legislated limits on consumer-related fees. A senior executive at a $10+ Billion bank commented that much of his bank's energy was focused on "swallowing the Durbin whale." This refers to the amendment added by Senator Dick Durbin to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. It placed a cap on the fees that banks can charge related to debit card transactions. The impact of this change on bank earnings has been significant, forcing them to look elsewhere for revenue growth. For example, an SNL Financial analysis on interchange revenues for top banks calculated that Bank of America suffered a drop of over $440 million in yearly interchange fees. While the decline was significantly less for others, any reduction in this area when combined with reduced activities in other consumer and commercial businesses in effect creates a negative growth hole for banks to dig their way out. This has created the need for banks to find new lines of business or build out previously underemphasized opportunities.

While many traditional growth areas have lost their earnings dependability, relatively few alternative opportunities exist to replace them. This is particularly true in light of the downturn late in the last decade. During that period, many banks lacked sufficient liquidity and capital, at least in the eyes of the regulators, forcing them to pull back from business lines that were generating insufficient returns (often due to risk issues). Banks also reduced exposure to businesses that management considered non-core, and equipment finance frequently fell into that category. The managers of those businesses were often told to monitor their portfolios closely and emphasize risk management and loss minimization over growth. However, during the past few years, portfolio quality concerns have abated and restrictions on growth have been removed in light of an improved credit picture, limits on traditional growth areas, and the desire both to put deposits to work and generate strong returns. Equipment finance has risen in bank priorities in part because it can address that gap, as stated concisely by one bank leasing executive: "Leasing companies generate high return assets, and lessors know how to sell." Several of the leaders of the bank-owned leasing companies we interviewed mentioned that in recent months they had been asked by their senior management to step up their asset growth. In addition many customers still reacting to the downturn are conserving cash. Another executive commented, "Companies are putting a premium on liquidity and holding on to cash and revolver availability."

Operating an equipment finance line-of-business offers bank-owned players substantial flexibility and is now widely viewed by senior bank management as a priority business. As described by industry insiders, depending

upon the bank, its customer base, capabilities, and needs, equipment finance can play one or multiple roles in building the loan portfolio, among them:

- The equipment finance group provides a cross-sell product that commercial bank relationship managers can offer to current customers, allowing banks the opportunity to build their lending relationships and increase per customer wallet share, a key goal as the cost of customer acquisition requires banks to generate more per customer revenues and profits.

- Equipment finance can serve as a lead product, used to introduce a bank to a new customer and serving as what one leasing executive termed a "wedge product" for a new relationship that commercial bankers can then further develop.

- Depending upon the customer situation, leasing can serve as either a defensive product to allow a bank to avoid losing business to a competitive bank or a relationship starter.

- Bank-owned companies can also establish one or more industry specializations that operate on a regional or national basis. These verticals may focus on generating assets with companies that provide little cross-sell opportunity either for reasons of risk quality or customer need. One lessor summarized his bank's willingness to look outside its slow-growth footprint, "Within the footprint is critical, but does it matter where earning assets are? The issue is how to deploy excess capital." This focus beyond bank borders often allows banks to put their deposits to work at returns that regularly exceed those of its more generalist-oriented commercial bankers. And, while banks are often reticent to lend outside their footprint (due to risk-related concerns), the expertise of equipment finance professionals and their knowledge of the assets can allow for geographic expansion while maintaining strong risk procedures.

Perhaps more than ever before, top bank management has become aware of the value equipment finance offers in a business environment in which asset growth is difficult to attain, net interest margins are being squeezed, and the differentiation of one bank from another has become increasingly difficult to achieve.

This report illustrates the why and how behind the different approaches banks are using to enter or energize their leasing focus and the market strategies they are pursuing. In many cases leasing has moved beyond being a product to becoming a major line of business that operates with a substantial degree of independence from the traditional activities of the bank, although the corporate office oversees its risk management policies. While cross sell and deepening commercial relationships remain a major goal for virtually all banks, in many cases the majority of the growth that equipment finance groups generate relies on non-bank customers and non-bank specializations. Increasingly, senior bank management accepts that change since their bank needs to generate quality risk assets to fuel growth. As one of our interviewees commented, "My bank doesn't have the customer base required to allow for much cross sell. We need to go outside the bank to put up the numbers that the bank wants." More banks, particularly community and regional players, now accept that remaining local will not allow for the revenue growth required by shareholders and the investment community.

Yes, the leasing company operates within the requirements of the larger bank, but it has the freedom to take the bank into directions it may have never previously considered based upon the equipment finance group's expertise and market sense. Bank management needs to find new paths to growth, and today leasing offers one of the most attractive growth alternatives with a strong risk-return tradeoff.

Currently, banks generate the majority of NBV for the equipment leasing and finance industry and their performance statistics demonstrate strength not only in asset generation but also in portfolio quality and productivity. While our interviews suggest that banks will continue to dominate NBV for the foreseeable future, expectations are that both Captives and Independents will remain strong and viable competitors based upon their specialized knowledge, sophisticated structuring capability, and/or risk appetite. Without exception the bankers we interviewed see a continued role for both groups and, to some degree, an increased role for Independents. As the report will discuss, many areas exist where commercial banks either cannot or will not focus, whether based on transaction size, structuring requirements, risk profile, or other characteristics. Operating where banks will not and differentiating themselves based on elements such as risk sector, loan/value levels, turnaround time, or other characteristics provides bank competitors with significant future opportunity.

The equipment finance industry meets many of the banking industry's needs as it navigates through an increasingly competitive period that features a more demanding and less loyal commercial customer base and greater regulatory requirements. Leasing offers a capability that differentiates a bank with its customers, generates improved margins, relies on secured lending with additional repayment options beyond cash flow, and provides a sustainable business line that can expand (and contract) as bank liquidity levels change.

Introduction

Evaluating the role of commercial banking in equipment finance raises two fundamental questions for consideration, even if in each instance, no easy answer emerges:

- *What is a bank?*
- *What is a core customer?*

For many of us of a certain age, a bank conjures up an image of a high-ceiled space in which both employees and customers speak in hushed tones as if in a library and a huge vault demonstrates the security the bank offers. However, today many of those mausoleum-type buildings have been turned into restaurants, banquet halls, or condominiums and customers are as likely to access their accounts by their smart phones or PC than by walking into a branch, in response to which branch closings are far exceeding openings.

As the bank customer experience has changed so too has the list of the biggest U.S. banks. In mid-year 2013, the list of the top 20 banks includes many companies not usually considered as commercial banks; furthermore, any branches they operate would be hard, if not impossible, to find:

- Morgan Stanley (ranked 4th in assets)
- Goldman Sachs (ranked 5th)
- GE Capital (ranked 7th)
- Ally Financial (ranked 18th)

CIT is ranked number eight in the *Monitor 100* and appears as the 35th largest U.S. bank on SNL Financial's ranking of the 50 largest banks and thrifts. Operating without retail branches, CIT offers U.S. consumers a set of CD and savings products with competitive interest rates. Their retail products combined with other sources of funds have enabled CIT Bank to provide low cost and stable funds to its financing business. These diverse sources of funds provide CIT Bank with a funding advantage over those Independents that lack its range of funding options.

CIT became a bank holding company in 2008 along with other financial institutions that wished to take advantage both of the deposit guarantee offered by the FDIC and the Treasury Department's capital infusion program, an initiative aimed at stabilizing the financial system. Post crisis, the bank holding designation remains, allowing CIT to offer a competitive online savings product with the FDIC's backing. An August 2013 article in *Forbes* magazine states that its bank now has "$14 billion in assets and $11 billion in deposits. These deposits represent about 35% of CIT's funding today."

CIT is hardly alone in forcing us to reconsider our assumptions about what makes a bank. Among others, EverBank, headquartered in Jacksonville, Florida, is approaching $20 Billion in assets but operates with fewer than 20 branches, leveraging direct banking and specialties such as commercial finance to generate growth. 1st Source, a community bank headquartered in Indiana, generates close to 50% of its bank's total loans and leases

from its specialty finance group. Marlin Leasing and Capital Source (now acquired by Pacific Western Bank) are among others that have created banks with a similar purpose to CIT. In fact, Marlin Business Services, Marlin's parent, fully funds itself by its bank-generated deposits. Marlin also further highlights the complexity related to categorizing these companies. Its 2012 results appear within the Independent section of data reported in the 2013 ELFA's Survey of Equipment Finance Activity (SEFA) while CIT's numbers are within the bank industry data, indicating the current murkiness over defining a bank. In addition, some Captives also operate industrial bank charters, further complicating the topic.

Remember the tagline "Not your father's Oldsmobile"? We have entered an era in which we need to change our mindset concerning what a bank is and what it focuses on. For the purposes of this report, within the bank category we will include any equipment finance company that categorizes itself as a bank. However, we should also understand that the staid image many of us carry around in our heads is both outmoded and inaccurate. Further, this issue has yet to be resolved. One lessor with decades of working within a bank environment says that: "It is not clear that the discussion is over about what it means to be a bank from a regulatory angle. A blessing could become a curse. What seems to be an advantage today for the Independents that formed a bank may turn out not to be."

Just as a need exists to reconsider what defines a bank, so too does the concept of "core" or relationship customer need to be rethought. Traditionally, banks have defined a core commercial customer as one to whom they can sell multiple products and services, including commercial checking, loans, and cash management advice. Usually these customers also operate within the bank's branch footprint. However, as one equipment finance executive based in the middle of the country mentioned, "We have had some clients for 30 years. How much more of a relationship can you get even if they are in LA or Albuquerque and not our state?" Another banker cites his strong syndications capabilities as a core relationship for growing his business, one that direct borrower relationships could not replace. At the same time, bank managements continue to look for additional deposits from leasing clients and also may attempt to pursue private banking opportunities with selected executives from these companies. However, many senior bank executives now realize that their opportunities to grow are increasingly constrained and the assets and income leasing transactions generated may trump the often-illusive benefits of traditional relationship banking. For more lenders their view of a core customer now includes any significant long-term revenue generator without consideration of geography or, oftentimes, cross-sell potential.

Bank executives view commercial banking, including equipment finance, as operating without many of the constraints imposed by Dodd-Frank and the Consumer Financial Protection Bureau (CFPB) it created. One reason more banks perceive equipment finance clients as "core" results from it providing a way to put deposits to work with returns that exceed most other bank businesses and without the rigorous and some believe onerous oversight involved in serving consumers. While defining a bank lessor today involves some unwanted complexity, other industry groups offer simpler definitions:

Captives. Typically, a Captive lessor operates as a manufacturer's leasing subsidiary with the mission of providing financing for equipment made by its parent company. The parent supplies funding and capital requirements.

Independents. An Independent is any company engaged in equipment finance that is not owned by a bank or Captive and is not regulated by banking authorities.

Leasing and equipment finance. The terms leasing and equipment finance are used interchangeably in this report, as these terms are used interchangeably by the bank industry experts we interviewed while preparing this report. However, one Independent executive stressed that banks have focused primarily on equipment finance transactions rather than what he termed the "pure" leasing that many Captives and Independent emphasize with their greater focus on residual risk.

As this report discusses, the nature of banking has changed and the role of equipment finance (as well as the economic value of other specialized lending and investment groups) within many banks has increased both in importance to the bottom line and perceived value to top bank management. While there are merits to understanding the circumstances that have resulted in the bank's current strong position, the report's greater value requires exploring whether the factors that have enhanced the prominence of equipment finance within banks are likely to continue in future years. In addition we will assess the actions individual banks should consider to meet the challenges involved in sustaining their current strong position.

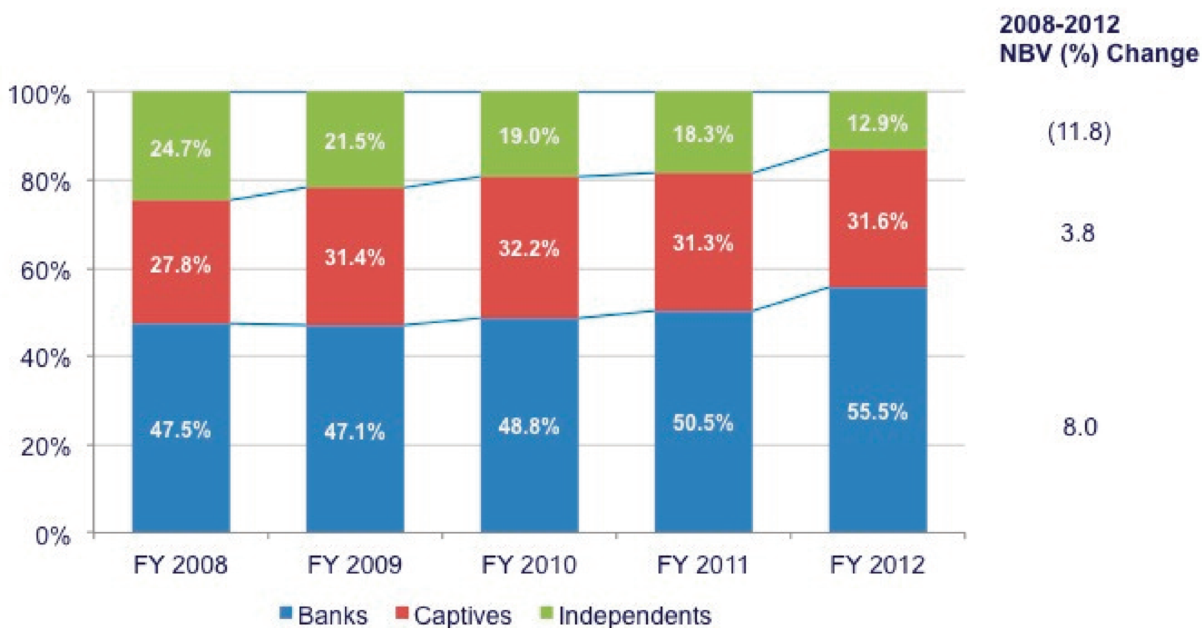
Profile: Current Performance of Banks In Equipment Finance

Survey data from the ELFA's Survey of Equipment Finance Activity (SEFA) shows that since 2009 bank-owned equipment finance companies have increased their market share. That growth occurred despite the economic challenges of the last decade and continues through today's stable but slow growth environment. Since 2011 banks have generated the majority of new business volume (NBV) and most interviewees believe banks will continue to grow share. This section reviews the recent performance of banks versus their Captive and Independent competitors, highlighting some of the specific ways in which banks have differentiated themselves and, thereby, gained share at their competitors' expense.

