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LEASING AND FACTORING

FINANCIAL SECTOR PROGRAM IN ANGOLA

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LEASING AND FACTORING

FINANCIAL SECTOR PROGRAM IN ANGOLA

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INSPECTION PROCEDURES: LOCACAO FINANCEIRA (LEASING)

A. Introduction

Of the nine principal sections in BNA's *Manual de Supervisao*, the first seven chapters contain much material that is relevant to the review and supervision of leasing activities. As with other products within the gamut of financial activities supervised by BNA, the objectives and the methodology used when examining and supervising leasing are essentially the same and include the following:

- Compliance with current Angolan legislation;
- Capable management;
- Appropriate corporate governance, management systems and procedures in place;
- Proper risk evaluation and control procedures in place; and,
- Acceptable levels of capital, earnings and liquidity are kept and generated.

In line with the Basel principles and recommendations, emphasis should be placed on a thorough understanding of the examined entities' policies and procedures, management capabilities, and the efficiency and efficacy of its internal audits and controls.

This section of the *Manual de Supervisao* focuses on those relatively few but important aspects of leasing which are somewhat different or unique from other financial products. Specifically, it provides:

- Additional product and risk information to give the examiner a better understanding of the context;
- Product-related examination objectives; and
- Product-related checklists and procedures to help the examiners collect and evaluate information on potential risk related to leasing activities.

This section does not address the leasing of real estate, operating leases or leveraged leases. Equipment leasing as authorized in Angola is in its initial, simplest and most basic form. It is restricted to finance leases and does not include the more complex leveraged tax leases or leases used to acquire aircraft and oil platforms nor does it address issues related to the cross-border international leasing of equipment. Additionally, at this time the issues related to accounting for leases, the taxation of leases and the multi-currency foreign exchange aspects of financing leases have not yet been approved in their final format. Therefore, this section will not address any of these elements and the related auditing, examining and supervisory issues.

B. Background and Definitions

The U.S. Comptroller of the Currency defines a lease as *“an agreement allowing one party to use another's property, plant or equipment for a stated period of time in exchange for consideration. A direct financing lease is one in which the lessor's only source of revenue is interest. The lessor (generally a bank or other financial institution) buys an asset and leases it to the lessee. This transaction is an alternative to the more customary lending arrangement in which a borrower uses the loan proceeds to purchase an asset. A direct financing lease is the functional equivalent of a loan.”*

The GLOSSARY section includes brief definitions of key words and concepts related to leasing.



C. Compliance with Angolan legislation and BNA Regulations

Objective: Verification that the leasing company or a bank's leasing department is properly authorized to engage in leasing activities, is properly registered, and that it complies with all applicable legal and regulatory requirements. At a minimum the following should be reviewed and verified:

1. Obtain documentation showing that the reviewed entity conducts its leasing activities through an entity properly established and registered in Angola, in accordance with the laws, avisos and directives governing such activities. Verify that the documentation is complete and valid.
2. Obtain timely evidence and verify that the bank or the leasing company being reviewed meets all requirements related to (a) minimum capital; (b) regulatory capital; and (c) limitations on claims on one party or related parties.
3. Verify that the leasing company has not made equity investments except as permitted.
4. Verify that the leasing company has not issued guarantees to third parties.
5. Verify that the leasing company or the bank's leasing department complies with all Angolan legislation and BNA regulations.
6. Obtain copies of the most recent reports required by law. Verify that the reports are submitted in a timely fashion and that they meet all requirements.

D. Review of Reports and Statements

1. A review should be conducted of the most recent reports required by law.
2. The most recent BNA examination reports should be reviewed. The examiners should determine how previous observations or any recommendations for correction or improvement were resolved.
3. Obtain and review the most recent internal management information reports and statements. In the case of independent leasing companies – whether or not owned by banks – this information should be available and used for the normal day-to-day management of the entity. In the case of leasing activities conducted by a bank through a bank department or division, some of this information might have to be assembled from the bank's internal books; nevertheless, this is necessary to enable examiners to obtain a clear view of asset based finance risk and its management, particularly if the volumes and amounts are deemed to be significant. The following is a listing of what is expected as a minimum:
 - a. Quarterly cash flow statements with detail about new originations.
 - b. Quarterly balance sheet and profit and loss statements, with the calculation of the following ratios:
 - (1) Return on assets (ROA), to show operational efficiency margins;
 - (2) Return on equity (ROE), to indicate return offered to shareholders;
 - (3) Time interest earned (TIE), to indicate the coverage that profits provide over the cost of funds.
 - c. Credit risk reports indicating the following details:
 - (1) Exposure at default (EAD);
 - (2) Probability of default (PD);
 - (3) Loss given default (LGD);
 - d. Updated risk acceptance criteria applied by the institution.



