



NATIONAL BANK OF SERBIA

BANK SUPERVISION DEPARTMENT

**ANALYSIS OF FINANCIAL LESSORS' RESPONSES TO THE
QUESTIONNAIRE ON ACTIVITIES REGARDING AML/CFT RISK
MANAGEMENT
OCTOBER 2015 – MARCH 2016**

Belgrade, July 2016

Introductory note

In 2010, the NBS established the practice of off-site monitoring of financial lessors' activities regarding AML/CFT risk management. Such monitoring is carried out twice a year on the basis of data submitted by financial lessors to the NBS, in the form of completed questionnaires (hereinafter: Questionnaires).

The analysis of the Questionnaires aims to:

- provide an overview of the current state of affairs in the process of identifying, measuring and managing ML/FT risk in financial leasing activities,
- promote adequate implementation of the established rules and principles of the "Know Your Client" procedure,
- ensure off-site monitoring of development of the AML/CFT risk management system by financial lessors,
- detect any weaknesses and timely inform financial lessors of potential risk exposure.

The questions in the Questionnaire are sorted into four sections:

Section I: General data on lessors

Section II: Lessors' activity

Section III: Lessees

Section IV: Employee training

As the analysis is based on data submitted to the NBS rather than collected directly on the premises of financial lessors, certain inconsistencies are possible, which is why these data serve for analytical purposes only.

In the October 2015–March 2016 period (hereinafter: reporting period), all lessors operating in the financial leasing market of the Republic of Serbia submitted their responses to the Questionnaire.

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1. Key findings

Financial lessors' exposure to the ML/FT risk is relatively low, particularly considering that:

- 1) balance sheet total of all financial lessors is way below that of the banking sector (e.g. as at 31 March 2016, the balance sheet total of the financial leasing sector was RSD 59.7 bln or 1.96% of the banking sector balance sheet total);
- 2) organisational network of the financial leasing sector is underdeveloped compared to that of the banking sector;
- 3) financial lessors have a very narrow scope of activity (financial leasing, rental and sale of returned lease assets) and do not carry out payment transactions, deposit operations, or engage in credit and loan approval.

The analysis of lessors' responses to the NBS's Questionnaire shows that the ML/FT risk through misuse of financial leasing transactions remained relatively low in the reporting period, given that:

- the obligations of financial lessors under the law and secondary legislation on the prevention of money laundering and terrorism financing are set out in detail in the adopted general acts;
- financial lessors are mindful not only of the risks to which they may be exposed, but also of the risks to which they may expose their parent company and the group of companies to which they belong. It should be noted that parent companies of all financial lessors owned directly or indirectly by a foreign entity are based in countries which apply high AML/CFT standards;
- the obligation to apply "Know Your Client" rules and principles is set out in internal acts of all financial lessors – all lessors enacted their KYC procedures which contain elements prescribed by the Decision on Minimum Contents of the "Know Your Client" Procedure;
- all financial lessors pay due attention to training, particularly of front-office staff or staff engaged in the performance of transactions;
- all financial lessors conducted internal control of AML/CFT measures and actions and took measures to remedy detected irregularities during the reporting period;

- all financial lessors prepared lists of indicators of suspicious transactions pursuant to Article 23 of the Rulebook on Methodology for Implementing Requirements in Compliance with the Law on the Prevention of Money Laundering and Terrorism Financing (RS Official Gazette, Nos 7/2010 and 41/2011) (hereinafter: Rulebook). In their lists, all lessors included all indicators published by the APML on its website, while a number of them even expanded the list.

Although the findings of the National Money Laundering Risk Assessment point to high risk involved in the real estate business, note that real estate trade activities performed by financial lessors cannot *a priori* be deemed transactions with an elevated ML/FT risk, given: 1) the nature of the financial leasing activity and lessors' permitted scope of activity; 2) level of development of the financial leasing market and 3) lessors' approach to ML/FT risk in financial leasing of real estate.

1) Given the legal nature of the financial leasing activity, real estate trade within this activity is limited to purchase of real estate by the financial lessor in order to obtain the right of ownership of such real estate and lease such real estate to the lessee.