Based on the 2013's SEFA, bank share of NBV now exceeds 55% of total volume.

Exhibit 1

Bank Growth in New Business Volume



Source: 2012 SEFA, Table 1a

Both banks and Captives increased their share over the past five years at the expense of Independents (Exhibit 1). Independents suffered an almost 50% drop in share (from 24.7% of NBV to 12.9%) during that same period. Bank-owned companies benefited widely during this period. Specifically, in the last year close to 85% of the banks surveyed stated that their companies grew NBV in 2012 compared with 68% for captives and 78% for Independents.

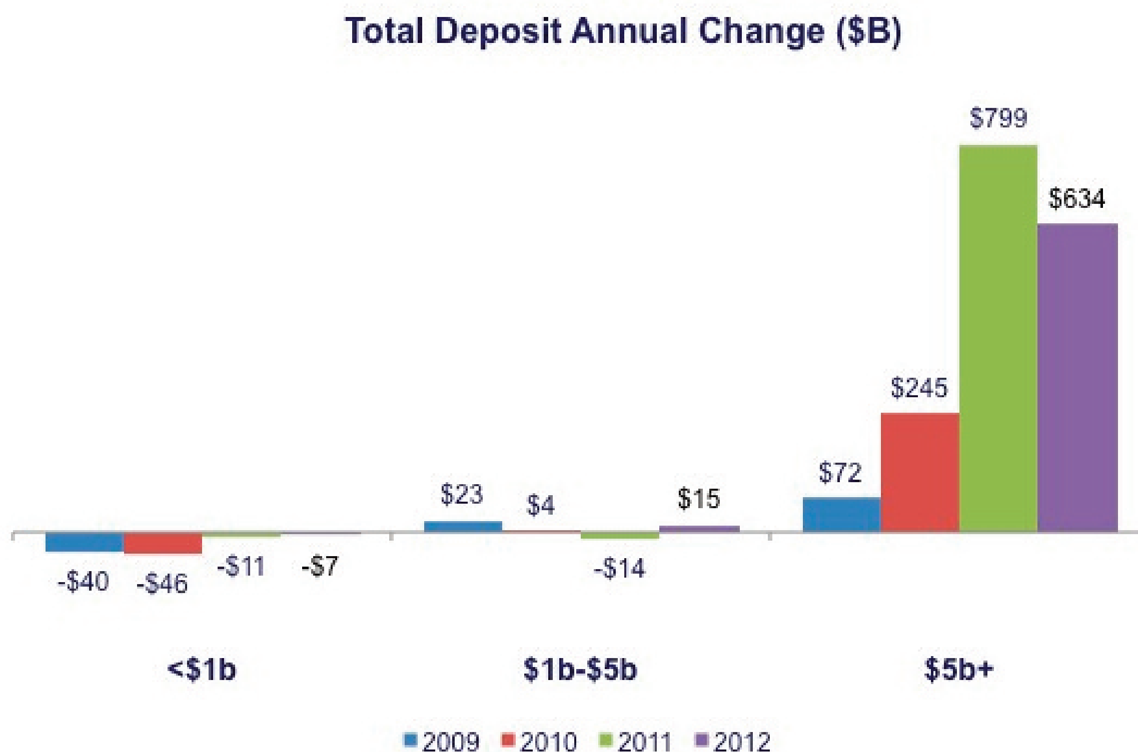
During the downturn, much of the banking industry's share growth occurred not due to its expansion but rather the rapid contraction of Independent activity due to its funding and in some cases risk management constraints. However, beginning in 2010-2011 and continuing until today, bank share has grown for at least four reasons tied to the industry's market commitment and perceived revenue opportunity:

1. Growth in deposits that the banks must put to work
2. Bank management's increased enthusiasm for the additional assets and strong margins that equipment finance loans and leases can generate
3. Funding costs that give banks a significant advantage
4. The continuing acquisition of Independents and experienced teams by banks

Focusing on deposits, banks, in particular the largest asset banks, have acquired liabilities at sharply higher levels in the last two years. At mid-year 2013 there were approximately 150 U.S. banks with assets above $5 billion. These banks increased their deposits by almost $800 million in 2011 and over $630 million in 2012, producing annual growth rates of 7-11%. Whether due to a perceived flight to Too Big To Fail (TBTF) banks, stronger marketing activities by these players, or for other reasons, the big banks are getting bigger. One executive working for a large bank commented on the impact of increased deposits saying, "Banks are aggressive today because of the level of liquidity they have; they do not want to leave it unused." He went on to stress one way in which leasing groups differentiate themselves from other parts of the bank: "When we use our balance sheet, we get paid better [when compared to a typical commercial banking loan]."

Exhibit 2

Deposit Growth for All FDIC Institutions by Asset Size



Source: Optirate, FDIC

While the big banks appear to be getting bigger, smaller banks with assets between $1 billion to $5 billion show flat growth in deposits over the past two years, limiting their need to find new areas for lending (Exhibit 2). More significantly, smaller community banks, while totaling over 6,000 institutions, have suffered a net deposit outflow of about $100 billion over the last four years. This has resulted from the acquisition of community banks by larger players, the increased marketing clout of bigger banks, and the capital issues some smaller banks have been struggling with, limiting their ability to grow. While many community banks remain strong and vital players in their local areas, others lack the liquidity, capital, and management resources required to engage directly in the leasing market. However, as we will discuss, smaller banks can mitigate their risk of becoming increasingly marginalized with their commercial customers by partnering with larger firms to offer an equipment finance capability. Nonetheless, given the growth patterns and shifts in deposits away from smaller players, larger commercial banks lead in pursuing inroads into equipment finance.

With the growth in bank NBV has come the increasing importance in direct originations for banks. In 2012, banks generated 50.9% of NBV directly, up slightly from 49.7% the prior year. For control, quality, and risk management reasons most of the banks we interviewed would prefer, if possible, to generate increased business from direct originations and cross sell, and interviewees frequently commented on their banks' increased direct origination focus. There are two aspects to direct origination; first, leveraging a targeted and usually specialized sales force across one or more industry verticals and, second, cross selling to a bank's current customers.

Equipment finance groups distinguish themselves from many of the commercial banking groups within the traditional bank by their extensive and disciplined focus on one or more industry specializations. Multiple banks pursue some of the more popular industries, such as health care, transportation, and aircraft. However, they will further define their focus to particular types of equipment and lessor requirements. Lessors emphasizing industry specializations cited the benefits of this approach, including lower cost of origination (due to developing a positive reputation within the industry and a network of targeted and pre-screened contacts) and strong risk management (due to knowledge of the equipment and their ability to focus on high reputation customers while avoiding others), among other factors.

Historically, cross sell, a growing source for direct originations, has been a frustrating area for many banks. The concept is simple, but good execution has often been elusive.

For decades selling more products and services to a commercial customer by instilling seamless cooperation between several units within a bank has been difficult to achieve, in part because internal groups operate with separate and even conflicting performance goals. In the past, leasing executives have frequently portrayed the commercial banker as being unwilling to bring in an equipment finance expert, preferring to keep the transaction within his current portfolio. Similarly, at many banks the leasing group has been viewed as an outsider by the bank relationship manager. Lessors, infrequently, if ever, referred deals to the traditional commercial bank and like the commercial bank group they concentrated on reaching their own goals rather than addressing the overall bank's total wallet share opportunities.

Insufficient product knowledge, issues of customer control, and compensation have all contributed to the prior lack of cross-sales success. Commercial bankers within the middle market or corporate lending groups have often failed to understand the “value added” provided by the equipment finance specialist, instead preferring to structure and book the loan without the input of another group. Feeding that defensiveness has been reasonable concern about the leasing group encroaching on a particular customer's internal “loan limit” and, thereby, reducing the amount of loan dollars available to a customer for whom the commercial banker believes he has

responsibility. Perhaps even more fundamentally, many banks offered poor or insufficient incentives to encourage the two groups to work together and failed to address compensation issues, “the elephant in the room” restricting internal cooperation.

At more banks today, senior management is addressing the organizational and compensation issues that have previously made success in this area difficult to achieve. In interviews, several bank-owned players expressed the view that a greater emphasis on cross-sell and the direct origination activity it requires increases their bank’s productivity and more effectively links the leasing group to the “core” bank that is focusing on serving the overall deposit, cash management, and lending needs of the commercial customer.

Signature Bank provides one example of the current focus on cross sell, including among those banks recently entering the leasing space. In 2011, this New York-based bank established its equipment leasing and finance group as part of a newly formed group, Signature Financial. Within this group a dedicated team operates to generate direct referral-based sales from commercial bankers. The Regional Direct Sales Group works with the bank’s relationship managers to develop and close equipment related referrals; equipment deals across the bank must be referred to Signature Financial both because of that group’s structuring capabilities and its pricing discipline. Management in effect insisting on transactions being referred to the group with the appropriate expertise has become a foundation step in effective cross sell at that bank and others. Signature Bank, a 2001 startup, began with a clean slate and an internal mandate regarding referral practices. Signature is hardly the only bank with an established referral process in place, but approaches like Signature’s are becoming more of the norm rather than the exception.

Huntington Bank provides an example of a more established cross-sales effort, what a Huntington banker terms a “bank cohesive model” whereby the leasing sales staff operates with a dotted line to the geographic regions and directly to the equipment finance group and each commercial lender has goals that include leasing. However, other banks we interviewed that also possessed long histories in the equipment finance arena continue to struggle with internal referral policies with few requiring the type of discipline Signature senior management has been willing to mandate. One noted that the heads of several of the regions in which his multi-state bank operates have decided to send all leasing deals to his group while those operating regions in other areas have still not required that step. He remained “hopeful” that ultimately those other regions will fall in line. Yet, as others have stated in different contexts, “Hope is not a strategy.”

At Signature, once a referred deal closes, the bank’s management communicates the details of the successful transaction to the staff, encouraging further cooperation. Not surprisingly, compensation policies play an important role in encouraging internal cooperation. Relationship managers (RM) will receive approximately 25% fewer basis points of compensation for a referred equipment transaction as for a Commercial & Industrial (C&I) loan booked within its own group. Therefore, on the face of it, it would make sense for relationship managers to handle the deal without leasing’s involvement. However, with referred deals Signature Financial takes responsibility for getting the deal completed and owns 100% of the credit risk of the deal versus the claw back on losses that occurs if a C&I loan goes bad. Improving RM productivity and compensation support cross-sell cooperation.

The equipment finance group at Key Bank, a longtime player in the leasing space, also encourages cooperation with the commercial bank both through compensation and process streamlining. A senior executive commented, “Bankers do not get “disincented” when they go from a loan to a lease. The impact on their compensation is mostly neutral. But the equipment finance group handles all aspects of the transaction and the commercial

banker receives credit in his loan production numbers." A streamlined process encourages banker cooperation at Key and other banks. One commercial banker at a small regional mentioned his small business bankers' enthusiasm about working with bank lessors on deals because of the speed with which transactions are completed versus a slower approval pace within the bank.

Key operates with a proactive approach to cross sales that we expect more banks to emulate. The equipment finance bankers will access the Key commercial banking database and proactively review it to uncover customer opportunities. For example, they determine target companies that have UCCs filed with other banks that will soon be expiring. One of the leasing group's jobs is to serve these leads up to the commercial banker and then participate with the commercial banker in the marketing process. Key also physically embeds equipment finance sales people in each of the 14 states in which it operates. They are part of the local team, attend local sales meetings, and even though they report up through the equipment finance group, they operate as if they are part of the local geography. As described by the bank, this has been the Key Bank approach for decades, allowing cooperation between bank groups to become part of the organization's culture. Co-location of leasing personnel with bankers was cited by a number of bankers as one of the factors necessary to increase the level of cooperation between the groups.