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- e. Detailed maturities of assets and liabilities in a spreadsheet.
 - f. Biographical information on the leasing company's senior management (or, in the case of a bank department, the key bank officers responsible for the bank's leasing activities); this information should include details related to their education and work experience, especially as related to banking, leasing, and management.
 - g. A memorandum on operational risk management, metrics, and mitigation measurement.
 - h. A management report indicating the type of business developed and the sectors and markets attended.
 - i. All this information, once validated, shall be published in BNA's website and be available to the public.

E. Documentation

Objective: A lease is “an agreement allowing one party to use another's property, plant or equipment for a stated period of time in exchange for consideration” Therefore it is essential that there be proper and clear documentation establishing who is the owner, who is allowed to use the owner's property, and under what conditions the permission is granted. The complexity and level of detail is related to the value and nature of the equipment and the complexities of governing law. The following is a listing of some of the documents, agreements and statements that should be considered for review by the examiners:

1. Proof of ownership of the equipment leased. Verify the existence of an equipment bill of sale and that it contains a representation that the seller has the lawful right and authority to sell the equipment.
2. Lease contract (between lessor and lessee), including price, payment terms and amounts, rights and obligations related to the use, maintenance, transfer, sublease and return of the equipment.
3. Maintenance agreement related to the equipment (possibly including the supplier).
4. Terms, conditions and proof of valid insurance.
5. Proof of proper registration of titles and security interest filing (if and as required by Angolan law – this section needs to be updated in accordance with current and future legislation).
6. Certified copies of any relevant corporate board of director resolutions providing lessee with the right to enter into lease agreements.
7. If the lease obligation is guaranteed by a third party, is it a full and unconditional guarantee? If not, what are the limitations and do the lessor's representatives understand the risks incurred?

F. Risk Review

Objective: To verify that the management of a leasing company or a bank's leasing department has a system that identifies, measures, monitors and controls risk exposure. To determine whether the system is effective, the examiner must understand the nature of leasing, the accounting for leases, and the reasons why leasing can be attractive to lessors and lessees, and the rules and regulations governing leasing.

Since the review of finance leases is very much like any other examination of asset quality, the examiner should follow the guidelines and procedures included in BNA's *Manual de Supervisao*. This section will merely highlight six types of risks that are particularly relevant to finance leases and which should merit examination from the perspective of asset based finance. The following paragraphs will discuss these aspects of credit, interest rate, liquidity, transaction and compliance risk.



(1) Credit risk:

Rental or lease payments on a lease carry substantially the same risk as payments on a secured loan. Although ownership of the asset leased can be an additional form of security since the owner is expected to have the ability to recover the asset, given the recent introduction of leasing to Angola, leases should be reviewed as if they were loans, using the same standards of classification, the same methods to allocate reserves, and the same accrual methodology. The examiner should verify that the lessor expects to realize the return of its full investment in the leased property and the estimated cost of financing the property over the life of the lease from the expected lease payments and the estimated residual value. Related to this is the need to establish the creditworthiness of the lessee, evidence of the proper inspection and valuation of the leased property, and regular monitoring of the lease payments and the lessee's creditworthiness.

(2) Interest rate risk:

Leases are subject to interest rate risk just like loans. However, in the case of loans, interest and principal are usually treated as two separate portions (explicit interest rate). To provide an even level of lease payments, typically leases have an implicit rate which is fixed at the beginning for the entire period and is repaid through periodic, equal lease payments. Fixed interest rates for longer time periods can expose a lessor – whether a leasing company or a bank department – to a significant interest rate risk. This risk is also affected by prepayment, early termination options and the size of the final residual value or balloon payment related to the overall value of the lease contract. Interest rate risk is primarily determined by differences between the timing of rate changes and the timing of cash flows. An examiner must determine (1) the nature and size of potential interest rate risk in the lease portfolio; and (2) the adequacy of the lessor's asset-liability management capabilities and procedures. The existence of interest rate risk is normal and expected in most leasing transaction. From an examiner and supervisor's perspective the important objective is to determine if the lessor is aware of this risk, can adequately monitor and measure this risk, and has procedures in place to control this risk.

(3) Liquidity risk:

Liquidity risk is the risk of losses resulting from a bank or a leasing company's inability to meet its obligations when they come due without incurring unacceptable losses.