2) The market of real estate financial leasing is underdeveloped (as at 31 March 2016, only 4.5% of all placements had real estate as the lease asset, and only two lessors engaged in financial leasing of real estate, one having 26 agreements on financial leasing of real estate and the other – only four such agreements).

3) Financial lessors have adopted a proactive approach to safeguarding their financial and legal interests from inadequate identification and management of risks relating to financial leasing of real estate. When establishing business relations with entities in this area of business (sellers and lessees of real estate), financial lessors take not only the prescribed actions and measures, but also undertake activities and apply procedures regulated by special internal acts to ensure the protection of lessors' interests, including in particular: analysis of all facts significant for lawful transfer of the right of ownership over real estate property from the seller to the financial lessor, so that the financial lessor's right of ownership cannot be contested (particular attention is paid to verification of data from the real estate cadastre and other data on records kept by relevant authorities); minimisation of operational risks that may occur in relation to the transfer of the right to use such real estate to the lessee, including in particular the ML/FT risk.

The fact that financial lessors took general CDD actions and measures even in cases when simplified actions and measures could be taken (the percentage of clients assessed as low-risk was higher than the percentage of simplified measures and actions taken during the reporting period,) and that the number of enhanced actions and measures rose by 20% while the number of clients classified as high-risk increased by only 0.20%, indicates that most financial lessors did not properly understand the purpose of client classification. Namely, the main objective of client classification is adequate and optimal allocation of human resources.

It is particularly important to note that, although the ML/FT risk is low in the financial leasing sector, it should by no means be ignored, particularly given the relatively small number of employees in the sector (407 as at 31 March 2016).

As obligors under the Law on the Prevention of Money Laundering and Terrorism Financing (RS Official Gazette, Nos. 20/2009, 72/2009, 91/2010 and 139/2014) – (hereinafter: Law), financial lessors are responsible for taking all actions and measures envisaged by the Law and secondary legislation to detect and prevent money laundering and terrorism financing that could ensue from the use of this financial product.

2. General data on financial lessors

A total of sixteen financial lessors operated in the Republic of Serbia during the reporting period. Eight lessors were in 100% or majority ownership of foreign legal entities, seven lessors were in 100% or majority ownership of domestic entities (of which six were owned by domestic banks in foreign ownership), while one lessor was jointly owned by a domestic bank in foreign ownership and a foreign legal entity, each holding a 50% stake. Most lessors owned directly or indirectly by foreign entities (through domestic banks) properly understood and applied AML/CFT risk management standards, policies and procedures in effect in the country in which their owners are based. All foreign credit/financial institutions – direct and indirect owners of domestic lessors are based in the EU.

Of all lessors, only five operated through branches (ten branches in total) during the reporting period.

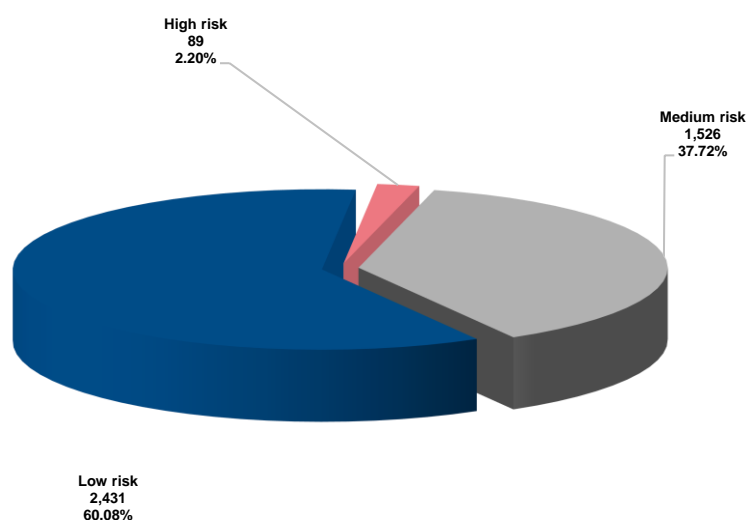
3. Financial lessors' activity

Based on adopted internal acts on AML/CFT risk management, all financial lessors prepared an AML/CFT risk analysis pursuant to the Decision on the Guidelines for Assessing the Risk of Money Laundering and Terrorism Financing (RS Official Gazette, Nos 46/2009 and 104/2009) issued by the NBS.