Key's equipment finance group has developed the referral program even further through a long-established approach termed "lead with leasing" by which they introduce clients to Key Bank by being the customer's entry point with Key. One example involved building off the vendor business they do with municipalities. Vendors themselves are understandably concerned about a bank using the limited lending facilities that banks allocate to municipalities for additional non-vendor-related debt transactions. Therefore, Key focuses on selling non-loan products to these municipalities, including deposits and other fee generating activities. A Key banker estimated that up to 70% of lead with leasing clients, those clients who have never done business with Key previously, go on to become broader customers of the community and commercial banks. Direct sales generates some of those clients while vendor relationships generate others. Other banks are just taking the first steps in promoting the organizational and cultural changes required to make cross sell a significant sales activity. However, our interviews indicate that this area has become a higher priority for bank growth as well as an area in which banks are increasingly willing to "walk the talk" and commit to action. Direct originations are likely to increase as banks continue to hire teams of industry experts with strong industry-specific contacts and as they establish internal cross-sell efforts aimed at greater commercial customer penetration.

Four principles appear to drive a successful cross-sell and relationship sales effort:

- Clarity about a equipment finance group's capabilities and the economic value it provides to the overall bank
- Commitment from senior management to encourage referrals
- Dedicated referral-focused staff within the equipment finance group
- Compensation policies (listed last but perhaps of first importance) aimed at putting a leasing transaction on an equal standing with a loan for a commercial banker

While more focus centers on direct origination, banker enthusiasm for working with brokers and Third Party Originators (TPO) to generate transactions differs dramatically, reflecting both some negative past experiences and market realities. In 2012 banks sourced a slightly higher percentage of transactions through third parties with

this channel's volume increasing slightly to 14.9% in 2012 NBV versus 13.8% in 2011. During the same period banks further decreased their dependence on captive/vendor programs (34.3% in 2012 versus 36.5% in 2011).

Some banks totally avoid TPOs while others embrace this channel as a way to broaden their marketing reach. Interviewees express a wide divergence of opinions concerning the value of third parties and their own willingness to work with them. Banks such as 1st Source refuse to pay referral fees to any third parties. Prospects brought in to the bank by third parties may pay fees directly to the TPO, but they know that 1st Source does not receive any portion of that payment.

While some banks avoid TPOs, other companies such as Financial Pacific (FinPac), recently acquired from a private equity firm by Umpqua Bank, generates virtually all of its volume from TPOs and has built this business source into the foundation of its business model. The nature of FinPac's business requires the use of TPOs as it focuses on transactions with an average ticket size of $25,000. Its risk management profile centers on internally rated "B" and "C" quality credits for private companies, many of which may have been previously turned down by other lenders. To generate its deal flow FinPac works with 500 TPOs across the country, some of which are one-person shops and others more established companies. Not surprisingly, the 80/20 rule applies here as elsewhere with most of the volume coming from fewer than 100 referral sources that the company knows well. FinPac has operated with this model since 1987 and has developed strong procedures to minimize fraud and concentration risk. A senior executive commented, that FinPac will "verify and validate everything." They have the procedures in place to check and underwrite all the data they receive from the TPOs. This includes ensuring that the potential lessee is operating from the location given and tracking the performance of each vendor.

Banks that use TPOs may look to them as the source of an initial transaction that they can then turn into multiple deals and a bank-wide relationship. The intensity of the current competitive environment may be resulting in more bankers rethinking their hesitancy to work with third parties and reconsidering the opportunities that third parties can provide. One interviewee commented that his bank, while remaining somewhat hesitant, now sees greater opportunity in selectively working with TPOs than simply eliminating that group as a possible source of business.

Even some banks that avoid a direct exposure to TPOs still take advantage of the deals TPOs generate, if only doing so indirectly. One bank lender to FinPac prior to its acquisition stated that they were involved in third-party opportunities through the deals FinPac does: "We [do broker-based business] by lending through [FinPac] rather than doing it ourselves. FinPac can "do that kind of business programmatically." Specific to companies like FinPac, "Banks do not have the tolerance for high losses even with high returns." Unlike many bank pricing practices, FinPac achieves those returns in part because of its ability to impose risk-based pricing on its customer base.

Whether generated directly or through third parties banks dominate NBV growth through these channels. In 2012, bank-owned companies captured close to 82% of total NBV originated directly and over 84% of all third-party transactions versus 2011's 80% and 79% performance.

Another origination channel that has revived involves syndications. During the downturn deals were fewer in number and the appetite to take on externally generated risk declined sharply. Some banks that want to achieve near-term growth in their equipment finance business now look to syndications as an immediate growth engine. Cole Taylor Bank, recently acquired by MB Financial, is in the process of hiring up to ten direct sales staff. However, as of the third quarter 2013, 100% of its volume resulted from buying participations in syndications originated by the top 15 banks.

Rather than accepting vanilla transactions with the low margins they offer, a senior leasing group executive states that Cole Taylor specializes in transactions that involve greater operational complexity: "We want to do transactions with a higher service element and higher fees." His group may focus on generalist rather than specialized industry lending, but it differentiates itself in the type of transaction it focuses on: multiple takedowns, multiple vendors, and multiple locations. These deals offer higher margins and in many cases they result in direct contact with the end borrower: "These deals have a lot of connectivity to the CFO because of the multiple takedowns."

This executive thinks that small to mid-sized banks entering the business are ideal candidates to engage in the syndications arena; these banks represent "fresh money" to the syndicators and being small they should, ideally, be able to make decisions quickly. These players are also hungry to put on assets: "We like being a player in the national market where [bank asset] size does not matter so much."

However, just as FinPac's leader stressed the need to verify all aspects of his TPO-generated deals, so too does Cole Taylor's views underscore the need for the buying bank to practice due diligence on each transaction: "We are checking what we buy." This includes not only credit analysis but also a strong focus on operational issues. He notes the sloppiness he has seen in some syndications offering memos and said his operational people have found missing or inaccurate documents in the offer package: "Many big banks treat back office staff as hourly employees; our operations staff is where we have a value-added component." Operational excellence has become a critical part of his bank's opportunity to be invited into syndications.

Given the higher growth rates occurring outside of the U.S., the international area could offer growth at least to larger banks with international networks; however, many banks are deliberately avoiding non-U.S. activities with some even reducing their current limited exposure. The most recent ELFA survey shows that only 26% of banks generating any international volume versus 44% and 31% for Captives and Independents, respectively (SEFA, 9a). International NBV grew by 60.1% from 2011-2012. However, Captives generated 85.6% of all international volume with banks reducing their share to 14.0% from 19.5% the prior year. Asia and Europe, increasingly critical for Captives (and their parents) are largely off the radar screen for banks.

One lessor at a bank-owned company with an international portfolio mentioned that it was refocusing more extensively on the North American market (including Canada) versus its earlier focus in Europe, Asia and the developing markets. Among the factors mentioned as causing this increased domestic focus were the greater transparency of information in the U.S. as well as a better ability to meet risk and regulatory requirements in the domestic market. It is "easier to get more done with fewer resources" in North America versus most other geographies, limiting the attractiveness of foreign markets. Both internal compliance and increased external regulatory scrutiny may act against exploring extensive overseas revenue opportunities.

While, as our interviews indicate, many of the best players select specific industry segments on which to focus, most banks do not significantly differentiate themselves by the type of product they offer (SEFA, Table 7c). One banker asserted that "90% of the industry's marketing is price driven," rather than differentiating on product or other attributes. Banks emphasize more non-tax oriented leases and term loans (56.4% of total NBV) versus their competitors and, not surprisingly given their local community connections, provide a greater percentage of municipal leases that others (8.9% of the bank's portfolio versus 2.0% for Captives.)

Although the banks' product mix may not differentiate their offer from Captives and Independents, the lower cost of funds provides a distinct differentiator, clear advantage, and major profit driver. As noted elsewhere, the banks'

funding advantage also continues to drive a number of Independents into the banks' corporate arms. Exhibit 3 depicts the funding advantage held by banks, particularly over Independents. In 2011 banks benefited from a 155 basis point advantage over Independents; in 2012's lower rate environment that advantage dropped to a still very significant 139 basis points. The starkness of the banks' advantage becomes clear when comparing total costs of funds between banks and Independents. While all players benefited from a cost of funds drop in 2012, the 2.67% cost for Independents exceeds the 1.28% interest charge for the banks by 108%.

Exhibit 3

Pre-tax Yield, Cost of Funds & Pre-tax Spread by Organization Type

*May not total due to rounding.

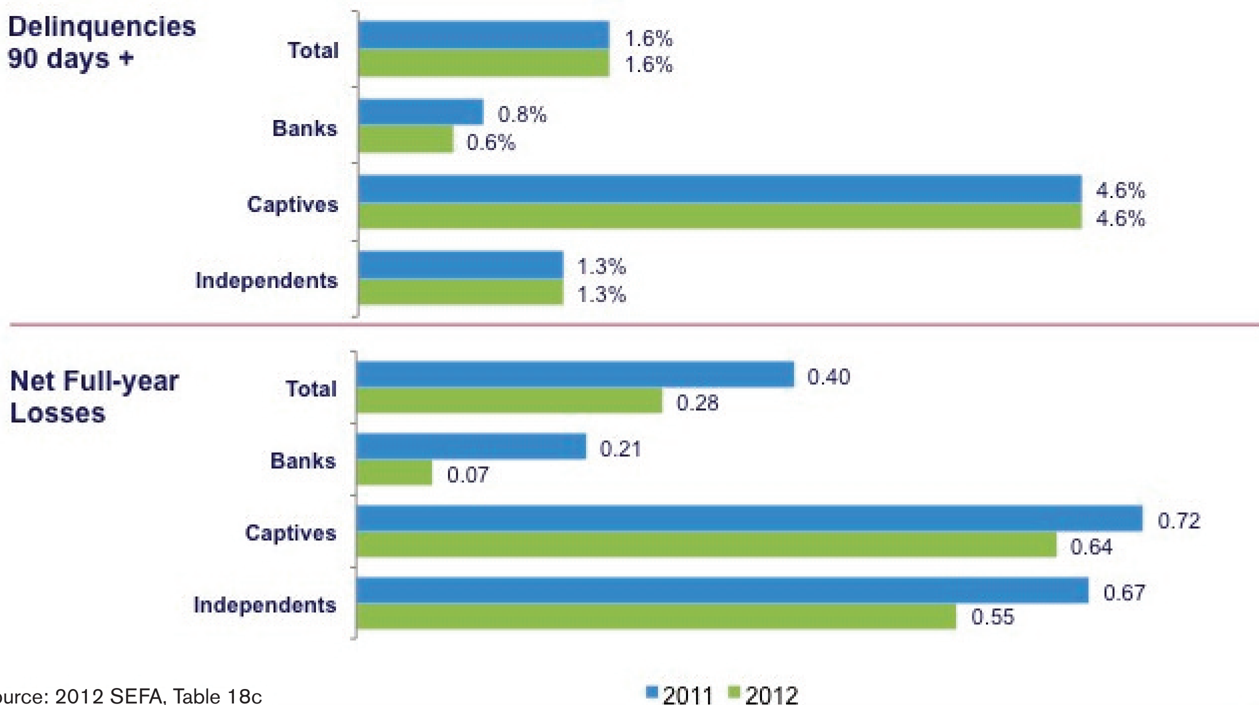
Source: 2012 SEFA, Table 10c

Bankers are well aware of this advantage and the benefits it provides. One bank executive from a large regional commented: "Big banks and regionals have a rather unique advantage in their cost of funds. It leads to better positioning in the credit quality of the deals we can do. We also have much greater financial leverage than Captives or Independents."

Both its funding advantage and the selectivity in the type of clients that banks pursue result in lower pre-tax yields versus competitors, 4.21% in 2012 versus 4.54% and 8.84% for Captives and Independents, respectively (10c). The bank's funding advantage and risk management philosophy allow banks to avoid many higher risk transactions and, thereby, operate with lower delinquencies and losses (18c). Most banks avoid deals below a B/BB rating both in deference to regulatory concerns and senior management's discomfort with high percentage losses. As discussed in a later section, this reticence may be one factor in ensuring the long-term viability of Independents.

