FINANCIAL VS OPERATIONAL LEASING –THE ROMANIAN EVIDENCE

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Abstract: Leasing is an important source of medium and long-term financing in developed economies and also in countries with transition economies because leasing is an economically-efficient solution to the question of asset acquisition. Leasing is particularly important in financing to small and medium-sized enterprises and start-ups, which play a key role in introducing innovation and competition into the economy and in job creation. The Romanian leasing market is developing in present and is extending to new fields, conquering a part of the fields which belong to the banks. In the same time, the sector will get to maturisation, the small firms will merge and will form important firms.

Key words: leasing, operational leasing, financial leasing, Romanian leasing market

Introduction

Leasing is an important source of medium and long-term financing in developed economies, and also in countries with transition economies because leasing is an economically-efficient solution to the question of asset acquisition. Leasing is particularly important in providing finance to small and medium-sized enterprises and start-ups, which play a key role in introducing innovation and competition into the economy, and in job creation. Leasing can also be an effective mechanism for jumpstarting an economy because the following reasons:

- a healthy leasing industry results in increased flows of financing to the productive sector of the economy, facilitating an increase in domestic production, a rise in equipment sales, and a wider choice of financing options available to business;
- leasing offers a way to modernize production and develop small business. Leasing companies play an important role in the financing of small and medium-sized businesses, which need financing to expand but often do not have the credit history or collateral sufficient for other financing sources;
- leasing creates competition in the financial marketplace. Leasing, which is not as risky as working capital lending, creates an alternative method of financing businesses and directly competes with bank lending products. In transition economies, leasing complements bank financing, allowing businesses to access both lease financing and additional bank financing without increasing their collateralized debt.
- leasing increases the total capital investment in an economy. Leasing is a complementary form of financing that serves as a substitute to bank lending and increases other forms of financing.

- leasing increases the sale of equipment. Leasing offers domestic and foreign suppliers a new mechanism for increasing their customer base, and access to new clients - previously poorly financed businesses.

The new legislative frame regarding the leasing in Romania

According to the law, leasing as an economic operation is defined as follows: *"... leasing operations whereby a party, referred to as the lessor/financer, transmits for a determined period the right of using a good owned by it to the other party, referred to as the lessee/user, at the latter's request, against a periodical payment, referred to as the leasing installment, and at the end of the leasing period the lessor/financer undertakes to comply with the lessee/user's right to choose either to buy the good, to extend the leasing agreement or to end the contract relationship."*

The definition comes not only from the new leasing law but also from the new law dedicated to non banking financial institutions. A simple inventory of the new legislation shows a tremendous legislative effort done in the last years:

• Leasing Law No. 278/2006 that modifies the Governmental Ordinance 51/1997 republished;

• Non Banking Financial Institutions Law No. 266/June 2006 that approves Governmental Ordinance No. 28/February 2006;

• Law No. 343/July 2006 that modifies Law No. 571/2003 on Fiscal Code.

All the legislative changes reflect the inclusion of financial leasing in the category of credit activities. Therefore, the leasing companies should have a minimum share capital, subscribed and paid equal to 200,000 EUR.

As a step forward to the non banking financial institutions special law, the leasing law brings amendments related to the:

- obligation for external audit of all leasing companies by accredited auditors,
- obligation for only one main field of activity which has to be leasing;
- the obligation to report on periodical bases to the Central Bank;
- the right and obligation to consult the banking risk data base.

The new legislation has also considered the consumer/lessee protection in case of lessor's bankruptcy. Thus, under bankruptcy procedure, all lessees' rights derived from leasing contract are opposable to the syndic judge and creditors.

With purpose to eliminate any confusion between financial and operational leasing, Law No. 287/2006 sets forth that leasing agreements should contain a clause to define the agreement as financial or operational leasing.

The law also clarifies the parties' rights and obligations related to the good's insurance aspects. Thus, while by the former Governmental Ordinance, the obligation to insure the leased assets fell exclusively to lessors, Law No. 287/2006 allows the parties to include a clause in the leasing contract setting forth derogation from the general rules. Nevertheless, the full risk insurance of the leased asset stays as a contractual obligation.

