

## **NATIONAL BANK OF SERBIA**

### **A GUIDE ON FINANCIAL LEASING**

#### **I. INTRODUCTION**

The purpose of this Guide is to provide basic information on financial leasing as a way to finance purchase of equipment and other fixed assets. It also highlights specific features of financial leasing relative to other forms of financing.

This Guide is formulated in compliance with the financial leasing regulations in force in Serbia – Law on Financial Leasing and secondary legislation enacted by the National Bank of Serbia.

Subject to the above Law, the National Bank of Serbia is charged with supervision of the financial leasing companies. It aims to ensure a stable financial leasing market within the overall financial market, and, as one of its principal objectives, contribute to maintaining financial stability.

#### **II. BASIC DEFINITIONS**

##### **III.**

##### **What is financial leasing?**

Financial leasing is described as a transaction whereby the lessor:

- concludes a supply agreement with the supplier of the leased item (thereby acquiring ownership of the leased item), after the supplier is selected and the item is specified by the lessee,
- concludes a financial lease agreement with the lessee thereby granting to the lessee the right to use the equipment during a certain period of time in return for the payment of rentals in line with agreed payment schedules.

##### **What is a leased item?**

A leased item is any movable durable property (equipment, facilities, vehicles).

## Who is a financial lessor?

A financial lessor is described as a company licensed by the National Bank of Serbia to engage in financial leasing operations. The list of licensed companies is available on the website of the National Bank of Serbia – [www.nbs.yu](http://www.nbs.yu).

## Who can be a financial lessee?

Financial lessee can be either a legal entity (company, institution, etc.) or a natural person (household).

## Are there any restrictions regarding minimum value of the leased item, agreement duration, minimum down payment by the lessee to the lessor and maximum amount of lessee's obligations, to be aware of when concluding a financial lease agreement?

Restrictions are applied with respect to:

1. Value of the leased item – Purchase value of the leased item **can be no less than EUR 2,000**, and is verified with reference to the overall value of a particular financial lease agreement;
2. Duration of the financial lease agreement – duration of the financial lease agreement **can be no shorter than two years**;
3. Down payment (the amount payable by the lessee subject to lease agreement is calculated with reference to the overall gross purchase value of the leased item) and ratio of total income to total obligations:
  - for legal entities – no restrictions;
  - for natural persons – restrictions are applied on agreements with the duration of up to 10 years, in which case:
    - 1) down payment by the lessee to the financial lessor may not be less **than 20% of the gross purchase value** of the leased item;
    - 2) total obligations of the lessee – natural person (the sum total of the contracted lease rentals, other credit obligations and obligations in respect of financial leasing) **may not exceed 30% of total regular income of such person.**

Restrictions in indents 1) and 2) **do not apply to entrepreneurs**, within the meaning of the law on companies, or to **agricultural producers** (i.e. insured agricultural

producers within the meaning of the law on pension and disability insurance, and owners of registered farmland, within the meaning of the register of agricultural estates), if the leased item is used in the performance of their core activity.

### **Where does ownership of the leased item reside?**

During the term of the financial lease agreement, the ownership of the leased item resides with the lessor, but the agreement may provide for an option whereby the leased item can be bought by the lessee. The lessee has full right to quiet possession of the leased item subject to no restrictions during the term of the financial lease agreement, but it at the same time incurs liability for all risks and costs arising from ownership right although the lessee is not the owner of the leased item in a formal and legal sense.

## **IV. RIGHTS AND DUTIES OF THE PARTIES**

### ***Rights and duties of the lessor:***

- The lessor shall acquire the leased item in accordance with the lessee's specification;
- The lessor is liable for any legal deficiencies of the leased item (if a third party has claims on the leased item which disable, diminish or limit free use of the leased item by the lessee) and responsible to the lessee for any damages sustained in that respect;
- The lessor may exercise its right to terminate the agreement if the lessee defaults on the agreed lease fee, right to have the leased item returned and claim indemnity for any damages sustained in that respect;
- The lessor may exercise its right to exclude the leased item from bankruptcy estate, in the event of the lessee's bankruptcy;
- The lessor may exercise its right to recover possession of the leased item in the event the lessee defaults on rental payments by resorting to a special procedure – the court will issue a decision to confiscate the leased item from the lessee within three days from the day of submission of petition, while confiscation of the leased item will take place within three days from the day such decision is issued.