Exhibit 4

Portfolio Quality – Delinquencies and Non-Accruals Type of Organization



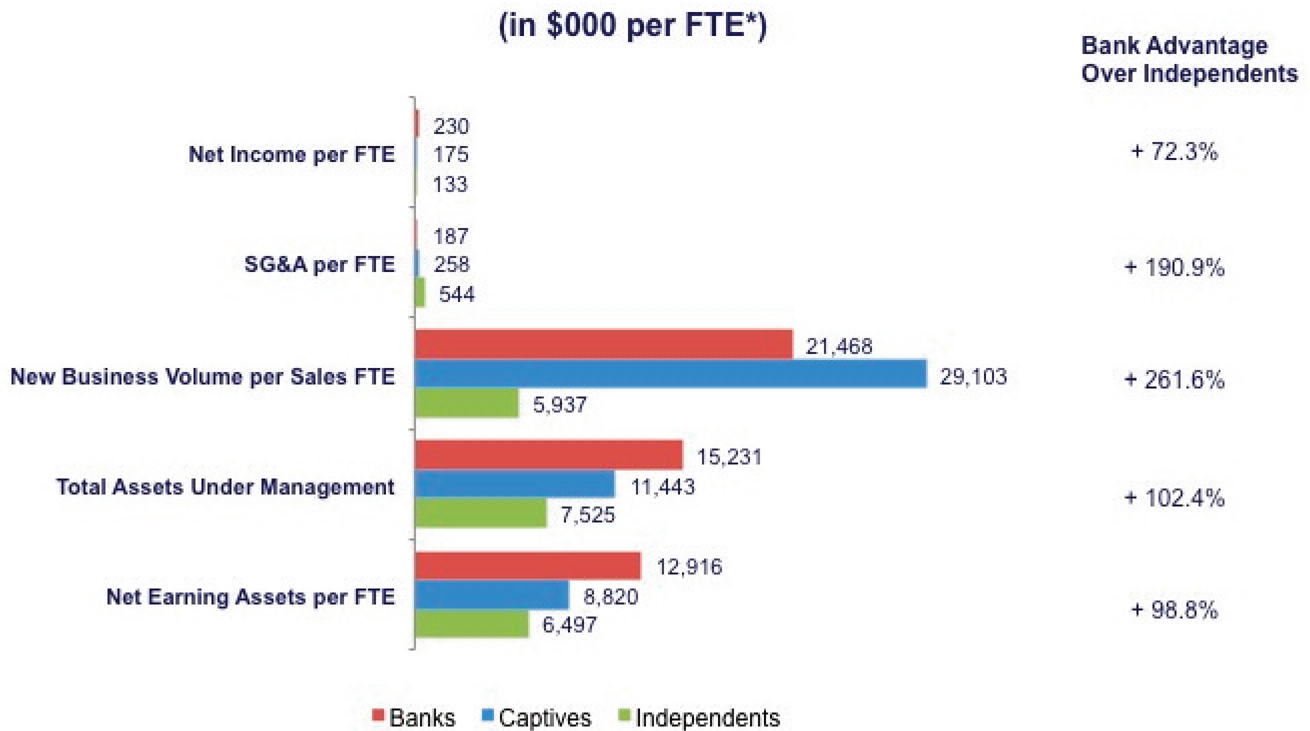
Source: 2012 SEFA, Table 18c

For 2012, delinquencies beyond 90 days totaled only 60 basis points while Captives and Independents suffered from much higher delinquencies of 4.6% and 1.3%. (Exhibit 4) Despite the improving 2012 economy, only banks reduced their 90+ day delinquencies from the prior year. Losses were also dramatically lower for banks than others (SEFA19c). Net full year losses in 2012 reached only seven basis points versus 21 basis points the prior year. Competitor write-offs, while well below 1%, were eight-nine times higher than for banks, at 64 basis points for Captives and 55 basis points for Independents.

Leasing group leaders have worked hard to minimize losses and believe that their groups outperform the traditional commercial bank in portfolio quality. One leasing group head of a bank-owned group says that lessors operate with a “different mentality” related to managing losses, and he discussed why bank-owned equipment finance portfolios usually show lower levels of losses versus a commercial bank group: “We have essential use collateral,” meaning some businesses cannot operate without the equipment his bank is financing. In that bank’s case, his group can have its leases reaffirmed in bankruptcy and companies will continue to pay if the equipment is considered critical.

Further, in many cases groups like his are transaction rather than relationship-focused suggesting that they can negotiate with greater intensity and, when appropriate, with less concern about a long-term relationship. Because of the concerns over the total bank relationship “a banker would negotiate himself out of [a restructured] deal.” This lessor and others state that banks often tend to charge off losses too quickly rather than trying to actively work them down.

Exhibit 5
Comparative Operational Efficiency



FTE = Full-time equivalent

Source: SEFA, Table 30b

Productivity has also been a critical factor in the banking segment's enhanced performance, increasing in the past year and dwarfing that of Captives and Independents in almost every available metric (Exhibit 5). Banks have been able to generate more net income per FTE than their competitors and close to four times as much 2012 NBV per employee as Independents. Bank-owned companies cite three key factors allowing them to operate so productively:

Focus. They define focus as operating with clear priorities concerning the areas in which their companies want to do transactions and the areas they wish to avoid.

Higher quality transactions. As noted above, banks typically want to deal with "B" or above deals. This eliminates some of the internal back-and-forth conversations with risk management and compliance groups that can occur with more difficult deals.

Culture and compensation. A significant component of leasing compensation is tied to revenues and bottom line results, more than has historically been the case with traditional bankers. Leasing sales staff trends to be very results oriented with the sales effort organized to minimize the time spent on administrative and other non-sales activities.

Again, the importance of compensation should not be underestimated in the extent to which it drives the success of bank leasing activities. The head of one major regional bank lessor said that, "The better sales people are in it

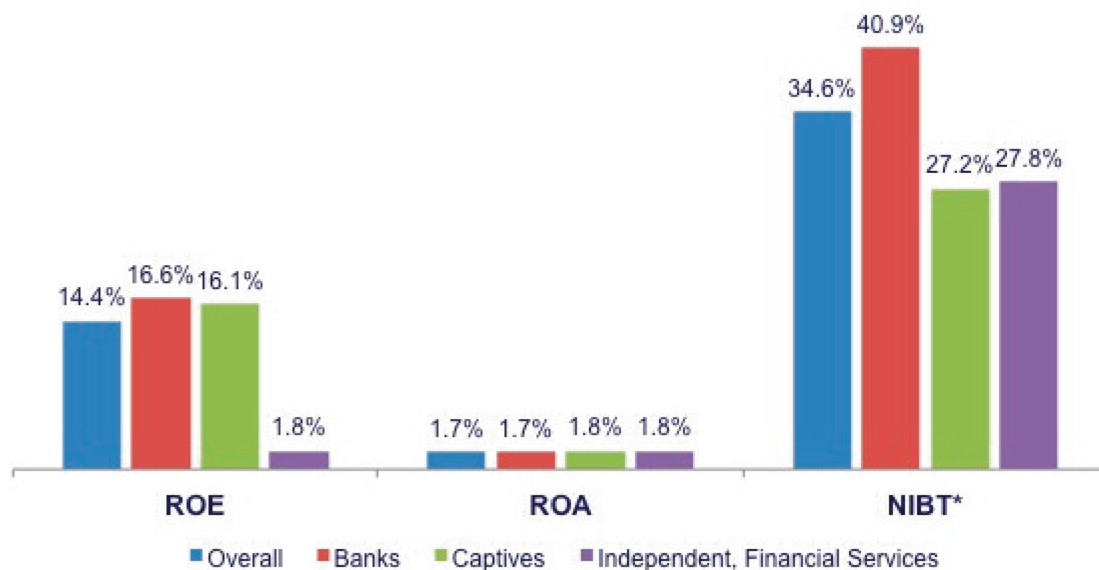
[equipment finance] for the money. They will focus on the deals that will work within the bank and avoid those that they think will go nowhere. They start with knowing what will get through credit approval…[commercial] bankers are a different breed than lessors. They need to be a jack-of-all-trades but master of none. Lessors know that the better they work the more money they make... the better ones know how much they will make personally from every deal they do." The most effective leasing salespersons within the banks have targeted their sales activities to those that meet their personal performance goals, including revenue generated. Another regional bank leasing executive contrasts his sales staff with commercial bankers: "RMs want to do a deal with a client even with thin pricing. They do those deals because they believe they will get others as part of their relationship building." Lessors are often more transaction focused and want to maximize the return from each deal.

Further enhancing productivity in recent years, banks have focused on cost reduction and "delayering" their organizations, an initiative that includes process streamlining. "Doing more with less" is a theme articulated by several leasing executives we interviewed. For example, from the beginning of the downturn until today, one group reduced its staffing by over 15% while at the same time increasing it NBV by over 30%. Part of this improvement resulted from executing on internal efficiencies in functional areas ranging from originations to documentation. In addition, the leasing group better aligned itself with the commercial bank, improving the lead generation and cross-sell process to increase internal bank deal flow.

Profitability ratios (Exhibit 6) reflect both the banks' greater productivity and higher leverage. Banks and Captives are able to operate with substantially more debt and leverage than Independents. In 2012, total debt to net worth was 9.2x for banks, 9.6x for Captives and only 2.5x for Independents. Banks and Captives held about 14% equity and 86% debt in 2012; Independents operated with 50.6% equity. Basel III may ultimately increase the banks' equity requirements, but a significant leverage cap favoring the banks is likely to remain.

Exhibit 6

2012 Profitability by Organization Type



*As a percentage of total revenue

Source: 2012 SEFA, Table 10c

As the end of 2013, banks appeared well positioned to achieve further growth in share and profits based upon their funding advantage, risk management discipline, ability to exploit commercial bank relationships, and strong productivity. The bigger issue may be not the banks' current position but whether their strengths are sustainable and long term. Are the banks likely to continue along this path moving from strength to strength or will they retrench in the face of market challenges or potentially more attractive uses for their capital?

Approaches for Entering or Growing Equipment Finance

As the economy emerged from the recent economic downturn, banks operated with widely divergent approaches to equipment finance and were at significantly different points in developing that business. Many banks, some of which were long-time players in this space, had entered a maintenance phase in which leasing growth was discouraged by senior bank management in light of capital and funding constraints. At these banks current customer needs were usually met, but new initiatives were largely off the table. In some cases, bank management viewed leasing customers as non-core and chose to allocate capital to other customer groups. Still other banks actively exited certain segments, as illustrated by Citicorp's sale of its middle market commercial finance business to GE Capital while it maintained a strong focus on its corporate segment. Yet another set of banks had never developed a leasing capability, had virtually no exposure, and viewed equipment finance as a startup.

Some of the well-established banks in this business, including Key Bank and US Bancorp, are continuing down a path they have been pursuing for many years. As we will discuss, they may add verticals or additional sales staff but their basic strategy has been established. However, another set of banks is either entering leasing for the first time or is making a more dramatic commitment to the business. It is those banks that are the primary focus of this section, since they are dealing with more fundamental questions concerning how best to enter the business and operate with a differentiated offer.

Three major options available to banks entering or wishing to grow this business.

In general, banks can either buy companies, attract experienced teams of leasing experts (lift out), or work with third parties to leverage their capabilities while minimizing the bank's upfront investment.

Acquisitions of existing companies. In most cases this involves a commercial bank purchasing one or more Independent companies with the acquired company usually reporting into the head of lending or bank President. Examples of this approach include:

- EverBank's 2010 acquisition of Tygris Financial
- City National Bank's 2012 purchase of First American Equipment Finance
- Umpqua Bank's 2013 purchase of Financial Pacific Leasing, LLC
- MB Financial's 2013 acquisition of Celtic Commercial

During the downturn many Independents struggled to maintain relationships with the banks financing them as some banks reacted to their own reduced liquidity by limiting funds available for lending to leasing companies, pushing many toward considering sale. However, in those years bank acquisitions of Independents were few in number and the acquisition options available to them limited. Today, the tide has turned for Independents, many of which appear to be able to select their buyer by targeting the handful of bank acquirers they believe provide the most appropriate cultural fit and growth opportunity for the leasing company and its employees.

While the story has ended happily for the acquired company, EverBank's 2010 acquisition of Tygris Financial provides a perspective on how even a well-capitalized and extremely respected Independent needed to face up to the funding crisis created as a result of bank reticence to lend. In the words of a senior executive, this

acquisition occurred "more out of necessity" than by design. By 2008 Tygris, focusing on small ticket and middle market leasing, found that the securitization market was closed, and with the banking system in turmoil, faced challenges in obtaining a bank license and the type of access to funding that CIT and Marlin Business Services, among others, were later able to achieve. To maintain its customer relationships Tygris needed to fund itself out of capital while trying to obtain a stable source of funding despite a highly unstable environment.

Enter EverBank. At that point EverBank was primarily a successful Internet bank focusing on offering consumer mortgages. In addition to its strong leadership team, it saw in Tygris "an unlevered loan portfolio;" a company that because of Tygris's strong capital position, would allow EverBank to increase its Tier One capital while diversifying its loan book. Tygris received the access to low cost funding it wanted while EverBank gained a growth business that provided a diversified stream of assets.

As with other players, the future growth path combines organic growth, acquisitions, and the hiring of new teams for the equipment finance area as well as expansion into other areas of commercial finance. In the leasing executive's view his company and other bank-owned players will continue to buy Independents to "build capacity and generate higher net interest margins in a low-rate environment." While EverBank has added originators and additional lines of business, cross-sell opportunities have been minimal with the equipment finance group working "autonomously" while taking advantage of existing capabilities in IT, Tax, Treasury, Compliance, and other functional areas. Unlike some other acquired finance players, the former Tygris group "does not need to battle with the entrenched C&I loan business" to generate assets and rather is leading the bank's move into the commercial space.