With respect with the above mentioned legislative changes related to the leasing activity, the Fiscal Code has been amended accordingly. Thus the new Law No. 343/July 2006 that modifies Law No. 571/2003 on Fiscal Code comes with specific definition of financial and operational leasing. This definition is with respect to International Accounting Standards - IAS 17, and brings more clearly the specific aspects of each type of leasing contract in direct relationship with the fiscal authorities.

Besides this basic redefining of financial and operational leasing, the new text of law makes a revolution from principals' point of view by recognizing the fiscal ownership of lessee in financial leasing contracts. The third aspect that brings a change for financial leasing is its fiscal recognition as a financial service from the profit deductibility provisions point of view.

Financial vs. operational leasing

Both the Law 287/2006 and the New Fiscal Code regulate two categories of leasing operations: *financial leasing* and *operational leasing*. To be included in the category of *financial leasing*, a leasing operation must meet at least one of the following requirements:

- the risks and benefits related to the ownership right pass on to the user at the moment that the lease agreement comes into effect;
- the parties expressly provide that upon expiration of the lease agreement the right of ownership over the equipment will be transferred to the user;
- the lease period exceeds 75% of the normal period of use of the asset.

By comparison, the *operational leasing* is defined to be any leasing agreement that meets none of the above-mentioned requirements.

However, starting with January 1, 2007, the above quoted provisions of the Romanian Fiscal Code regarding financial leasing will be amended as follows:

- the lessee shall have the option to buy the asset at the date the lease agreement expires for a residual value that must not be higher than the difference between the maximum normal period of use and the duration of the leasing agreement as related to the maximum normal period of use;
- the total value of the lease installments without the auxiliary expenses is higher or equal to the value of the asset when the lease was executed; or
- the lease period exceeds 80% of the normal period of use of the asset (and not 75%, as currently set forth)
- the risks and benefits related to the ownership right pass on to the user at the moment the lease agreement comes into effect; or the parties expressly provide that upon expiration of the lease agreement the right of ownership over the equipment will be transferred to the user.

The new leasing regulations define *lease installments* as related to either financial leasing or operational leasing as follows:

- for *financial leasing*, the installment must be computed as a quota of the asset's entry value plus the leasing interest as set by the parties;
- for *operational leasing*, the installment shall be determined by mutual agreement of the parties.

According to Law 287/2006, to avoid any doubt, all lease agreements must contain a clause defining explicitly whether the agreement as a financial or an operational leasing contract. The obligation to insure the leased assets must be included in a provision in the lease agreement incurring such liability either to the lessee or to the lessor. Also, Law 287/2006 extends the enforceability of lease agreements to all personal and real securities used to guarantee fulfillment of the obligations under the equipment lease agreement.

If both parties agree, the law entitles the lessee to purchase the goods before the end of the leasing period, but no earlier than 12 months, provided that all the contractual obligations are executed.

Leasing should be profitable for all parties involved:

- with limited financial resources and no collateral requirement, the lessee can acquire equipment that increases their productive capacity and their ability to generate revenue.

- lessors have a lower risk method for financing businesses, because they maintain ownership of the asset until the lease has been completely paid off by the lessee;

- for suppliers, leasing expands their market base by providing businesses a way to purchase equipment without having significant upfront cost.

In practice the operational leasing is not as common as the financial leasing. This is because the leasing companies are reluctant to proceed with the operational leasing. The possible arguments of small number of the operational leasing agreements:

- the clients are not very well informed with regard to the advantages of this type of leasing;

- the leasing companies prefer to conclude financial leasing agreements with an irrevocable option to buy from the lessee, thus the lessor want to be sure that the ownership shall be transferred to the lessee;

- in the majority of cases the clients desire to acquire the property of the goods regardless of the type of leasing;

- the leasing companies shall have to register the depreciation of the good in its accounting books and to reevaluate the fixed assets at the end of each accounting year.

- when concluding operating leasing agreements, usually the clients desire to take the benefits of deducting the entire leasing installment (as operational leasing) and acquiring the leasing object for a residual value established form the very beginning. Because there are suspicions of fraud, the fiscal authorities, when performing an overall control of the company, are very carefully in establishing the nature of the leasing operations.