In a dynamic well-regulated market, liquidity risk should be lower in the case of sound leases than for unsecured loans. If the lease is properly written and the equipment being leased has a ready market, the owner (lessor) should be able to readily convert a non-performing lease into another, profitable lease to another, solvent lessee or to sell the equipment and recover the full investment.

(4) Transaction risk:

The major difference between a loan and a lease is that in a lease, the lessor (bank or a leasing company) owns an asset and collects payments for the use of the asset. Consequently, one of the major risks in such a transaction is the legal status of the lessor's ownership rights. Proper documentation and registration are essential and, therefore, a reviewer must examine their status and the procedures being followed.

If the lessee is permitted to sub-lease the equipment, this presents an entire set of additional transaction risks which the examiner must understand. What are the terms and conditions? How do these relate to the original obligations the lessee has undertaken? What are the risks related to the sub-lease, first to the lessee, then to the original lessor (owner of the equipment)?

Residual value risk is another element which makes leases different from loans. Residual value is the estimated value of the equipment at the end of the lease term. Depending on tax and accounting rules, this value may or may not be defined at the beginning of the lease. In either case, it is important to know what the market or replacement value of such equipment is at the end of the lease period. Examiners



should review how the leased property is valued initially and periodically throughout the lease to determine whether the estimated residual value is reasonable. A bank or a leasing company should control such risks by periodically evaluating leased property for misuse, obsolescence, or market value decline which can depreciate the value of the property.

(5) Equipment risk:

Throughout the life of a lease, the lessor (bank or leasing company) owns the equipment leased. As all owners, lessors may be held responsible for risks associated with use and ownership. Among these are risks related to what may happen to the equipment itself (damage, obsolescence, break-down, etc.) as well as possible damage that the use of the equipment itself may cause to people or property. Proper insurance may reduce – but will never completely eliminate – such risks and the examiners should evaluate their potential magnitude.

(6) Compliance risk:

Typically compliance risk is increased in an environment in which there is a lack of clear or well-established and well-tested rules. Correct and complete documentation is an essential element of well-run leasing departments or leasing companies. If there are problems with documentation the lessor can lose its contractual rights under a lease. Compliance risk affects leasing as much as it does lending. Therefore, a bank's compliance procedures for leasing activities should be very similar to those for lending activities.

LEASE FINANCING -- EXAMINATION PROCEDURES

I. General Procedures

Objective: To set the scope for assessing the quantity of risk and the quality of risk management in lease financing.

1. Review the following documents to identify any previously identified problems related to the leasing area that require follow-up:

- Previous examination reports;
- Follow-up activities;
- Overall summary comments;
- Work papers from previous examinations; and
- Internal and external audit reports.

(Note: If an examiner is assigned internal and external audit, a copy of any significant deficiencies for this area should be obtained from that examiner. If internal and external audit is not part of the overall scope of the examination, review the work performed by the internal and external auditors in this area and obtain a list of any deficiencies noted in their most recent review.)

2. Obtain any reports management uses to supervise the lease financing area. Examples include:

- Trial balances;
- Subsidiary controls;
- General ledger;
- Call report, if using a quarter-end examination date;



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- List of equity participations purchased and sold as of examination date indicating from whom purchased or to whom sold;
 - List of past-due and defaulted leases, as of examination date, that gives the date of lease, terms, book value, residual value, date of last payment, description, and location of property;
 - Latest appraisal report or other collateral evaluation for past-due and defaulted leases;
 - Past-due and defaulted lease reports submitted to the board of directors or its loan or leasing committee;
 - A schedule of lease commitments, as of examination date, that gives the name of the prospective lessee, the date of commitment, expiration date, cost, and description of property to be leased;
 - A list of off-lease property, as of examination date, which discloses the book value, the date property came off lease, a description and location of property, the date of latest appraisal, and the appraised value; and
 - A list of liability and other information on common borrowers from examiners assigned cash items, overdrafts, and other loan areas.
3. Determine, during early discussions with management:
- How management supervises lease financing;
 - Any significant changes in policies, practices, personnel, and control systems; and
 - Any internal or external factors that could affect lease financing.
4. Based on the performance of the previous steps and discussions with appropriate supervisors, determine the scope of this examination and set the examination objectives.
5. As examination procedures are performed, test for compliance with established policies or practices and the existence of appropriate internal control processes. Identify any area with inadequate supervision and/or undue risk, and determine the need to perform additional procedures.

II. Quantity of Risk

Conclusion: The quantity of risk is (low, moderate, or high).