On the basis of data on client classification by degree of exposure to the ML/FT risk, financial lessors assessed the majority of clients as low-risk (60.08%), 37.72% as medium-risk and only 2.20% as high-risk (Chart 1).

Such very high percentage of clients classified as low-risk comes as a result of the provision under Article 5a of the Rulebook, which allows obligors to assess client risk based on an analysis conducted in line with their own criteria.

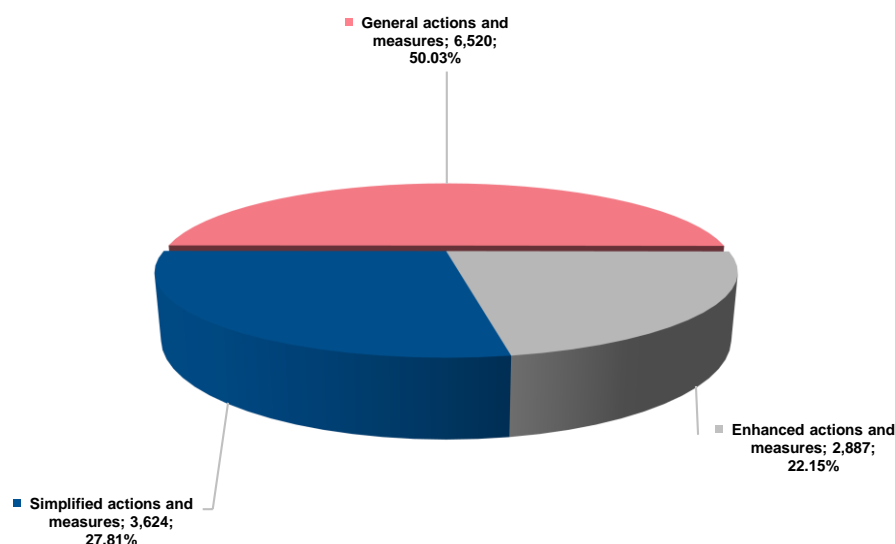
Chart 1 Lessees by degree of risk (as at 31 March 2016)



Pursuant to the Law, lessors are required to take general, simplified and enhanced CDD actions and measures. The analysis of Questionnaire responses shows that, though 2,431 clients of the total of 13,031 were classified as low-risk, lessors took simplified CDD actions and measures in respect of 3,624 clients only. General CDD actions and measures were taken in respect of 6,520 clients, and enhanced in respect of 2,887 clients.

Chart 2 Lessees by taken CDD actions and measures

(as at 31 March 2016)



As Chart 2 shows, lessors took general actions and measures in respect of 50.03% of all clients, regardless of whether they were classified as low- or medium-risk, simplified actions and measures in respect of 27.81%, and enhanced in respect of 22.15% of all clients, at overall financial leasing sector level. Questionnaire responses relating to the frequency of client monitoring show that lessors allocated their human resources inadequately, engaging in the monitoring of low-risk clients (and taking general CDD actions and measures in respect of such clients). This means that human resources are not used in an optimal way, as an equal amount of attention is paid to clients of different risk levels.

During the reporting period, four lessors carried out 44 analyses of suspicious transactions, but identified no grounds for reporting these transactions to the Administration for the Prevention of Money Laundering.

In the reporting period, fourteen lessors carried out internal control in relation to the prevention of money laundering and terrorist financing, while two lessors carried out such control before the reporting period. Four lessors detected irregularities. Control findings mostly related to:

-inadequate and incomplete documentation at the time of client identification for the purpose of establishing a business relationship;

-incorrect client classification by degree of AML/CFT risk exposure.

All lessors in which internal control detected irregularities took adequate measures and removed such irregularities.