A more recent bank acquisition, Umpqua Bank's 2012 purchase of Financial Pacific Corporation, occurred under very different circumstances. Prior to its purchase, a Chicago-based private equity (PE) firm had owned FinPac. PE firms usually expect to monetize their investments, often not more than five years. As a sale became more likely, the company's president knew he wanted to be proactive in looking for an acquirer. In his words, "I did not want to be sold. I wanted to influence who the buyer was. I knew the best [buyer] profile for the employees. " As it turned out, the "best candidate was under our nose," and in fact Umpqua was already part of FinPac's existing bank syndicate and understood its market focus and operation approach.

The equipment finance industry, while not a closed club, remains a tightly knit industry where networking plays a critical role. FinPac's knowledge of Umpqua and some of its senior personnel allowed his team and owners to negotiate directly with the bank rather than solely through an investment banker, reducing costs and time to complete a transaction: "The fit was too perfect" and while a good price was important to the owners the market for the company was "limited due to its risk profile and delivery channels."

FinPac focuses on a business niche that many banks avoid, namely, small ticket transactions (average ticket of $25,000) often to small companies that may have previously been turned down by other lenders. The company brings to this business decades of management experience in this space, a proprietary scorecard, streamlined processes, core collections competency, and other capabilities that combine to create the company's "secret sauce." FinPac "knows how to underwrite small businesses that other lenders have neither the knowledge, tools, and/or confidence to do so effectively," a differentiating capability in today's market. Unlike most commercial bank lenders the company also risk-base prices, a discipline that "helped us manage through the elevated risks of the downturn."

Its business also diverges from most banks in its strong reliance on brokers or Third Party Originators (TPOs), as noted in an earlier section, a channel most banks avoid. A bank executive acknowledged that this origination source needs to be managed carefully and noted that one prior competitor "got hurt by this channel" due to that company's insufficient risk management procedures. In his view, lenders sometimes blame the TPOs for their risk problems instead of their own flawed scoring systems and an inadequate emphasis on verification of data.

Prior to this acquisition Umpqua had begun a leasing effort in 2011 to replace a third-party referral relationship that had not generated much volume. The bank's focus on leasing started primarily for defensive reasons as its customers were going outside the bank to meet equipment finance needs. In effect Umpqua replaced the outside vendor with a leasing expert who works directly with the bank's commercial lenders to cross sell to existing relationships and prospects; virtually all the equipment finance outstandings generated resulted from banker referrals.

While the FinPac acquisition (leveraging TPOs) and the more traditional cross-sell emphasis (leveraging feet on the street) may represent two distinct approaches to growth, the expectation is that this combination begins to build out Umpqua's offer in this space and provides the bank with a new and attractive path for deploying its capital. In effect Umpqua acquired a leasing "platform" that could quickly and easily be scaled into alternative market segments, given the bank's capital and cost of funds. This can include focusing on higher quality credits from the TPO channel and the small business and middle market segments by adding an in-footprint direct channel as well as a national vendor channel capability. The traditional FinPac model, though continuing to be a focus, may quickly be diluted by the extent of growth in these other market opportunities. When all is said and done, the expectation is that FinPac will look very much like the traditional bank leasing operation that so many others have built. Its first priority will focus on in-footprint and cross-sell opportunities, however, a bank executive, like the heads of several other bank-owned companies we interviewed, believes that most of the obtainable equipment finance growth exists outside of his commercial bank.

Many Independents are now in the position of being able to pick a buyer or at least avoid those potential buyers they view as least attractive. While as in FinPac's case, the potential buyer list may be limited based upon the type of business the leasing company pursues, in the current environment there appears to be multiple buyers for any established player with strong management that made it through the downturn intact.

Most potential acquirers we interviewed prefer to buy existing companies rather than teams. They want a group that can "hit the ground running" and generate assets as quickly as possible. In addition, some bankers commented that in their view potential lift-out groups overvalue themselves and require too high a price both in immediate and long-term compensation. Further, some mentioned that the portfolios of lessees that lift-outs promised to bring over to their new firm sometimes did not materialize.

Bringing in experienced teams. While some banks prefer acquisitions for growth, others take a different approach, building out their leasing opportunity on a de novo basis, often with one or more experienced teams of new hires. Examples of banks bringing in one or more experienced leasing executives include Cole Taylor Bank, headquartered in Chicago (its acquisition by MB Financial was announced in early 2013), and BBVA Compass which recently announced in a press release that it was entering the leasing business with the expectation that "This new division strategically fills a gap in the bank's product offering." However, no bank provides a better example of a bank avoiding acquisitions and relying on hiring teams than Signature Bank of New York.

Founded in 2001, Signature Bank serves metropolitan New York and emphasizes serving privately owned businesses. Its assets total almost $20 billion. Growth has occurred both organically and by an established program of hiring teams of experienced executives from other banks, who maintain relationships with prior clients and hope to bring them to Signature. The bank has never acquired a company, preferring the experienced hire approach. It attracts these hires in part because of its very flat management structure that allows most teams to report directly to the bank's president. The bank's organizational structure and operating philosophy translate into as 37% operating efficiency ratio versus over 60% for the overall banking industry.

The bank made the decision to enter leasing in 2012 because in the opinion of the banks' former CFO and now EVP in charge of Corporate and Business Development, "We wanted to round out our capabilities for our customers," primarily private middle market companies. Previously, Signature had referred leasing deals to a third party. However, the loan volumes generated were low; the "bankers were not paid enough" for their referrals; and, banker were concerned about the impact on their customer relationship if the third party mishandled or could not complete the transaction.

Signature's reluctance to pursue acquisitions involves several issues: concern over effectively integrating a non-bank acquisition; the often high cost of the companies for sale; the bank's concern that the management of the selling company is "looking to cash out" and "will be gone" undercutting the value of the acquired unit; the longer-term concern that even if the acquired management transitions to Signature, they will not operate with the same degree of intensity that initially made them successful. Another regional banker shared this skepticism about acquisitions. He recounted his bank's purchase of a specialty Independent in which in his view the owners departed as a result of "having dollars in their pocket" and their discomfort with bank compliance requirements, a new issue for them.

Signature also wants to screen for personality and fit with the existing staff, noting that a "big cultural difference" exists between most Independents and banks. Instead of acquisitions, Signature attracts seasoned employees who have the desire to establish what a Signature banker terms a "franchise" within the confines of an established bank that provides its bankers with significant latitude to operate: "We want to create and not buy businesses and want to bring people in who do not have ownership but want it."

The head of Signature Financial, the bank's leasing arm, joined the bank having previously been the leader of Capital One's (and before its acquisition North Fork's) equipment finance group. Colleagues who had joined that bank from North Fork introduced him to Signature. He underscored the importance of cultural fit for Signature stating that the "best candidates [for the bank] are those who have been working in the opposite environment" from Signature and "want to control their destiny… Signature promotes what every other bank is afraid of, the individual banker."

How does the bank create that sense of ownership and avoid a situation in which the banker attracted to Signature develops a portfolio and takes it elsewhere? Beyond a flat organizational structure and its cooperative culture, compensation plays a critical role. Management states that the bank's approach to compensation has been consistent for many years. It gives bankers "a piece of the action" without any caps on potential dollars earned, allowing the best performers "to make multiples of what they would make elsewhere." The Signature banker "abhors changing the model" as bankers "want to know how much they will make today and ten years from now" based upon their portfolio's performance. For example, commercial bankers receive a percentage of revenues generated by deposits collected, FX fees, and leasing assets. Compensation also ties the banker to the bank for the long term. The compensation plan includes an annuity element, so if a banker performs well over the

long term, the annuity portion can serve as an effective retention tool. A Signature banker said, “The attitude at most banks is ‘God forbid that someone makes more money than me’ [the senior executive]. That is not true here.” Unlike others concerned about bankers departing with their customers, Signature does not offer or require contracts or non-compete agreements. Management creates the circumstances whereby a successful banker, in effect, locks himself to the bank for the long term. While always subject to change, up to this point Signature has only lost a couple of teams to other banks.

As the bank has grown and its strong performance has continued, management has been able to hire from banks that had previously been immune to Signature’s overtures, and the bank is now hiring nationally as well. A recent press release mentioned that this group had booked more than $1.3 billion in new originations in just over one year and that in its first appearance on the *Monitor 100* list it ranked 27th among bank-affiliated leasing companies, the “highest ranked new entrant over the last decade.” Going forward, the expectation is that more banks will grow by acquiring teams, allowing banks to enter the market without the balance sheet commitment that an acquisition may require.

Pursuing Acquisitions versus Teams. Of course following one of these paths does not constrain a bank from changing course or mixing the two approaches. One senior leasing executive at a large bank stated that “We have no preference [between acquisitions and teams or individual hires]…both work.” However, depending upon a bank’s current capabilities, the optimal approach will vary. New leasing entrants or those with small current staffs will likely go the acquisition route. An established lessor commented: “People buying companies don’t have anything; they have no systems and lack an infrastructure.” They need to acquire a company to obtain a basic platform for growth. He contrasted that with more established companies; “For them buying may not make sense. Today, these deals are expensive; the basic business already is up and running at the bank; and the acquisition may not bring substantial assets [if assets have been sold off rather than maintained on the balance sheet. Banks are mainly buying an infrastructure, and we already have one.”

Integration Issues. As a result of industry consolidation, MB Financial Bank, among other players, demonstrates a growth model that may predominate going forward, one that combines both acquisitions and selected hiring of experts. As previously noted, Cole Taylor Bank started a leasing group by hiring a senior executive who continues to add experienced leasing professionals; its current focus is syndications, participations while it builds up a direct origination group. MB decided to increase its leasing activities by acquisition with its 2013 purchase of Celtic Capital, a California-based commercial finance company whose products include equipment finance and aims at companies which its website describes as not qualifying for “traditional bank financing.” While still branded as LaSalle Solutions, MB Financial acquired the company in 2002 focusing on leasing and providing technology to manage leasing assets. Two of these businesses were acquired; the other was a de novo and, in effect, was also acquired, this time as the result of the Cole Taylor bank purchase. The risks these three companies focus on and how they differentiate themselves versus competitors also differ. MB Financial, as well as other banks that are growing both organically and by acquisition, has created a portfolio of leasing companies with different approaches, strategies, and customer segments. This raises both organizational and strategic issues for banks operating several leasing companies as they decide whether to permit different brands, maintain separate leadership, or rationalize their activities.

First American Equipment Finance (FAEM), acquired by City National Bank (CNB), will also retain its name, leadership, and separate brand while serving the leasing needs of CNB clients. FAEM has added “A City National Bank” company as a tagline, a combination that maintains a separate brand, allowing the company to continue its separate identify as an equipment finance specialist while benefiting from both firms’ strong service reputations.

CNB's approach contrasts with other banks such as Capital One. When part of North Fork Bank and, later, Capital One Bank, the leasing company operated under the name All Points Capital. That company, since expanded, now operates as the Commercial and Specialty Finance Group with Capital One Bank, indicating that bank's desire to go to market with a common brand.

A Third Way: Outsourcing/Partnerships. Another possible approach for entering leasing minimizes costs, but, unless managed effectively, may result in a disappointing level of volume and revenues generated. A number of banks, many of them community players, have decided to offer leasing services while limiting their investment by teaming up with an experienced outside third-party provider. The provider can be an Independent or a bank-owned lessor with an expertise in small ticket and/or mid-sized transactions. Companies offering outsourcing services include DLL, Marlin, and Orion Financial. In addition, in 2011 the Independent Community Bankers of America (ICBA) selected OneWorld Leasing, a "commercial services cooperative," as its preferred provider to members.

Many community banks have no choice but to follow a partnership strategy. As noted earlier, a significant number are not growing their deposits. Most operate with more limited product knowledge than bigger banks and within commercial banking most of their activity has been confined to real estate lending. Buying syndications does not provide a viable option because of staffing constraints and many may lack the employee base to assess leasing participations. These banks are also suffering from increasing operations expenses as regulators heighten their compliance requirements, often resulting in the hiring of additional, non-revenue producing staff. While smaller banks may predominate in outsourcing, larger banks also work with third parties. During 2013 Union Bank of California with assets of close to $100 Billion and owned by Bank of Tokyo-Mitsubishi established a relationship with Marlin Leasing. Union did not have a leasing group and was looking for a solution that gives it additional product breadth while avoiding competitive banks encroaching on its commercial relationships.

Third-party arrangements can often be customized to meet the preferences of the bank originator. Depending upon the appetite and capabilities of the bank, outsourcers can handle underwriting, operations, monitoring, billing, and similar functions, allowing the bank to focus almost exclusively on origination which should be its strong suit. Outsourcers can also provide structures in which the originating bank underwrites the transaction with the third party focusing on evaluating the related collateral.

The banks offering these programs need to work hard and demonstrate their corporate commitment in order to make third-party arrangements work. The experience of Umpqua and Signature Banks, both of which abandoned the partnership approach for other initiatives, illustrates the level of frustration that can occur both for the originating bank and the third-party provider. Based upon conversations with community bankers and outsourcers and prior client work, several "principles" need to be established by the third-party provider in order to make outsourcing a success for both the outsourcers and the bank partner:

Bank selection. There are more than 6,000 community banks, many of which make alluring targets for outsourcing. However, the actual number of meaningful targets is much more limited, as most community banks have neither the reputation nor sales strength to deliver a meaningful number of transactions to a leasing partner. Picking the right handful of partners sets the foundation for success.