Objective: To evaluate the adequacy of credit quality, collateral, and collectability as well as to determine the quantity of other risks in various types of lease financing activities.

FOR ALL LEASES

1. Prepare for examination a sample of leases that in the examiner's judgment require in-depth review.
2. Using the list of liabilities and other information on common borrowers, decide who will review the borrowing relationship.
3. Using selected lessee liability records and document files, transcribe or download the following information onto line sheets:
 - Name of lessee;
 - Type of business and other affiliations;
 - Name(s) of guarantor(s);
 - Date lease was made;



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- Terms, including options;
 - Expiration date of lease;
 - Date of last lease payment;
 - Aggregate unpaid rentals;
 - Description and location of property;
 - Cost of property;
 - Book value;
 - Residual value;
 - Accumulated depreciation;
 - Insurance coverage;
 - Corporate resolution to lease and/or guarantee;
 - Current amount owed lender(s);
 - Terms of the debt;
 - Maturity of the debt;
 - Name of owner trustee (person holding title to the leased property for the benefit of the equity holders); and
 - Name of other equity participants and percentage of equity owned.
4. Request credit folders on all selected leases, and transcribe the following information to financial statement line sheets and comment line sheets:
- Balance sheet and profit and loss statements for the preceding three fiscal years;
 - The most recent interim balance sheets and profit and loss statements;
 - Projections of future operations, including cash flow debt servicing requirements, earnings, and lease commitments;
 - Current financial information on any guarantors;
 - Past and present borrowing records with the bank and outside credit inquiries; and
 - Relevant information from the loan officer's credit memorandums.
5. Check central liability file on lessee(s) selected for review who are suspected of having additional liabilities in other loan areas.
6. Assess the reasonableness of the bank's calculation of the inherent gain or loss for each lease selected for review.
7. Analyze both current and projected yields computed by the bank for reasonableness and accuracy by:
- Comparing the yield against the bank's share of investment for leveraged leases;
 - Tracing income and lease balances from the yield calculation to the general ledger; and
 - Obtaining a listing of unearned income-leasing account and reconciling the total to the general ledger liability account.



DELINQUENT AND DEFAULTED LEASES

1. Evaluate the credit quality of each selected delinquent or defaulted lease by considering:
 - The lessee's ability to properly amortize the fixed obligations, including all present and proposed lease arrangements;
 - The correlation between projected and achieved operational results, with emphasis on cash flow;
 - Duration of adverse operating trends and prospects for the future;
 - The reasonableness of residual values and any exposure to income adjustments or loss on termination. Determine whether the residual value has been reviewed in the last 12 months;
 - The reasonableness of the latest appraisal report or other collateral evaluation;
 - The usefulness of the leased property to a third party given the condition of the property;
 - The status of any proposed sale or lease;
 - The support offered by other collateral;
 - Potential exposure to income through the recapture of tax benefits or changes in tax laws or rates;
 - The support afforded by guarantors;
 - The support afforded by vendor support arrangements;
 - Accelerated payments in the early years of the lease; and
 - Any concentration of leases.
2. Assign classification of credit and specific allowance allocations for each lease if appropriate.
3. Determine the cost to the bank of repossessing and selling the property or repossessing and converting it to income-producing status through release.
4. Evaluate the reports submitted to the board of directors, or its loan or lease committee, to determine if they are complete in their evaluation of risk factors, loss potential, and causes of delinquency or default, and if they propose a course of action.

DIRECT FINANCING AND OPERATING LEASES

1. Determine that the terms and conditions of selected direct financing and operating leases are appropriate.
2. Evaluate the credit quality of each selected direct finance or operating lease by considering:
 - The lessee's ability to properly amortize the fixed obligations, including all present and proposed lease arrangements;
 - The correlation between projected and achieved operational results, with emphasis on cash flow;
 - The reasonableness of residual values and any exposure to income adjustments or loss on termination. Determine whether the residual value has been reviewed in the last 12 months;
 - Potential exposure to income through the recapture of tax benefits or changes in tax laws or rates;
 - Possible adverse operating trends;
 - The support offered by other collateral;
 - The usefulness of the leased property to a third party, in the event of default;