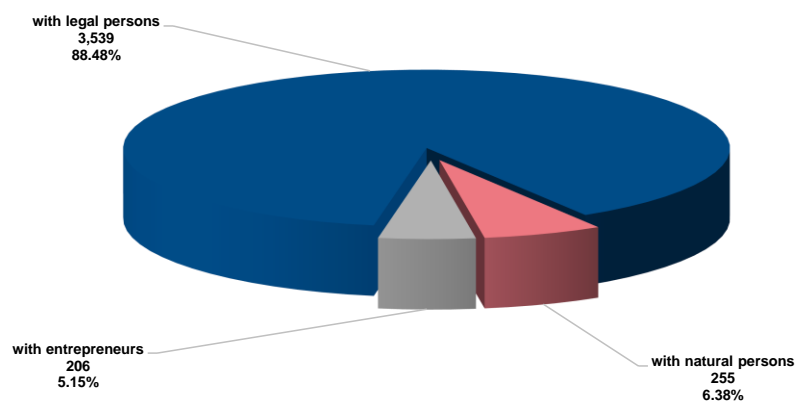
All lessors terminate their business relationship with a client if they are unable to take CDD actions and measures. According to data from the Questionnaire, in the October 2015–March 2016 period, five lessors refused to cooperate with a total of six clients because they could not take CDD actions and measures.

According to Questionnaire responses, two financial lessors entrusted some of the CDD actions and measures to a third party, namely to parent banks – their founders or other persons to which these tasks can be entrusted according to Law.

4. Lessees

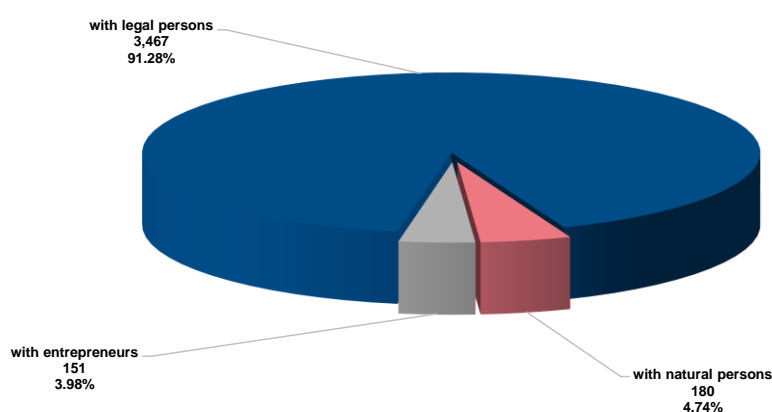
In the reporting period, lessors concluded 4,000 lease agreements, of which 3,539 with legal persons, 255 with natural persons and 206 with entrepreneurs.

Chart 3.1 Lessees by number and structure of concluded lease agreements
(as at 31 March 2016)



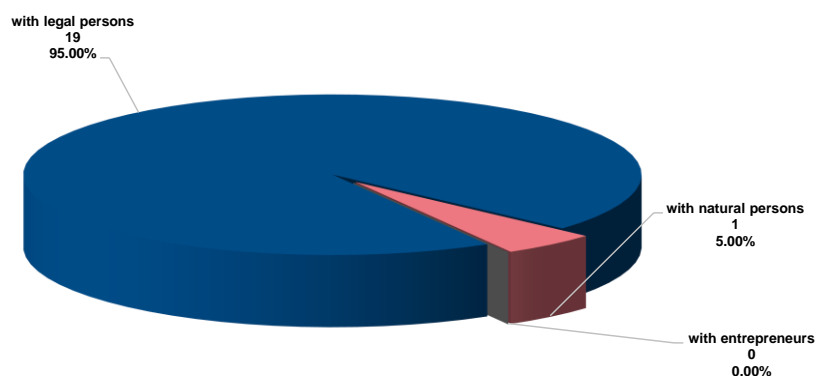
In the reporting period, lessors concluded 3,798 supply agreements, of which 3,467 with legal persons, 151 with entrepreneurs and 180 with natural persons.