Rule setting. The outsourcer and bank need to agree on the specifics of the transactions they will consider. Ideally, an internal bank employee will review all potential transactions prior to referring them to the outside

company to ensure that the transaction aligns with that agreement. Outsourcers will often comment that a significant portion of the deals they see should never have been submitted for consideration.

Training. Bankers are often skilled in a specific type of lending. One lessor commented: "Most banks lived off commercial and residential mortgages for a long time. The appetite and the market for those loans does not exist to the extent that it did." In contrast, many bankers lack an understanding of working capital or collateral-based lending. The bank needs to institute an ongoing training program, ideally with the input of its leasing partner.

Compensation. As noted earlier, most commercial bankers will cooperate in selling equipment finance, if their compensation encourages them to do so. One banker with experience at several bank-owned companies underscored this fundamental requirement: "It is very important to have shadow accounting or some sort of fee sharing arrangement." Typically, the bank's compensation program needs to encourage this focus as in part due to Human Resource policies, most banks hesitate to allow an outsourcer to provide direct compensation to a banker for a referral. Without an easily understood and attractive compensation "carrot" a referral program will fail.

Dual internal sale. Typically, third parties need to develop a dual-pronged sales program. First, they need to sell to senior bank management in order to set up a program. The logic of offering this product and the fees and/or assets it can generate facilitates that sale. Second, and both more important and difficult, is "selling" to the banker. That requires helping them understand the product, assisting them in diagnosing their customer and prospect base for opportunities, providing them with a methodology for marketing to a leasing customer, and closing a transaction. Too often, third parties effectively sell to senior management and then are unable to successfully engage the line bankers who need to convert the end customer.

Outsourcer selection. Community banks often fail to develop the leasing business in part because in the words of one bank president "it will not move the needle," meaning by itself it will not significantly increase revenues. The relatively small revenues it generates also impacts the enthusiasm of some outsourcers to pursue this opportunity. One executive of a company that discontinued providing outsourcing services referred to this business as a "side event" versus other more robust opportunities. He also offered the view that some banks should be concerned about the financial stability and servicing capabilities of the companies to whom they outsource.

Selling a financial services product to an end customer through a banker requires persistence and patience. To some extent relying on a commercial banker to sell an outsider's equipment finance offer may be even more difficult than asking them to sell investment or cash management capabilities. Many bankers will view leasing as a competitive area and may need to be convinced that sending a loan "outside" makes sense. In large part outsourcing remains an opportunity that still needs to be developed by specialty providers.

Contrary approaches: exiting or downsizing a bank's equipment finance focus. Just as today appears to be the optimal time for Independents to sell, so too is this an opportunity for banks to sell either if they lack commitment to the leasing business or want to place higher priority on other areas. However, given limited alternative growth opportunities and the good returns that leasing can generate, banks sales are few. One of the rare bank sales involved the purchase of Marquette Business Credit from Arizona-based Meridian Bank by PacWest Bancorp of California.

Rather than outright sales, banks are exiting low priority leasing segments. In recent years banks such as US Bancorp curtailed their broker relationships, several banks exited vendor financing or, like Citicorp, sold

businesses that focused on less critical segments (in their case middle market clients) in order to conserve capital and emphasize their continued service to key customers groups (such as large corporations).

In summary, different entry approaches will be appropriate for banks based upon their starting point, risk appetite, capabilities, and other investment options. Banks may begin by going down the acquisition, lift out or partnership path and, as we have seen by some examples in this section, switch to an alternative approach as they pursue more sustainable growth.

Strategic Choices

As banks grow their leasing assets, the complexity of their activities and the need for integration with other parts of the bank also increases. Over ten years ago we interviewed the head of one major bank-owned leasing company. When we asked him how he worked with his commercial bankers, basically he said he avoided them as much as he could. He felt that they did not understand the business, that they reduced pricing, and made it more difficult to complete a deal. In short he wanted his team to be left alone by his commercial bank to get its deals done. When we told that story to one of the current heads of the same leasing group, he recognized the person who made that comment (no longer there) and said, "That exact comment is exactly where we are not today," meaning cooperation, cross-bank relationship building and an integrated approach to providing customer solutions had replaced a "go it alone" philosophy.

> ***Case Example: Stand-alone asset generator.*** Earlier, we discussed EverBank and its beginning as an Internet-only institution. Therefore, because the bank had virtually no traditional commercial banking activities, EverBank Equipment Finance could operate as a stand-alone company, unconstrained by the need to put resources toward cross sell, at least initially. At least one community bank has until recently pursued a similar approach. The future for community banks includes some concerns related to deposit gathering and the extent to which its product set can meet the needs of commercial customers. A community bank with a decidedly different approach that relies to a significant extent upon equipment finance to drive earnings is 1st Source, a South Bend, Indiana-based bank. At year-end 2012, the bank's net loans and leases totaled $3.3 billion. 1st Source Bank Specialty Finance Division generated $1.6 billion or almost 50% of those net loans; in contrast most equipment finance groups represent less than 10% of total loans and leases. Ranked 22 on the most recent Monitor Bank 50, 1st Source exceeds other banks in the percentage of assets generated by equipment finance or leasing.

While many community banks are struggling to harvest assets, the president of the Specialty Finance group, says his bank has been able to grow because of its differentiated industry focus, long-term commitment to its customers and their equipment finance needs, quality people, and product mix. The growth is being achieved with fewer sales people since, in his words, he "purged" his group of the lowest producing performers. He is able to produce more volume with fewer people: "The people at the bottom were net negative. They were bottom feeders who plugged up the system… Quality people know how to package and structure." The group operates with an industry specialization emphasis in areas ranging from auto and trucks to construction equipment and funeral cars and a mid-ticket emphasis.

At this point cross-sell activity remains lower than he would like, but the executive says the initiative has "momentum, as cross sell is evolutionary not revolutionary." For example, he says that it is unlikely that the bank will ever be able to gain much additional non-leasing business from a large trucking customer in Utah where they play a minor role in the company's bank group. However, he also cited a trucking company in western Indiana for which they have the "entire relationship," including deposits, real estate, and various fee-based products.

The bank's chief executive states that leasing is "part of the bank's DNA," a unique quality among banks his size. Even during the downturn the bank remained focused on this business, refocusing some of its financing activities based upon risk management concerns brought on by the financial meltdown but remaining active in each of its lines of business. Centralized credit and risk management groups that have responsibility for both the bank and specialty finance allow for more rigorous analysis of risk and proactive management of potential concentration issues. He mentioned the greater emphasis now being placed on areas such as deposit generation and

highlighting the potential value of remote deposit capture (RDC) to serve out-of-footprint customers. While 1st Source differentiates itself by its industry and product focus, cross-sell activities are likely to continue to increase due to both the leasing group and bank management's view that it is "one bank" where "Everyone thinks like a shareholder…We don't care who does the deal because the bank wins."

1st Sources' initial involvement in leasing began more than 50 years ago. Obviously, banks do not have that kind of time to develop a specialty. The lessons 1st Source offers, particularly to small banks, includes the value of specialization and segmentation, the importance of long-term knowledge and experience, staying committed to a business line even in a downturn, and the opportunity that equipment finance offers to be an important revenue generator for a bank with a dedicated team and consistent strategy. Its initial primary focus on generating financing relationships established the foundation for yearly increases in cross sales of other bank services.

Another player, BankUnited, is a startup within the bank, dedicated to equipment finance. As he builds his portfolio, the group leader's view is that his business "should not become dependent on the bank," but that "mutual respect" also needs to exist between his leasing subsidiary and the bank, whereby, opportunities can be referred between units as appropriate. While quality cross sell is always welcome, his mission largely focuses on extending the bank's asset gathering to non-bank targets. This targeted emphasis is one that regional banks and others with excess deposits to put to work may consider as an initial emphasis as they develop an integrated sales effort related to this space.

> ***Case example: Lead with leasing.*** Competition has intensified in the commercial arena, and banks continue to try to differentiate themselves with their increasingly sophisticated customer base. Leasing can serve as an entry point, a "unique" product that serves as a wedge for a bank to begin a new relationship. This approach involves more leasing reps aggressively pursuing direct origination opportunities and positioning their solution as the first product sold by a bank, as it works to build a multi-faceted relationship. What has often been an elusive goal is becoming more of a reality at many bank-owned lessors as improved product knowledge by both the leasing and commercial) bankers, compensation, a more coherent bank culture, and intense competitive pressures combine to build a "one-bank" marketing effort that "leads with leasing."

Key Bank likely first used the phrase "lead with leasing" but now not only Key but other established lessors, including Huntington Bank, operate with a marketing emphasis on lead generation and hand offs for the commercial bank. Increasingly, bank-owned lessors operate with a team dedicated to integrating their activities with the larger bank, as more lessors become what one termed "bank friendly." A bank executive of Huntington highlighted his company's "bank cohesive model," whereby, fee sharing encourages cooperation and equipment finance professionals are embedded in commercial bank line groups. The impact of referring opportunities to the banks has been very positive: "Bankers are not used to getting referrals. Each referral comes back to us tenfold." Building off the leasing product may indicate the extent of bank commitment to equipment finance. The president of Key Bank's equipment finance group observed: "Banks that use equipment finance as a lead product do not go in and out of the market," and mentioned that this has been part of his bank's approach for 40 years.

The path forward: four strategic options. Exhibit 7 summarizes the four areas in which banks need to make strategic choices, each of which has major implications for successful execution.

1. Origination options. While the "sidebar" examples show instances in which one origination approach takes precedence over others, increasingly, equipment finance companies are exploring multiple ways to grow assets,

Exhibit 7
Strategic Choices

- **Origination emphasis** – one or more of 10 options
- **Specialization** – Industry verticals or generalist
- **Transaction size** – small ticket, mid-sized, and/or large ticket
- **Complexity** – simplicity versus complexity/operational intensity

for example, direct and independent origination, cross sell, vendor finance, syndications, and, in some cases, working with brokers. While one approach may dominate as banks push asset growth, leasing and bank managers will explore multiple ways to grow, emphasizing one lever over another based upon their stage of development, market realities, and risk elements. For example, one regional bank succeeds by generating more than 50% of its outstandings from commercial banker referrals while also pursuing a number of vertical industries by both going direct and buying participations.

The Equipment Finance Game Board (Exhibit 8) summarizes the major origination options available to banks, many of which overlap, with brief comments on the major positives and negatives of those paths as well as one

Exhibit 8
Equipment Finance Origination Game Board

Initiative	Pros	Con	Example
Direct Origination - Independent	Business line control over credit and processes Quick decision making	Not bank relationship builder Can alienate leasing from core bank May lead to funding issues	1st Source
Direct Origination - Lead with Leasing	In addition to the above: Positions leasing as foundation product Leverages traditionally aggressive leasing sales staff	Could harm leasing relationship Requires giving up relationship control	Key Bank
Cross sale to current accounts	Supports one-bank culture Encourages relationship "stickiness" Reduces origination cost	Commercial banker needs to screen Can lead to poor productivity	Signature
Cross sale to bank prospects	Establishes importance of leasing Builds relationships with line bankers Potentially increases bank productivity	Productivity issues	Huntington
Vendor finance	Establishes origination partner Allows a "wholesale" marketing approach Create cross sell opportunity	Threat to quality Need to analyze portfolio regularly	Key Bank
Syndications	Opportunity to diversify risk Access to new markets, segments Fee generation	Rely on lead bank for ops/monitoring	Huntington
Lease portfolios	Low origination cost Portfolio diversification	Extensive due diligence required No end customer relationship	U.S. Bancorp
TPOs/Brokers	Needs fewer originators, efficient	Quality control Requires strong analytics	FinPac
Referrals to third parties	Provides customer service Broaden product offer without cost	Quality of third party response Low fees generated	Union
Loans to Independents	Good NIM Portfolio diversification	Sustainability of Independent Funding potential competitor	Wells Fargo

example of a bank pursuing that approach. Please note that banks provided as an example are also likely to pursue growth through one or more of the other approaches listed.

- *Direct Origination* — Focuses on generating lease assets based upon expertise and market reputation with a limited emphasis on cross-selling additional bank products.

- *Lead with Leasing* — Results from direct origination led by the Equipment Finance group with the intention and expectation of additional bank product sales by the bank.

- *Cross sale to current commercial bank customers* — Involves the sale of lease products to current bank customers as part of a relationship building focus by the bank's relationship manager.

- *Cross sale to bank prospects* — Entails the sale of lease products to prospects as part of the commercial bank sales effort.

- *Vendor finance* — Provides financing for end users purchasing equipment from a vendor; transaction may occur at point of purchase. This could also involve the bank as serving as a captive finance company for a vendor.

- *Syndications* – Pursues buying selling of pieces of larger exposures generated by other lessors, often to diversify risk and employ excess capital.

- *Purchase of lease portfolios* – Involves the purchase of portfolios from Independents, Captives, or banks.