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- The support afforded by guarantors;
 - The support afforded by vendor support arrangements;
 - The support offered by various payment structures such as accelerated payments in the early years of the lease; and
 - Any concentration of leases.
3. Assign classification of credit and specific allowance allocation for each lease, if appropriate.
4. Based on the findings from the previous direct financing and operating lease procedures, determine whether additional sampling is needed to complete the following verification procedures. If so, select a sample of leases from the listing, and:
- Reconcile the trial balance of the lease liability records with subsidiary controls, the general ledger, and the call report if using a quarter-end examination date.
 - Determine that the lease is properly categorized as an operating or direct financing lease.
 - Prepare and mail confirmation forms to lessee. Confirmation forms should include a description and location of the property, monthly or annual rentals, terms, and other major provisions and options. The confirmation should also include the outstanding balance of lease receivables.
 - Determine that (1) an order to purchase or a legally binding agreement indemnifying the bank against loss was executed before the bank was committed to purchase and deliver the property, or that (2) the acquisition of these assets is consistent with the bank's existing leasing business or with a business plan for expansion of the bank's existing leasing business or for entry into the leasing business.
 - Determine that the files contain bills of sale, invoices, titles, or other evidence of ownership for the property leased.
 - Ascertain that a properly executed non-cancelable lease is held.
 - Determine that the bank has recorded ground leases or waivers from owners or mortgage holders of property on which the leased property is located.
 - Review insurance coverage and determine that property damage coverage is adequate relative to book value and that liability insurance is in effect.
 - Determine that periodic inspection reports are being received.
 - When a lease is to a corporation, determine that corporate resolutions to lease have been executed.
5. For **operating leases** selected above:
- Reconcile the bank's recorded cost of the property to purchase invoices and payment drafts.
 - Compare rental income from operating leases in the general ledger to the amounts of stated rents in the individual leases.
6. For **direct financing leases** selected above:
- Verify that the lease receivable amount is correctly recorded and includes minimum rental payments plus residual value.
 - Compare the amount of the lease payments to the lease agreement.
 - Recalculate the amount of unearned income.
 - Ensure that the proper lease amounts are recorded in the general ledger.



COMMITMENTS TO LEASE

1. Using the schedule of lease commitments, select items for examination.
2. Evaluate the ability of selected prospective lessees to service the anticipated obligation.
3. Evaluate reasonableness of estimated residual value.
4. Compare lease commitments to approvals recorded in minutes of board of directors or committee meetings.

OFF-LEASE PROPERTY

1. Determine the reason for off-lease status.
2. Evaluate the reasonableness of the latest appraisal or other collateral evaluation and evaluate condition of the property.
3. Determine the cost to the bank of selling the property or converting it to income-producing status through re-lease.
4. Determine the status of any proposed sale or lease.
5. Assign classification of credit and specific allowance allocation for each off-lease property if appropriate.
6. Determine whether the bank disposes of off-lease property as soon as practical.
7. Balance the aggregate book value to general ledger.

PROPERTY ACQUIRED FOR FUTURE LEASING ACTIVITY

1. Obtain a list, as of examination date, of all property acquired and held for future leasing activities. The list should include the date the property was acquired, the book value of the property, and the original cost of the property.
2. Determine that the acquisition of these assets is consistent with the bank's existing leasing business or consistent with a business plan for expansion of the bank's existing leasing business or for entry into the leasing business.
 - Obtain all subsidiary asset ledgers, foot on a test basis, and check against the general ledger control accounts.
 - Test the propriety of significant acquisitions. To do so, compare each such acquisition's cost with that of similar assets, review the method used to select a vendor, and inspect the asset in person.
 - Test the propriety of the lease price by comparing the price with that of similar assets and by reviewing the method used to establish the lease price.
3. Determine whether property held for an extended period has been reviewed for impairment of value. If the value of property is permanently impaired, ensure that the bank has written down the book value to reflect the impairment.

III. Compliance with Laws, Rules, and Regulations

Objective: To determine compliance with applicable laws, rulings, and regulations for various types of lease financing activities.



FOR ALL LEASES

1. Determine that rentals, estimated tax benefits, and the estimated residual value of the property at the expiration of the term are such that the bank can reasonably expect to realize the return of its full investment in the leased property plus the estimated cost of financing the property over the term of the lease.
2. Determine that all leases are net leases under which the bank is not directly or indirectly responsible for servicing, repair, maintenance, purchasing of parts and accessories, or insuring the leased property.
3. Determine that any purchase of property is consistent with the provisions of Angolan law related to leasing (determine whether financing arrangements meet the limits on loans or extensions of credit; determine whether financing arrangements meet the restrictions on transactions with affiliates; determine that the aggregate book value of all tangible personal property held under leases does not exceed x percent of consolidated bank assets; determine that the initial lease term was not less than x days; determine that the estimate of the unguaranteed portion of the residual value is reasonable and does not exceed x percent of the original cost; determine that all leases represent non-cancelable obligations of the lessee; determine that the lease agreement provides that, upon expiration, the lessee becomes title holder of the property).