All of these reasons may be a direct explanation of the fact that operational leases represent around 1.5% out of the total leasing agreements on the Romanian market.

It is also expected that the new legislation related to the supervision of this market will have a direct impact on this aspect. The leasing ordinance implies the possibility that the National Bank of Romania could issue norms that may limit the level of operational leasing agreements for authorized financial lease companies. Such a norm will definitely divide the players into two types of authorized leasing companies: financial leasing companies acting strictly under the rules and norms of National Bank of Romania and the operational leasing companies that will remain under the governance of commercial legislation.

As a consequence of the still unclear fiscal and accounting treatment, the leasing business has shown a lack of interest in developing real estate leasing. The current domestic legislation provides no specific rules for real estate leasing, which is treated like any other leasing transaction. Romanian leasing-related authorities have focused on redefining for tax purposes financial and operational leasing for the purpose of creating a better and clearer distinction for to avoid the risk of re-classifying an operational lease as a financial one and vice-versa. An updating of the Fiscal Code in this regard is expected to enter into force once Romania joins the EU.

Since only the financial leasing market falls under the direct authority and control of the Romanian Central Bank, these businesses must to take into consideration and follow the National Bank's prudential banking rules. Consequently, in order to eliminate the differences between the applicable fiscal regimes, the Ministry of Public Finance should treat all financial leasing operations as benefiting from the treatment afforded by banking legislation to credit operations.

Despite the operating leasing contracts are not so numerous still there are important issues relating to the deductibility of the installments, the way of calculating the installments, depreciation during the leasing period, ownership transfer at the end of the leasing agreement, transfer price.

When analyzing the advantages we have to take into consideration the parties implicated in these leasing operations: lessor, lessee. For the supplier of the good it makes no difference the type of leasing concluded. The main advantage for the lessee is the possibility of the entire deduction of each leasing installment with the direct consequence of paying less profit tax. In case of financial leasing the lessee shall deduct only the interest which is contained in the financial leasing installment. The advantage for the lessee in operational leasing is considerable, but this incentive makes the difference only in case of companies with 16% profit tax and not for micro enterprises where the deductibility of the expenses is not relevant for revenue tax.

Under the provisions of the Romanian Fiscal Code, in the case of financial leasing the user is considered the owner; while in the case of operational leasing the lessor is the one considered to hold such capacity.

The monthly lease installments are treated differently from a fiscal point of view depending on whether they are financial leases or operational ones, as follows:

- financial lease installments represent a part of the purchase price and so the lessee must deduct the relevant interest;
- in the case of operational leases, such an installment would represent the rent paid in exchange for the usage of the goods and hence be deductible as a royalty by the lessor.

The insurance premiums paid for the good are also deductible for the lessee regardless of the type of leasing. Notwithstanding the significant advantages for the lessee still the number of the operational leasing agreements concluded is not so high.

Recent Evolutions regarding the Romanian Leasing Market

With a history of more than 10 years within the Romanian local market, the Romanian leasing market speaks for itself when statistics are to be presented. The economic growth of last years was also experienced at the level of the leasing market, which registered a significant development, confirming the status of leasing as a complementary financial product to other banking products and accessible to a high number of economic agents. To this extent, one could claim that leasing became a medium-term financing source capable of supporting the development of different sectors of the national economy at competitive financing costs.

The total number of players on the market is around 200. Some 18 of these firms are leasing companies affiliated to banks, a few are companies created by manufacturers or dealers of automobiles and other goods while the rest are independent leasing firms. A number of 38 leasing firms are affiliated to the Association of Leasing Companies of Romania (ASLR) whose members account roughly for half of the market, while other 15 are members of the Leasing Bankers' Association (ALB).

According to ASLR, the size of the Romanian leasing market in terms of value of concluded contracts has grown over the last six years at an average compounded rate of 40% per year from EUR 285 million in 1999 to over EUR 2.2 billion in 2005 (table nr. 1). The top 20 leasing firms account for 80% of the market.