- *TPO/Brokers* – Provides transaction opportunities from non-bank customers.

- *Referrals to third parties* – Outsources a lease opportunity to a third party in areas in which the bank may not operate, for example, small ticket.

- *Loans to leasing Independents* – Provides debt financing to Independent lessors.

The above list is not necessary all-inclusive, but it does capture the majority of options that banks have to generate revenues. Banks pursue multiple paths today and individual lessors are likely to change their approach going forward depending upon both market opportunity and internal appetite. As the exhibit indicates, each approach has positive and negative qualities and each approach has banks succeeding with that strategy.

2. Industry verticals or other specializations. Selecting industries or "verticals" on which to focus is another basic strategic choice. Today, some industry verticals are relatively common from one bank to another (such as health care, trucking, and municipals) while others are more unique (such as taxi medallion financing, sports facilities, and shuttle buses) and in many cases niche oriented. In addition a small number of banks can act as both a principal and a paid advisor to structure large and complex lease transactions, allowing them to establish a strong fee-based business in addition to leveraging the balance sheet. This requires the ability to structure often complex solutions for the client, execute them effectively, and provide the client with multiple financing products.

3. Transaction size. Bank-owned lessors select where along the size scale (small, mid, or large ticket) they wish to participate; few, if any, operate in all three areas. Umpqua's Financial Pacific and other small ticket lessors possess an expertise in managing a high volume of small dollar transactions. Conversely, many banks avoid small-

ticket transactions because of their operational requirements and risk characteristics. For example, Huntington Bank once focused on small and mid-ticket deals but has transitioned to mid and large sized transactions.

4. Transaction complexity. Lessors can operate as industry generalists if they specialize through other criteria. Cole Taylor primarily segments its approach to syndications by deal complexity. They pursue multi-takedown, multi-equipment transactions because they believe these deals offer significantly higher spreads. In contrast, other banks discourage complexity due to operational risk concerns.

Determining which strategies to pursue includes consideration of:

- *Current status in leasing and commercial banking* – Many banks lack a sufficient share in commercial banking to allow the leasing group to rely on cross sell to any significant extent. As part of internal review, banks also need to ensure that compensation policies encourage internal cross-bank cooperation.

- *Risk management capabilities* – Banks working with Vendors, TPOs or syndicators need to be able to verify information provided by those groups and develop detailed analytics that allow portfolios to be analyzed for performance and concentration risk.

- *Skill set* – Interviewees have mentioned that as more banks enter the leasing business, both pricing and, of more concern, deal structure are deteriorating. In particular smaller banks need to assess their origination, risk, and operational skills and determine strategic approach after that assessment.

- *Competitive intensity* – Many interviews included discussions concerning current margin declines due to competition. Several leasing executives mentioned their preference for emphasizing leasing businesses that had some barriers to competitive entry, whether due to their specialized natures, the degree of analysis required to underwrite a transaction, or other characteristics.

The four levers than banks can control as they build their portfolios – origination channel, area of specialization, size of transaction, and transaction complexity – will result in different sales, operational, and risk management requirements as well as the size and quality of potential growth opportunities.

Requirements for Success: Key Principles Required for Sustainable Success by Banks

Several principles and areas of execution excellence typify the banks that are most effective in equipment finance.

Organizational clarity. Successful banks eliminate internal ambiguities concerning equipment finance and commercial bank responsibilities. Process and procedures are streamlined and have been well communicated across the bank. Both company culture and, when necessary, bank management enforces clarity.

Customization of the leasing offer to the bank's preferences and culture. The prior section discussed the strategic choices that banks need to make as they decide on the best origination approach, verticals, size transactions, and complexity for their institution.

Deemphasizing the transactional. While this report has demonstrated that many banks are emphasizing cross sales between the equipment finance group and the commercial bank, at least one leasing head acknowledged what remains a fundamental difference between the two groups: "Our dirty little secret is that equipment finance is a transactional lender. That's reality and that's the weakness of equipment finance for a bank." Leasing groups are addressing that issue by putting more focus on the cross-sell initiatives discussed in this report.

Embedded sale staffs. Cross sell requires close cooperation and the breaking down of barriers between the leasing and commercial bank groups. This goal may require leasing groups to set up a dedicated bank-oriented unit and, if possible, physically located lease bankers with commercial bankers.

Profitability reporting. Banks need to be able to track client revenue on a per product/line-of-business basis. This analysis usually supports a continued focus on building a bank's leasing activities because of the higher returns the group generates.

Non-exclusive reliance on bank referrals. While it is important for most bank-owned leasing groups to work closely with the commercial bank, many lessors have also found that their banks do not have the client base required to fuel growth goals. In these instances, greater leasing growth opportunities exist outside the bank origination channel than with the bank customer or prospect base. For one regional bank, a leasing executive observed that his product was one of 33 offered by commercial bankers. Therefore, most lessors want an independent origination effort that not only reduces reliance on the bank but also allows the leasing group to generate potential relationship opportunities for the bank.

Targeted incentive programs. One banker noted the recent deterioration in margins, highlighting a ten-year fixed transaction completed by a major bank at the rate of 282 basis points. In his view production-based incentives, rather than incentives based on profitability, resulted in unattractive deals. As already noted, compensation programs that incent the commercial banker to work with the leasing group break down internal organizational barriers to sale success.

These initiatives in addition to excellence in risk management result in the type of performance that more than justifies continued investment in equipment finance versus other options available to most banks.

Factors Impacting the Future Role of Commercial Banking in Equipment Finance

The current picture looks very bright for banks and their continued strong performance in equipment finance. As one executive from a large bank commented: “Banks will continue to move on this space and continue to grow.” However, both new and established players will need to address several emerging issues; as noted below, the impact of some of them is still being determined.

Regulatory issues. As banks increase their equipment finance activities and further engage in risks that go beyond their traditional commercial banking activities, they can expect increased regulatory questions and oversight, according to our conversation with a group of OCC regulators. In particular once credits are part of the bank rather than a separate subsidiary, they will be viewed as a bank credit and subject to bank lending criteria. One regulator commented that “[internal] bank credit people may be quite surprised at the level of risk they see.” The OCC oversees bank-related risk while the Federal Reserve monitors holding company exposures.

As expected, regulators will look for a “robust risk management process” during their examinations. They view leasing as a “different business” from traditional commercial lending, one in which attention needs to be paid to the location of an asset, “whether the equipment is really there,” as well as what one regulator termed the “volatility” of the asset: “What is the level of collateral and inventory monitoring? It needs to be more intensive than with the typical commercial loan… Does the lessor inspect the equipment on a frequent basis?” They also cited assessing residual values as a key part of the required risk management process.

Current OCC handbooks related both to lease financing and accounts receivable and inventory are now being rewritten (each is now more than ten years old). However, a 2012 OCC memo related to third-party relationships is current and discusses the responsibilities of banks and the risks they need to address when working with third parties. It focuses extensively on the need for a detailed due diligence process concerning the third party and states that “The OCC will scrutinize carefully any such arrangement and may use its supervisory authority to examine the operations of third parties who act as service providers to national banks which are sought out to deliver potentially abusive, predator, or unfair and deceptive practices. Accordingly, the OCC will likely conduct regular examinations of both the bank and the third party to assess the risks associated with these activities.” To a greater extent than ever before, bankers entering into third-party relationships (whether with vendors or outsourcers) appear to be responsible for the actions of those partners.

As the OCC notes, in some cases banks entering or extending their leasing focus are taking on risks that have not traditionally been considered “bankable.” The head of a bank-owned lessor acknowledged this commenting, “It takes some education of external and internal auditors and regulators to teach them that money good deals are OK even if they are not bankable [by the traditional commercial lending area].” Umpqua’s acquisition of FinPac, among other recent transactions, also appears to take that bank into a new and potentially more complex area of risk, given its focus on small transactions for companies that may have been previously turned down by other lenders. Leasing executives now operating within banks believe they are well prepared to address the types of concerns suggested by the OCC. The president of one equipment finance company that focuses on “tougher” credits points to its 15 years of customer data and internally developed proprietary scorecard. While it is working with TPOs on small ticket transactions from tougher credits, its monitoring, risk management, and collections processes provides the company with a capability that on Day One of a new transaction “allows us to know well what the ultimate result will be.” In this executive’s view his company’s detailed analytics follow the principles of

safety and soundness so important to regulators, including the ability to dissect risk in detail, provide very accurate loss predictions, and demonstrate product and customer knowledge as well as fair lending practices. Related to this issue is the reality that there can be wide disparity between, for example, a "B" credit as viewed by a bank leasing group versus the public debt market perspective.

While leasing professionals can likely answer the questions that both internal auditors and external regulators will ask, it seems that, at least initially, they need to be prepared to invest substantial time and effort in assuaging concerns and establishing credibility. In particular the regulators mentioned that, in their words, "heightened expectations" existed for larger institutions related to risk management; for example, one executive specifically mentioned that Federal Reserve regulators were reviewing concentration levels at his large bank. Based on our conversation with the OCC, it appears that the type and extent of risk management requirements will depend on multiple factors, including the corporate entity that houses the risk, the type of risk being pursued, the past performance of the leasing business and the bank as well as the bank's asset size. The industry appears confident about meeting these requirements with several other interviewees echoing the comments of this bank leasing officer: "Equipment finance performs better from a regulatory and compliance perspective than the traditional bank. We operate with strong internal controls and the ability to slice and dice our portfolios."

Potential accounting and Basel III changes. It is beyond this report's scope to provide a definitive perspective on the impact of proposed accounting changes on banking's leasing activities. Proposed changes are still in the process of being finalized.

One significant accounting change proposed by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) involves capitalizing leases. As described in a September 9, 2013 *CFO Magazine* article these groups "are proposing a single method of accounting by lessees that would recognize the assets and liabilities arising from all lease contracts on company balance sheets." One concern stated by some leasing executives is that putting the value of leases on a company balance sheet will increase leverage and make leasing a less attractive financing alternative.

The head of a consulting firm that focuses on accounting and capital-related issues believes that this proposed accounting change will have limited impact. In his view small and mid-sized private (SMEs) companies are not concerned about the impact on their balance sheet. He says SMEs value leasing for multiple reasons: it is an additional source of capital; the lessor takes the residual risk; repayments are level; the lease rate is fixed: and, the SME can better match his cash flow with expenses. However, investment grade companies, a group that he believes represents a small part of the leasing opportunity, may look to alternatives if they need to put lease assets on their balance sheets. In his words, "The percentage of leases done merely to keep financing off the balance sheet is miniscule. Perhaps 1% of transactions will be impacted."

As a result of the last decade's financial crisis, the Basel Committee began to revise existing capital adequacy requirements based upon risk weighting. Basel III regulations look to assign higher capital requirements depending upon the makeup of their business portfolios with variables to include loan transaction structure, tenure, residual risk, and similar factors. While the specific guidelines of Basel III are still being determined, bankers view it likely that businesses that are viewed by a bank as higher risk, such as equipment finance, will require greater capital. This could result in lower returns by those bank-owned leasing, and/or the need to increase transaction pricing.

However, many bankers expect Basel III's impact to be relatively muted. Some note that capital requirements have already been raised as part of internal bank reviews. No banker we interviewed suggested that new capital requirements would significantly harm their ability to grow; a few commented that it may make leasing look even stronger internally versus other lending businesses, once the risk rating process is completed.

Integration risk. Our interviews have already surfaced several instances in which friction appears to exist between bank-owned leasing groups and the commercial bank. One leasing executive commented on the difficulty of working with commercial bankers: "Because they do not do a lot of deals, they are slow …and clumsy in underwriting. We are more of a machine when it comes to underwriting. Another lessor commented, "We are better at sales." The head of yet another regional bank leasing group was dismissed after his bank acquired an Independent, raising concerns by commercial bankers that current customers' needs might not be met under the bank's new marketing emphasis.

The cultural differences between lessors and commercial bankers have been long known. Banks that have reengineered the culture have done so through a combination of ongoing senior management attention and relationship building between the two groups. Over time these groups realize that working together is mutually beneficial. One regional bank leasing executive underscored how small successes build a new culture: "If we can take a banker on a cold call, the banker loves that. You do that and you are a rock star…We are the first product they refer." Nevertheless, the integration risk remains substantial and requires ongoing senior bank management attention.

Independents: Continued Share Loss or Improved Future Prospects?

As a segment, the market share and performance of Independents has suffered some significant deterioration in recent years while Captive share has remained relatively stable. Therefore, it is worthwhile to take a look at the viability of the Independent model. Their past losses were multiples of what the banks suffered, as both competitive pressures and their cost of funds pushed them to higher yielding and higher risk deals. Their internal resources, whether financial, marketing, or operational, may pale in comparison to what a bank can provide. Nonetheless, many Independents have survived through the downturn, and bankers view Independents as competitively vital and, for some, likely to be even stronger competitors in future years. One bank executive typified others when he commented, "I don't believe in the death of the Independent." This quote captures the prevailing perspective of bank leaders with many suggesting significant growth opportunities for this segment.