IV. Quality of Risk Management

Conclusion: The quality of risk management is (weak, acceptable, or strong).

POLICY

Conclusion: The board (has/has not) established effective policies regarding lease financing.

Objective: To determine whether lease policies are adequate and whether the board of directors has adopted effective lease policies and practices.

1. Review the bank's lease financing policies and practices. Do they:
 - Establish procedures for reviewing lease financing applications?
 - Define types of leasing activities that the bank will consider, including any limits?
 - Define qualified property?
 - Establish minimum standards for documentation?
2. Determine whether lease financing policies and practices are reviewed at least annually by the board of directors. Does the board of directors determine whether policies are compatible with changing market conditions?

PROCESSES

Conclusion: Management and the board (have/have not) established effective processes regarding lease financing.

Objective: Determine the adequacy of lease administration processes.

1. Determine the quality of reports available to effectively administer lease financing. Consider the following:
 - Are periodic property inventory reports prepared by the lessee or trustee?
 - Do reports clearly indicate the condition and location of property?



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- Does the board of directors, at its regular meetings, receive for review reports listing leases that are past due, criticized, or receiving special attention?
 - Does the board of directors receive accurate reports on lease transaction yields?
2. Assess the bank's process for obtaining inspections on leased personal property. If inspection of the leased property is either infrequent or not feasible, has the bank taken measures to protect its personal property and prevent its misuse?
 3. Review the bank's procedures for accepting bids for the purchase of the leased property at termination of the lease to ensure that reasonable estimates of value are obtained. For a lease with no specific purchase options or renewal or extension periods, does the bank require outside appraisals or other reasonable estimates of value before accepting a bid for the purchase of the leased property?
 4. Determine whether review procedures are in effect to maintain the necessary insurance coverage on all leased assets. Does the bank's insurance coverage include its potential public liability risk as owner- lessor of the property?
 5. Review the adequacy of safeguards in effect to prevent the possibility of a conflict of interest or self- dealing in selecting the following:
 - Seller of the leased property;
 - Servicer of the leased property;
 - Insurer of the leased property; and
 - Purchaser of the leased property.
 6. Review the approval process for leases to determine whether:
 - Provisions within the normal credit policy are met;
 - The originating loan officer(s) or loan/lease committee has adequate lending authority; and
 - Modifications of terms require the approval of the board or the lease committee that initially approved the lease.
 7. Review the process to ensure that leases are supported by current credit information.
 8. Determine whether commitments are contingent upon receipt of certain satisfactory information. If so, is someone other than the account officer responsible for rejecting or accepting that information?
 9. Determine whether the bank's manner of establishing and updating residual values on leased property is in accordance with generally accepted accounting principles. Consider whether:
 - Residual values are reviewed annually;
 - Residual write-downs are in accordance with SFAS 13, if there is a permanent decline in value;
 - The bank uses modeling to derive residual values, whether or not assumptions are reasonable; and
 - Residual schedules balance.
 10. Determine whether the bank's manner of establishing the depreciable life of leased property and depreciation methods are reasonable and in accordance with generally accepted accounting principles. The examiner should consider:
 - Testing the footings of the depreciation schedules; and
 - Tracing depreciation expense from depreciation schedules to the subsidiary and general ledgers.



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11. Review the bank's practice of accounting for terminated leases by reviewing leases terminated since the previous examination. Consider whether:
 - Terminated leases are properly recorded;
 - The sales price for personal property that has been sold was reasonable; and
 - Any gain or loss on the termination is calculated accurately.

PERSONNEL

Conclusion: The board, management, and affected personnel (do/do not) possess the skills and knowledge required to manage and perform duties related to lease financing.

Objective: Given the size and complexity of the bank, determine whether bank management/personnel possess and display acceptable knowledge and technical skills in managing and performing duties related to lease financing.

1. Determine significant current and previous work experience of management and leasing personnel. Consider:
 - Specialized lending experience (i.e., leveraged leasing)
 - Tax and accounting experience
2. Determine whether management and leasing personnel are well-educated in lease financing and whether they plan further education in the subject.
3. Assess technical knowledge and ability to manage leasing operations using results of lease administration evaluation and determination of the quantity of risk.

CONTROLS

Conclusion: Management (has/has not) established effective control systems.

Objective: To determine the effectiveness of control systems employed to manage lease financing.