Chart 3.2 Lessees by number and structure of concluded supply agreements
(as at 31 March 2016)



In the reporting period, lessors concluded 20 agreements on re-leasing of returned assets, 19 with legal persons and one with a natural person.

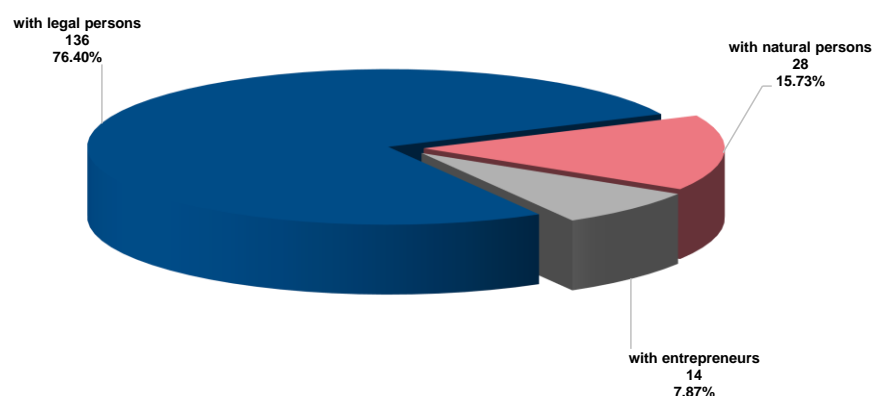
Chart 3.3 Lessees by number and structure of concluded agreements on re-leasing of returned assets
(as at 31 March 2016)



In the reporting period, lessors concluded 178 agreements on sale of returned lease assets, of which 136 with legal persons, 28 with natural persons and 14 with entrepreneurs.

Chart 3.4 Lessees by number and structure of agreements on sale of returned lease assets

(as at 31 March 2016)



In the reporting period, fifteen lessors accepted joint and several guarantee as collateral in relation to conclusion of 1,848 lease agreements, judging that there is a clear connection between lessees and guarantors. In addition, lessors also accepted payments from persons other than lessees, when there were legal grounds for such third-party payments – debt takeover agreement or assignation agreement.

In the reporting period, six lessors retained a broadly unchanged number of clients relative to the prior month, while the number of clients of six lessors declined due to regular and early purchases of the lease asset, agreement termination due to default on obligations and change in the business strategy of lessors' owners. Four lessors saw an increase in the number of clients thanks, in their view, to a good business approach.

One lessor faced a situation where the legal representative of a client – legal entity was not present in person at the start of the business relationship. For this reason, during the identity verification and identification stage of establishing a business relationship, such authorised person's identity was verified using not only data from the provided ID documents, but also using World Check and other data available on the Internet. Such authorised person acted on the basis of a letter of authority duly issued in accordance with the Law. In this specific case, enhanced actions and measures from Article 31 of the Law were taken. In the internal records of the lessor this client was classified as high risk and is subject to further monitoring.

According to Questionnaire responses, two lessors established a business relationship with three foreign officials which makes these business relations high-risk, due to increased client risk. In these cases, enhanced actions and measures prescribed by Article 30 of the Law were taken at the time of establishing the business relationship and regular monitoring is carried out in accordance with that Article.

In the reporting period, no financial lessors agreed on and/or carried out a transfer from any offshore destination in case of activation of warranty, or agreed on and/or carried out a transfer of funds (in the case of warranty) from countries where strict AML/CFT regulations are not applied.

5. Employee training

As at 31 March 2016, the financial leasing sector employed a total of 407 persons, 12 fewer than at 31 December 2015 and 21 fewer than in the prior reporting period (on 30 September 2015, the number of employees in all lessors was 428). Lessors prepared annual programmes of professional education, training and development for employees engaged in the detection and prevention of money laundering and terrorism financing.

Employee training is carried out in accordance with the annual plan and programme. All lessors held training events once a year.

Training is most often held by compliance officers and their deputies, through presentations in training centres, lectures and online presentations, group and individual consultations, internal portals and face-to-face training.

AML/CFT knowledge testing is carried out once a year, and tests are stored in paper or electronic form from five to 10 years.

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