Several factors will allow the Independents to continue to succeed even with the current increased bank activity:

Focus on a different credit tier. Several bankers underscored that their companies will only underwrite credit that are viewed as BB or above. One noted, "It is difficult for us to do a "B" credit. That is something the Independents can do more readily." A regional commercial banker commented, "Independents need to do things banks will not do" while another said that "Banks are more constricted in what they can do…they do not have the tolerance for high losses even with high returns." This does not suggest that the Independents are left to focus on poor credits, but rather than the banks' "credit box" has narrowed in the face of the downturn and increased regulatory action. Another banker said "We lend money to companies that do not need it," meaning that his bank aims at high quality customers often with multiple funding choices. This comment contrasted with an Independent who stressed that "We compete on risk. We take deals by understanding the credits better and emphasize our speed of decision making."

The Independents' higher funding costs suggest they will continue to focus on non-bankable credits. During our interviews, one banker noted a recent five-year bond issued by an Independent at a 5% coupon. He commented that most of his new loans were only priced at generating on average 3-4% and said that funding played a major role in determining the risk types that Independents focused on.

Niche for success. While "B" credits (as defined by individual banks and not the public credit markets) and below provide a risk management niche for Independents, other potential niches suggested by bankers include developing expertise in certain equipment types and building a local geography-based reputation. One equipment finance leader commented, "Independents can blend business verticals with focusing on the assets of companies of varied size and quality. Their expertise differentiates them." A regional banker described a specialized niche Independent's approach as resulting in a "beautiful company with a recurring revenue stream. It operates with a great model for the IT business…bank leasing companies would suck at most areas of IT" both because of the type of financing required and end of term issues.

Operate counter-cyclically. One bank executive mentioned the coal industry as one that many banks are currently avoiding, allowing Independents to write deals with stronger structures and higher margins.

Lever residual knowledge and embrace complexity. Many banks avoid residual risk or work to minimize their reliance on this factor. A regional banker supported this view: "Banks will not use collateral to make the credit

decision... and they avoid funding what they view as unusual funding obligations." Independents can exploit their equipment expertise and can operate with a more flexible approach to residual values than many banks. They can operate with an understanding of the equipment's life cycle and develop approaches to dispose/sell equipment coming off leases.

Offer smaller transactions. Banks, particularly larger ones, have struggled to offer smaller deals cost effectively while maintaining excellent risk performance. The tendency among banks today is to head toward larger transactions in order to build asset growth more quickly with better per transaction productivity.

Build third-party relationships. While many banks work with vendors and brokers, others avoid them. Independents can establish long-term co-dependent relationships that consistently feed them deals that match their screening criteria.

Price for risk. Few banks have instituted a rigorous risk-based pricing program in their commercial banks, often blaming competitive pressures for the failure of that initiative. One Independent noted that his company's spreads can range by up to 1500 basis points and that "taking risk and getting rewarded for it is a disconnect in the banking industry."

Wait for Basel III. Analysts uniformly view Basel III as increasing the capital and liquidity required for loans, in particular those characterized as higher risk: "Basel III will tighten capital big time." In turn, these changes will likely increase loan pricing at least for banks above $10 Billion in assets and perhaps drive some banks out of some higher risk areas, potentially aiding the competitiveness of Independents.

Stay small for higher returns. "Independents don't need to be big to be profitable," said one banker who mentioned that companies with higher assets often have difficulty maintaining strong returns. Instead, operating one or two verticals can allow an Independent to exploit its knowledge, price higher, and maintain returns that exceed many bank-owned groups. Several commented that big is not better in being an Independent, expressing the view that a $1 billion Independent can generate strong returns because of its focus and ability to understand and manage product life cycles.

Both the banks, Independents, and other industry experts we interviewed agreed that the equipment finance market is both large and complex enough to allow Independent players not only to survive but to thrive. The benefits provided by the banks' funding advantage is not insurmountable. Independents can apply expertise to a niche focus, they can market where the banks can't operate or where they can't operate effectively, and they can often adapt more quickly than a bank-owned company. Certainly given the near-term availability of funding for Independents and the challenges presented by Basel III and other bank-related regulations, Independents will continue to operate as effective competitors.

Conclusion: Will Banks Continue to Dominate?

Virtually every bank or bank-owned leasing executive we interviewed expressed the view that banks were in this business for the long-term and that they would continue to have a dominant hold on business generation. Several elements contribute to this view, most of which we have already discussed, among them: a major funding advantage for the banks, existing customer relationships that can be developed further, bank infrastructures that can be leveraged at low additional cost, improving compensation programs that encourage bank cooperation, greater focus on sales across the bank, and an increased risk appetite for non-traditional businesses such as leasing.

As they are currently demonstrating, this is a business that banks can invest in, whether through acquisition or by attracting teams of experienced employees, and in a relatively short time benefit from high quality and high return asset growth. Importantly, as occurred during the last decade, it is also a business that banks can "tamper down" without exiting should the need exist due to bank liquidity or other issues. Banks may change their strategies and priorities related to this business, but wholesale abandonment of it appears unlikely, given banking's limited growth options and the growing positive impact of equipment leasing on overall bank performance.

However, banks neither have the ability nor the interest in dominating all aspects of equipment finance, as already noted in the section on Independents. One Independent noted that banks "want more pristine and less operationally intensive credits." In certain markets, such as small ticket financing Independents "get better at it all the time" and banks have shown isolated success dealing with this segment's execution requirements.

Both Independents and Captives have capabilities that the banks do not possess, providing these competitors with strong competitive positions.

Banks and their non-bank competitors differ significantly about the willingness of banks to remain in the equipment finance business through the next down cycle. The bank industry's summary perspective about the future of equipment finance may have been best summarized by one comment: "I do not see banks moving out. In a downturn, there will be a little tightening of the credit, a little more selectivity, and a little more price tightening." However, this view contrasts significantly with one Independent that said banks were short-term oriented with many lacking commitment to this business: "Banks go in cycles. Leasing is just another product. Leasing is all we [Independents] do. Banks go in and out of products all the time. If they stub their toe, they get out."

Of course, some banks will exit the business or replace their enthusiasm for equipment finance by focusing on another business line. But as the leader of a major regional bank lessor stated, for most banks, including his own, this is "not a side line, but a real business…Bank-owned leasing companies will not have unfettered growth, but for the next few years there is a great growth opportunity for banks."

Appendix

1. Research Methodology
Financial Institutions Consulting, Inc.'s (FIC) approach for researching this report involved a combination of industry research and one-on-one interviews with a cross section of leasing and bank industry leaders.

2013 Survey of Equipment Finance. This survey provided the most recent and accurate data available concerning the recent growth and performance of the banking industry in equipment finance.

Recent Literature. Secondary sources included Monitor and Monitor Daily, Equipment Leasing & Finance Magazine, and Leasing News.

OCC Documents. We reviewed four OCC publications as part of our research:

Lease Financing: Comptroller's Handbook.
January 1998

Accounts Receivable and Inventory Finance: Comptroller's Handbook.
March 2000

Concentrations of Credit: Comptroller's Handbook.
December 2011

OCC memo on Risk Management Principles, Third-Party Relationships.
November 2001

FIC Industry Experience. In preparing this report, we took advantage of our prior experience in preparing the ELFF's *State of the Industry* report over multiple years and our extensive client experience over the past 20 years in the equipment and commercial finance segments.

Industry interviews. As the list below demonstrates, as part of our research we had the opportunity to interview many successful bank lessors, Independents and other industry experts. They provided detailed and thoughtful perspectives on the current state of the industry as well as likely developments over the next few years.

2. List of Interviewees
In preparing this report FIC was able to access an extraordinary group of industry stakeholders, including company executives both from banks and Independents, industry experts, and regulators. This report has benefited from their involvement and frank comments. Our interviewees included:

William J. Bosco, Consultant, Leasing 101
Tom Cira, President, Bridge Capital Leasing (BankUnited)
Anthony Cracchiolo, President and CEO, Vendor Services, US Bank Equipment Finance
Edward Dahlka, President, Cole Taylor Equipment Finance
Dan Dyer President and CEO, Marlin Business Services
Richard J. Doherty, President, PNC Equipment Finance, LLC
Jeffrey Elliott, SVP, Huntington Bank

Louise Francis, Commercial Credit Technical Expert, OCC
Burt Feinberg, President and Group Head, CIT Commercial & Industrial, Corporate Finance
Harry Glenos, Senior Financial Advisor, Credit & Market Risk Policy, OCC
Richard Gumbrecht, Chief Growth Officer, EverBank Commercial Finance
Evelyn S. Havasi, Global Head, Asset Finance Group, Citigroup Global Markets
Eric Howell, EVP, Corporate & Business Development, Signature Bank
Stephen V. Key, Assistant Director, Bank Activities & Structure Division, OCC
Christopher Menkin, Editor, Leasing News
Paul Menzel, President & CEO, Financial Pacific Leasing
Christopher Murphy, Chairman, President & CEO, 1st Source Corporation
Walter Rabin, President & CEO, Signature Financial
David Schaefer, President, Orion Financial Corp.
Gavin Shea, SVP, Umpqua Bank
Kenneth A. Turner
Al Qualey, President and Chief Operating Officer, Specialty Finance Group, 1st Source Bank
John Unchester, Senior Vice President, First American Equipment Finance
Adam D. Warner, President, Key Equipment Finance

3. Interview topics

We developed the interview guide that follows and provided it to interviewees before our phone meetings. While the guide provided some initial structure to the interviews, each interview differed based upon the perspective, expertise, and interests of the interviewee.

For all interviewees:

- Today, banks are generating more than 50 percent of new business volume in equipment finance.
- What are the major factors that have resulted in banks growing their market share?
- What industry specialization or other initiatives is your company taking to differentiate itself?
- How do banks differentiate themselves with customers? Product? Rate? Relationship? Do they differentiate themselves with customers differently than Captives or Independents?
- Banks operate with significantly greater productivity than Independents. What key factors contribute to their productivity advantage?
- Are these factors sustainable or is it likely that over the next few years banks will reduce their focus on this business?
- What should non-bank competitors do to rebuild their share?
- In three-five years will bank share be greater or less? What circumstances will determine that?

For Bank-owned units:

- How has senior bank management's view of or expectations for the equipment finance group changed over the past two-three years?
- Is the group more integrated into the "core" bank than a few years ago? If not, why not? If yes, what steps has bank management taken to link your group more effectively with the bank?
- Are you generating more of your NBV from direct originations? Why or why not?
- Have you increased your use of third-party referrals? Why or why not?
- What specific actions, if any, should your own group and/or bank management be taking to further take advantage of the bank's strengths?
- What most frustrates your group, if anything, as being part of a bank?

For Independents and teams acquired by banks:

- What are the most significant adjustments you and your team have had to make as part of a bank organization?
- What roadblocks, if any, exist in working within a bank organization?
- How does the pace and type of change differ between a bank and an Independent company?
- What specific actions, if any, should your group or bank management be taking to further take advantage of the bank's strengths?
- What has most frustrated you? What has most surprised and delighted you?
- Teams can be acquired, but they can also leave. What approach do banks use to retain teams?

For Independents that compete with banks:

- What are the banks' greatest strengths?
- What are the banks' greatest weaknesses?
- Do you think a significant percentage of banks will back out of the equipment finance business/lessen their involvement? What circumstances would cause that to occur?
- If you were part of a bank, what actions/initiatives would you advise a bank to take that banks seem unable to take?
- Has the increased role of banks in this business caused you to change your approach? How?

4. Acknowledgements

A Steering Committee of industry volunteers provided very helpful feedback and targeted suggestions throughout the development of this report. Their participation is appreciated and was critical to the study's success. They are Tom Cira, Jeff Elliott, and Rich Gumbrecht - Chairman of the Foundation's Research Committee. The Foundation's Michelle Fevola and, in particular, Kelli Nienaber, its Executive Director, played a critical role both in designing this project and keeping it on track. Kelli's focus and direction were greatly appreciated.

About Financial Institutions Consulting, Inc. (FIC)

For 20 years Financial Institutions Consulting, Inc. (FIC), a New York-based management consulting firm, has provided fact-based advice and counsel on issues related to growth and profitability to financial services clients around the world. FIC emphasizes practical, bottom-line results. We not only provide targeted recommendations but also work with our clients to ensure successful implementation of our recommendations.

Our equipment finance related consulting work has included:

- Evaluating expansion opportunities in new segments, markets, and geographies
- Recommending and implementing process redesign changes to increase lessor and commercial banker productivity
- Developing analytics to determine priority customer targets and markets
- Assessing acquisition opportunities
- Providing insights on adopting industry best practices
- Developing strategic plans with detailed implementation plans

In addition, FIC has completed projects in commercial finance, inventory finance, franchise finance, timeshare finance, factoring, among other areas. We tailor how we work with our clients to their needs; our approach may involve a formal engagement, targeted workshops, and/or ongoing retainer-based counseling to clients.

We have a long history in the equipment finance space, both as a consultant and researcher, having written the ELFF's State of the Industry Report in recent years.

Visit our website at: www.ficinc.com for more information about our consulting and advisory services.

For additional information about research presented in this report or to discuss FIC consulting capabilities, contact:

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