1. Determine the effectiveness of the loan review system in identifying risk in lease financing. Consider the following:
 - Scope of review;
 - Frequency of reviews;
 - Qualifications of loan review personnel; and
 - Examination results.
2. Determine the adequacy of the audit function for lease finance activities. Consider the following:
 - Scope of the internal audit;
 - Frequency of reviews; and
 - Qualifications of internal audit personnel.
3. Determine whether management has appropriately addressed concerns and areas of unwarranted risk.
4. Determine whether management information systems are capable of accurately gathering and tracking information and providing needed reports.



5. Determine whether the appropriate operational tools exist to safeguard assets and ensure the integrity of accounting data/financial reports for lease financing. Consider the following:

FOR LEASE FINANCING RECORDS

- Are separate files maintained for each lease transaction?
- Does each file supporting the acquisition and disposal of assets reflect the review and written approval of an officer other than the person who controlled the disbursement and receipt of the funds?
- Is the preparation and posting of subsidiary lease financing records performed or reviewed by persons who do not also:
 - Issue official checks and drafts singly?
 - Handle cash?
- Are the subsidiary lease financing records reconciled to the appropriate general ledger accounts at least monthly, and are reconciling items investigated by persons who do not also handle cash?
- Are delinquent account collection requests and past-due notices checked to the trial balances, and are they handled only by persons who do not also handle cash?
- Are inquiries about lease balances received and investigated by persons who do not also handle cash?
- Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash?

FOR INTEREST AND RENT

- Is the preparation and posting of interest and rent records performed or reviewed by persons who do not also:
 - Issue official checks and drafts singly?
 - Handle cash?

FOR DEPRECIATION

- Is the preparation and posting of periodic depreciation records performed or reviewed by persons who do not also have sole custody of property?
- Do the bank's procedures require that depreciation expense be charged at least quarterly?
- Are the subsidiary depreciation records balanced to the appropriate general ledger controls at least quarterly by persons who do not also have sole custody of property?

FOR PROPERTY ACQUIRED FOR FUTURE LEASING ACTIVITY

- Do the bank's procedures preclude persons who have access to property from having "sole custody of property" in that:
 - Its physical character or use would make any unauthorized use or disposal readily apparent?
 - Inventory control methods sufficiently limit accessibility?



- Is the addition, lease, or other disposal of property approved by the signature of an officer who does not also control the related disbursement or receipt of funds?
- Is the preparation and maintenance of property subsidiary records for additions, leases, and other disposals performed or reviewed by persons who do not have sole custody of the property?
- Are subsidiary property records balanced, at least quarterly, to the appropriate general ledger accounts by persons who do not also have sole custody of property?
- Is the existence of property checked or tested, such as in a physical inventory, and are any differences between the property's characteristics and its description in property records investigated by persons who do not also have sole custody of equipment?
- Does the bank maintain separate property files that include bills of sale, invoices, titles, or other evidence of ownership?

V. Conclusion Procedures

Objective: To communicate findings and initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

1. Provide EIC with brief conclusion regarding:

- • The adequacy of the bank's policies or practices regarding leases;
- • How bank officers conform to established policy or practices;
- • Adverse trends in the leasing department;
- • Internal control deficiencies or exceptions;
- • Any corrective action recommended for deficient policies, practices, or procedures;
- • The quality of departmental management;
- • The quantity of credit/residual risk in the portfolio;
- • The adequacy of MIS; and
- • Other matters of significance.

2. Determine the impact on the aggregate and direction of risk assessments for any applicable risks identified while performing the foregoing procedures.

- Risk Categories: Compliance, Credit, Foreign Exchange, Interest Rate, Liquidity, Price, Reputation, Strategic, Transaction;
- Risk Conclusions: High, Moderate, or Low; and
- Risk Direction: Increasing, Stable, or Declining.

3. Determine, in consultation with EIC, whether the risks identified are significant enough to merit bringing them to the board's attention in the report of examination. If so, prepare items for inclusion in "Matters Requiring Board Attention" (MRBA).

- MRBA should cover practices that:
 - - Deviate from sound fundamental principles and are likely to result in financial deterioration if not addressed; and
 - - Result in substantive noncompliance with laws.