Table no 1. Romanian leasing market

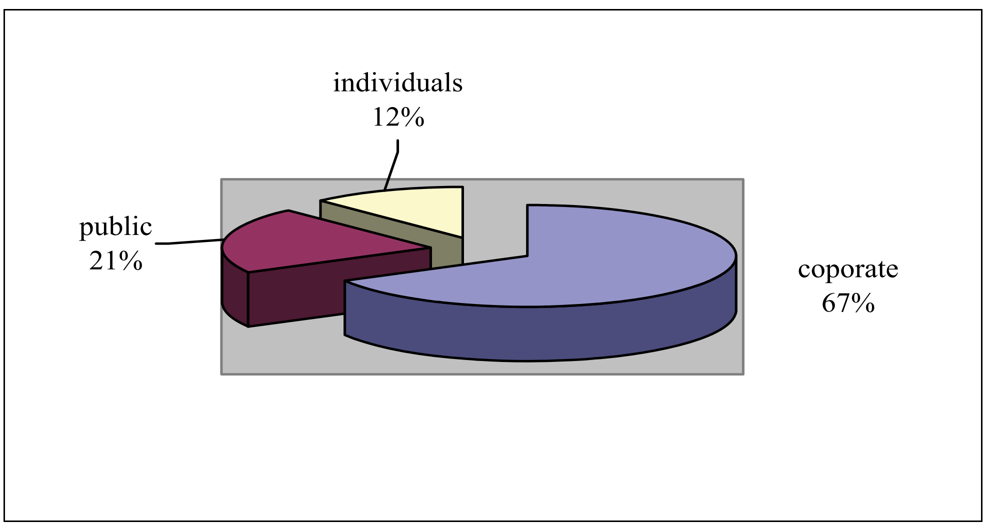
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Market size (EUR mil.)	285	422	962	900	1400	1815	2215	2769
Growth rate per year (%)	-	48%	128%	-6%	56%	30%	22%	25%

Source: Association of Leasing Companies of Romania (ASLR)

Historically, most of the lease contracts on the market have been financial leases. Based on ASLR statistics, in 2004, financial leases accounted for 91% of the total (in terms of value of goods), a weight that had increased to 96% in 2005.

Bank affiliated leasing companies register the largest market share with 61.5% of the total, followed by captive companies with 24.8% and the independent companies with 13.7%.

By customer type, 67% of the leasing operations are concluded with the corporate customers, the public sector accounts for 21% while the leases to individuals represent the remaining 12%. (figure 1)

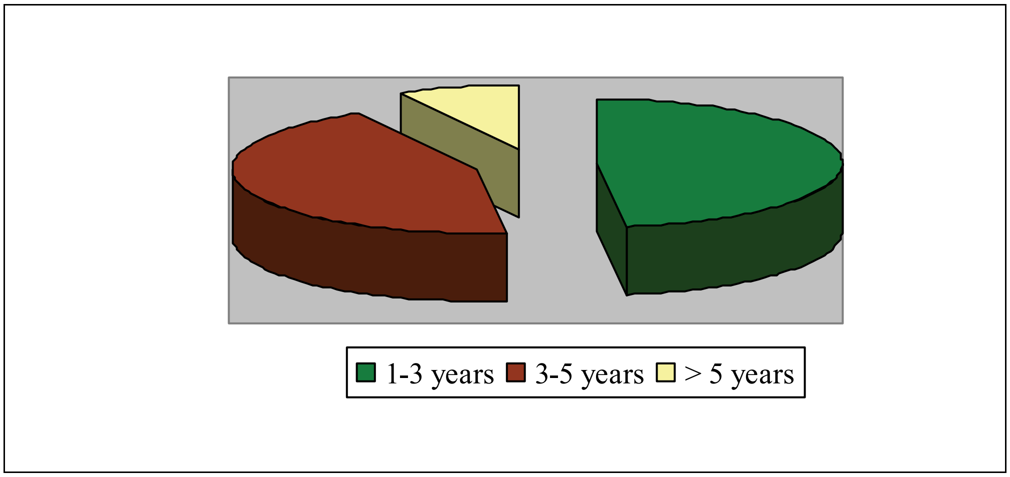


Source: Association of Leasing Companies of Romania (ASLR)

Figure no 1. Leasing contracts by customer type (2005)

As far as the term of such agreements is concerned, most of these (48%) are for a period of 3-5 years, and only 44 % are short term (1-3 years). (figure 2)