### ***Rights and duties of the lessee:***

- The lessee shall take over the leased item in the manner, time and place specified in the agreement;
- The lessee shall be entitled to terminate the financial lease agreement if the leased item is not delivered in compliance with the terms of the agreement (the leased item is not delivered or is delivered late or fails to conform to the supply agreement), to claim indemnity for damages sustained in that respect and to withhold rentals payable under the lease agreement pending delivery which fully conforms to the lease agreement;
- The lessee's rights derived from the supply agreement shall not be affected by a variation of any term of the supply agreement previously approved by the lessee unless it consented to that variation ;
- The lessee shall be liable for damages caused on the leased item;

- The lessee shall take proper care of the leased item;
- The lessee shall be liable for payment of the lease fee;
- The lessee shall be liable for payment of costs of accidental destruction or damage to the leased item, from the moment of taking over the leased item;
- The lessee is committed to take insurance on the leased item;
- The lessee shall be liable for rental payments.

***Rights and duties of the supplier:***

- The supplier shall deliver the leased item to the lessee in the manner, time and place specified in the supply agreement;
- The supplier shall be liable for any material deficiencies of the leased item.

**V. FINANCIAL LEASING – SPECIAL FEATURES AND COMPARATIVE ADVANTAGES OVER OTHER FINANCING OPTIONS**

Financial leasing is one of the ways to finance investment in fixed assets, i.e. movable durable property. It is an alternative to spending own resources, using bank loans and borrowing by issuing debt securities. This form of financing is frequently compared with bank loans, as they share a number of features (repayment in predefined instalments, interest, bookkeeping entries...). However, important distinctive features of financial leasing are:

- funds are always approved for financing a precisely specified item,
- leased item is acquired by the lessor and not by the lessee,
- ownership of the leased item resides with the lessor for the duration of the lease agreement,
- leased item is at the same time collateral for payment, which is why lessors most often do not request other collateral instruments,
- lessor is fully protected against any liability resulting from destruction or damage of the leased item (insurance of the leased item), default on the lease fee (repossession of the leased item by special procedure), bankruptcy or liquidation of the lessee (exclusion right).

**Advantages of financial leasing** compared to other forms of financing are as follows:

**Financial considerations.** A key advantage of financial leasing compared to other forms of financing arises from the fact that the lessor remains a formal and legal owner of the leased item throughout the duration of the lease agreement. This means that the lessor will be prepared to assume a higher risk with respect to creditworthiness of a potential client. This form of financing is therefore especially convenient for newly established small and medium enterprises, entrepreneurs and all other lessees with diminished creditworthiness or for lessees who do not have sufficient funds available in the way of credit collateral. In practice, this means that the lessor will base its decision to finance a lessee not only on such lessee's creditworthiness (which is a dominant factor in bank credit approval and determining the level of requested collateral) but also on the estimated degree of marketability of the leased item, i.e. the likelihood of selling the leased item in the market at a realistic price.

**Facilitated procedure.** The procedure for obtaining financing is most often shorter in case of financial leasing than in case of traditional forms of financing. The reason is that additional collateral instruments (e.g. mortgage) are most often not requested, while lessors often already have established business cooperation with suppliers of the leased item. All this results in lower overall transaction costs.

**Specialization and experience of the lessor.** An additional advantage of financial leasing, especially with regard to the newly established companies, is the possibility for the lessor to obtain the leased item on more favourable terms because of established cooperation with the supplier of the leased item and trade transactions effected by the lessor via such supplier. In addition, the lessor and the lessee can, as part of this arrangement, agree on provision of services of maintenance, servicing, parts replacement, technical-technological improvement, training of lessee's personnel to use the leased item, etc.

## VI. PROCEDURE FOR FINANCING VIA FINANCIAL LEASING

1. Selection of the item to be leased and obtaining the supplier's offer;
2. Supplier's offer with respect to the item to be leased is submitted to the lessor along with application for financing, based on which the lessor makes a financing offer (informative offer). In certain cases, the supplier of the leased item can prepare the informative offer for the lessor;
3. All documentation (the list of necessary documentation can be found on lessor's website) necessary for deciding to approve or reject an application for financing is submitted to the lessor;
4. If the application is granted, the lease agreement is signed with the lessor;
5. After the agreement is signed, down payment is made, along with payment of all other costs specified in the agreement;
6. Leased item is taken over from the supplier.

## VII. WHAT ARE THE IMPORTANT ELEMENTS OF A FINANCIAL LEASE AGREEMENT?

**Important elements of a financial lease agreement are:**

**Gross purchase value of the leased item** – this differs from supplier to supplier, but can also depend on terms granted to the lessor by the supplier. It is in the lessee's interest that the gross purchase value is as low as possible, as its obligations to the lessor will vary accordingly (see item: Terms of supply agreement).

**Residual value of the leased item** – if the agreement contains a provision on the residual value of the leased item, this will reduce the level of individual instalments, but it will also create an obligation for the lessee to pay a higher amount of money upon expiration of the lease agreement if it wishes to become the owner of the leased item. In practical terms, this means that the lessee should put aside money during the period in which it pays lower instalments in order to be able to make this substantial future payment.

**Costs of insurance** – insurance of the leased item is a legal obligation of the lessee, but the lessor can assume this obligation subject to agreement. Damage indemnity shall be paid to the lessor. Cost of insurance is not included in the effective lease rate.