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- MRBA should discuss:
 - - Causes of the problem;
 - - Consequences of inaction;
 - - Management's commitment to corrective action; and
 - - The time frame and person(s) responsible for corrective action.
4. Discuss findings with management including conclusions regarding applicable risks. Include the following subjects, if relevant:
 - Delinquent leases;
 - Violations of laws, rulings, and regulations;
 - Leases not supported by current and complete financial information;
 - Leases for which documentation is deficient;
 - Personal property deficiencies revealed in inspection reports;
 - Off-lease personal property;
 - Concentrations of leases;
 - Classified leases; and
 - Leases to major shareholders, employees, officers, directors, or the interests of officers or directors.
 5. As appropriate, prepare a brief comment on lease financing for the report of examination. In general terms, address the following subjects:
 - Quantity of risk; and
 - Quality of risk management.
 6. Prepare a memorandum or update the work program with any information that will facilitate future examinations.
 7. Update the ongoing supervisory record and any applicable report of examination schedules or tables.
 8. Organize and reference working papers.

GLOSSARY

Balloon Payment: a final payment that is larger than the regular, periodic lease payments (typically monthly or quarterly). This payment may be significantly larger if calculated to amortize the debt through a repayment schedule which during the life of the lease lowers the cost to the lessee.

Conditional Sales Agreement: a contract that provides for the time financing of an asset. The seller retains title to the asset until the buyer fulfills all specified conditions.

Discounted Cash Flow Analysis: a calculation which determines the present value (today's value) of future cash payments. Such calculations assume and include a given time value (such as a rate of interest).

Fair Market Purchase value (fair market value): an asset's value determined in the open market under normal market conditions, in which there is a willing buyer and a willing seller, with neither under compulsion to buy or sell.



Full payout lease: A form of lease that will provide the lessor with a cash flow generally sufficient to assure a full, appropriate return on equipment investment; pay the principal, interest, and other financing costs related to the debt; cover related sales and administration expenses; and generate a profit. The cash flow is determined from the rental payments, the ownership tax benefits, and the equipment residual value. The lessee typically has the right to use the leased equipment for most of its actual useful life. (Definition from “The Complete Equipment Leasing Handbook,” by Richard. M. Contino).

Lease agreement: a lease is an agreement allowing one party to use another’s property, plant or equipment for a stated period of time in exchange for a consideration. Under such a contract the *lessor* (owner of the equipment) transfers the right to use certain equipment, subject to specific terms and conditions, to another party, the *lessee*, for a specific period of time and in exchange for a defined flow of lease payments.

Lessee: the user of equipment that is the subject of a lease agreement.

Lessor: the owner of equipment that is the subject of a lease agreement.

Level lease payments: equal payments during the lease period that include repayment of both the investment (capital) portion and the associated return on investment (interest).

Master lease agreement: A lease agreement designed to permit future equipment not contemplated when the lease is executed to be added to the lease later. The document is set up in two parts. The main body contains the general, or boiler plate provisions, such as the maintenance and indemnification provisions. An annex, or schedule, contains the type of items that usually vary with a transaction, such as rental rates and options. (From “The Complete Equipment Leasing Handbook,” by Richard M. Contino).

Net lease: A lease arrangement in which the lessee is responsible for paying all costs such as maintenance, certain taxes, and insurance, related to using the leased equipment, in addition to the rental payments. Typically, finance leases are net leases. It is a lease under which a bank-lessor will not, directly or indirectly, provide or be obligated to provide for:

- (1) Servicing, repair, or maintenance of the leased property during the lease term;
- (2) Parts or accessories for the leased property;
- (3) Loan of replacement or substitute property while the leased property is being serviced;
- (4) Payment of insurance for the lessee, except when the lessee has failed in its contractual obligation to purchase or maintain required insurance; or
- (5) Renewal of any license or registration for the property unless renewal by the lessor is necessary.

Non-cancelable lease: A lease that cannot be canceled without the permission of the lessor or unless circumstances develop that appear to be remote possibilities at the inception of the lease.

Operating lease: A form of lease arrangement in which the lessor generally commits to provide certain additional equipment-related services other than the straight financing, such as maintenance, repairs, or technical advice. Generally, operating leases are non-payout in nature. (From “The Complete Equipment Leasing Handbook,” by Richard M. Contino).

Residual value: the estimated fair value of the leased equipment at the end of the non-cancelable lease term.

Sublease: the re-lease by a lessee of equipment that is on lease to the lessee.

Termination value: A value – typically expressed as a percentage of the original equipment cost – in exchange for which a lessee may terminate a lease at any given time during the life of the lease.



Unearned income: The total income expected to be earned over the remaining life of the lease. At inception, unearned income is the difference between the lessor's investment in the property and the gross investment in the lease. Unearned income has three components: minimum lease payments, unguaranteed residual value, and investment tax credit.