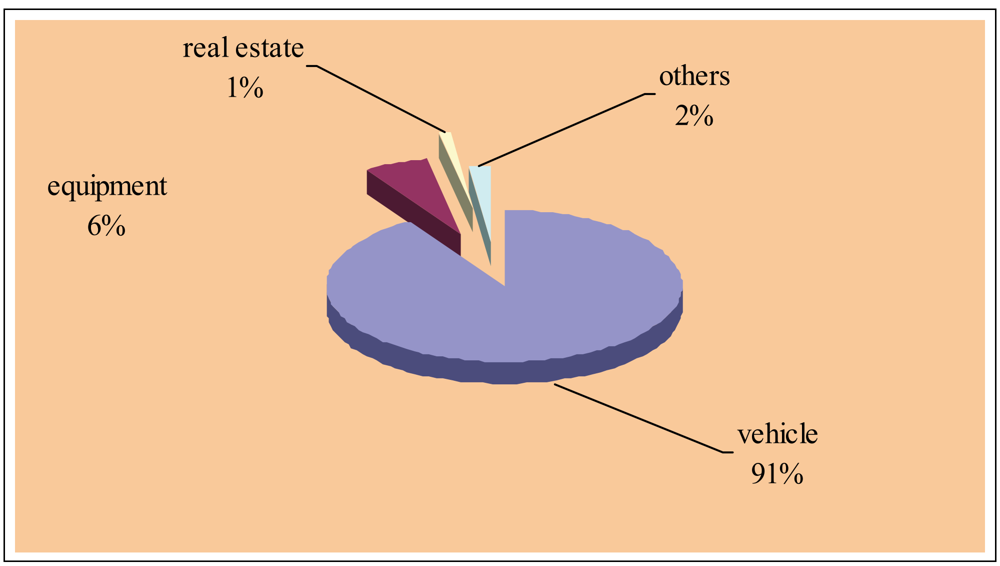
The usual term for real estate leases is 5 to 8 years.



Source: Leasing Bankers' Association (ALB).

Figure no 2: Leasing contracts by contract term (2005)

The overwhelming source of demand for financing through leases on the local market comes from the vehicle sector, which accounted in 2005 for 91% of total contract value for ASLR members. The remainder was split between equipment leases (6%) real estate investments (1%) and others (2%) (figure 3).



Source: Association of Leasing Companies of Romania (ASLR)

Figure no 3: Leasing contracts by assets type (2005)

Analyzing the trend of vehicle importation and sales, it is not difficult to assume that, in structure, the lease financing, on one hand will decrease, concerning the passenger cars segment, but on the other hand will increase, concerning the equipment and real estate segments.

For the end of year 2006, ALB estimates a total amount of EUR 1.4 billion leased assets with a total of 2.3 billion at Romanian leasing market level, meaning 15% growth rate.

Conclusions

The Romanian leasing market is developing in present and is extending to new fields, conquering a part of the fields which belong to the banks. In the same time, the sector will get to maturisation, the small firms will merge and will form big, important firms, being encouraged by the law issued by the National Bank of Romania regarding the minimum share capital. Also, this law imposes a higher transparency and standards regarding the financial reports and audit of the leasing companies which will constitute advantages for them and will insure more credibility for the investors.

A main objective of the Romanian Government is the harmonization of respective Romanian legislation with European Union requirements. The current provisions of the Romanian Fiscal Code do not cover the IAS17 standards which relate to leasing in a very detailed manner.

Consequently, operational leases have suffered from fiscal mistreatment with a direct effect on the total volume of such operations in the country. The fiscal definition does not follow the accounting one related to financial and/or operational leases. It may be a direct explanation of the fact that operational leases represent around 1.5% out of the total leasing agreements on the Romanian market.

Romania's accession to the EU should bring large corporate, multinational customers into the country and specific leasing products will have to be offered to those who already have a portfolio history with present leasing companies in Romania. This is one very good reason why most of the important players on the market are interested in a quick harmonization of all Romanian leasing legislation.

The improvement of the regulatory framework in view of alignment to the EU standards, the strengthening and consolidation of the Romanian financial institutions and the increasing competition among these are factors likely to stimulate for the leasing operations.

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