If it is the lessor that decides on the insurance company with which the leased item is to be insured, the lessee will not be able to opt for a company offering the most favourable terms of insurance.

Care should be taken with respect to wording in the agreement regarding the relations between the lessor and the lessee in the event of damages incurred on the leased item, i.e. if and in which circumstances is the lessee entitled to a part of the indemnity paid out by the insurance company. It is recommended to regulate these relations by the agreement.

**Other costs under financial lease agreement** – these are very important from the aspect of comparing different financing offers. There is a possibility that low interest rates would be offset by higher fees and charges. Moreover, certain costs present in one form of financing may be absent from another. The effect of these costs on the nominal interest rate (only the part that is paid to the account of the lessor) is reflected in the effective lease rate.

**Currency clause** – by assuming a foreign currency-indexed obligation a substantial foreign exchange risk is also assumed, expect in case of regular inflow of money in the same currency. Lessors include foreign currency clause in the agreement in order to safeguard against exchange rate risk when their obligations (sources of financing) are denominated in that currency.

If nonetheless you are ready to assume the exchange rate risk, pay attention to the exchange rate at which the lease rental is calculated – is it the middle or the selling exchange rate, is the exchange rate valid at maturity of the lease instalment or at payment date.

**Option right** – is there an option under the agreement to buy the leased item at the end of the lease period and on what terms? Is this what you want to do (or you wish to purchase a brand new item after the lease period)? The lessor can make the option right conditional upon payment of a certain fee level (option price).

**Terms of early repayment** – if you have planned to put aside a certain amount of money during the lease period in order to effect early repayment of the remaining lease fee and buy the leased item, you should be aware of the fact that early repayment can only be effected after two years have expired. By that time the major portion of interest will already have been repaid – the outstanding debt principal often does not decline with time – as can be seen from the Repayment Schedule. In addition, you should also check whether and in what manner the lessor will charge the cost of early repayment, which, in certain cases, can be far from insignificant. In view of the above, make sure to consider justifiability of early repayment well before you decide to take such a step.

**Effective lease rate** – this rate shows the relative cost of the financing approved by a lessor (gross purchase value less down payment), in a way that ensures comparability of terms of financing offered by different lessors, and comparability of terms of financing

offered by lessors and/or banks. The level of this rate depends on the nominal interest rate, other costs arising from a financial lease agreement and the timing of cash flows and payments in respect of lease agreement.

**Possible change in the level of nominal interest rate** – special attention should be paid to the contractual provision on the right of the lessor to change the level of the lease instalment during the validity of the lease agreement. This most often happens if there is a rise in EURIBOR or another reference interest rate (the type of interest rate on the domestic or international financial market with reference to which interest rate in a given transaction is set). Thus EURIBOR, for instance, is an interest rate on euro-denominated deposits in the interbank market. Depending on deposit maturity, EURIBOR can be one-week, two-week, three-week, monthly, three-month etc. Lessors include this provision in the agreement in order to safeguard against interest rate risk, and this is very often an indication that the interest that lessors pay to their creditors is set with reference to that particular interest rate.

For the lessee, it is important to know that a rise in the EURIBOR rate will trigger a rise in its future monthly obligation to the lessor and an increase in total interest it will be liable to pay. If the agreement stipulates that the leased item can be bought at the end of the lease period, any change in the lease rental level will lead to increased VAT charge due to a change in the base for VAT calculation.

Any financial lease agreement should specify in detail in what way the lease rental will be indexed to changes in the reference interest rate, and the dates on which the lease rental will be determined. For the lessee, it is important to know that a rise in EURIBOR will trigger a rise in its future monthly obligations to the lessor and an increase in total interest it will pay. If the agreement stipulates that the leased item can be bought at the end of the lease period, any change in the lease rental level will lead to increased VAT charge due to a change in the base for VAT calculation.

The financial lease agreement should set out in detail in what way the lease rental will be indexed to changes in the reference interest rate. The agreement should also specify the dates on which it will be determined whether such change has occurred or not.

For information on EURIBOR levels, click the following link: [http://www.euribor.org/html/content/euribor\\_data.html](http://www.euribor.org/html/content/euribor_data.html). Data published on this Internet page are informative in character, while data published by Reuters are deemed official.

**Before signing a financial lease agreement, make sure that all reasons that prompted you to choose this form of financing and to select a particular lessor are precisely and unambiguously covered by the agreement.**

**BEFORE SIGNING A FINANCIAL LEASE AGREEMENT, STUDY ITS CONTENTS IN DETAIL AND REQUEST ALL ADDITIONAL INFORMATION FROM THE LESSOR REGARDING ANY AGREEMENT PROVISIONS THAT YOU DO NOT FULLY UNDERSTAND.**