WORLD BANK GROUP
Finance, Competitiveness & Innovation

Product Card & Credit Infrastructure Requirements

Operating Leasing

What is an Operating

Operating ("true") leases are a form of specialized financing in which a financing company (the "lessor") acquires an asset and gives a customer (the "lessee") the right to use the asset for a specific period of time in exchange for periodic rental payments. The rental payment is based on the asset cost minus the residual value (lessor's estimated future value of the asset), plus cost of funds and lessor's profit.

At the end of the lease term, the asset is either: (i) returned to the lessor, or (ii) the lessee may purchase the asset at present market value. This product is a pure rental type agreement for the use of an asset for the specified rental period. Given that the asset may be returned to the lessor at the end of term, there are generally usage limits (i.e. maximum mileage on vehicles), with which the lessee must comply during the agreement or pay usage penalties.

How does Operating Leasing work?

An operating lease arises by agreement between the lessee and lessor for the financing of a specific asset for a period of time. After credit approval (that considers the lessee's financial health, the asset's lifespan and the residual value), the lessor delivers the requested equipment to the lessee. Under an operating lease, the lessor recognizes and depreciates the leased asset in its balance sheet. For the lessee, the lease payments are considered an operating cost on its income statement.

- Credit Availability: The lessor conducts a financial analysis of lessee focusing on cash flow generation and ability to serve the operating lease payments. The lessee can be required to provide a down payment of the asset value (10-25%). If the asset is leased more than once, the accumulated term for all leases should not exceed the useful lifespan of the asset.

- Operating Lease Payments: The operating lease payments consists of periodic rental payments, which can be monthly or quarterly. Lessee is required to honor the rental payments, even if an operating issue arise with the asset (hell or high-water clauses). A lessor will recognize lease payments from operating leases as income. Costs, including depreciation, incurred in earning the lease income is to be recognized as an expense

- Operating Lease Parties: The operating lease includes three parties: (i) the lessor which is the financing party of the transaction, (ii) the lessee that is given the right to use the asset, and, if applicable,
(iii) an equipment supplier, selected by the lessee.

- Use of the Asset: If the lessee performs the rental payments and lease requirements as agreed, the lessor is obliged to provide the lessee the full and quiet enjoyment of the equipment.

- End of Term Options: At the end of lease term, and considering whether all lease payments and obligations have been fulfilled, the lessee can generally choose to: a) return the asset to lessor, or b) purchase it for present market value (i.e. the current sale value of the used asset in a liquid secondary market). There are cases in which the lessor can provide early purchase option(s) at a pre-defined price. Additionally, some operating leases provide for the replacement of original equipment, with up-to-date equipment, after lease term or other agreed upon date.

Operating Leasing

Operating (Ture) Leasing Credit

- Credit Information Systems:

  It is necessary that the financier knows the lessee's historical payment performance, but it is not strictly necessary for the product to exist if other remedial or pricing measures are taken.

- Secured Transactions Law:

  The operating lease would benefit from a Secured Transactions Law, but the product can exist in an environment without it, so long as the law (commercial code) permits an lessor to deliver possession of the assets, under a lease, to a third party lessee while preserving legal recognition of ownership for legal and accounting purposes with the lessor. In case of default, a secured transactions law is also highly desired for enforcement purposes.

- Collateral Registry:

  Since the asset is owned and depreciated by lessor but is in possession of the lessee, a Collateral Registry is helpful for the product to operate properly, providing notice to third parties that the party in possession cannot transfer free and clear title to the asset. It is not uncommon, however, for operational leases in jurisdictions without a Collateral Registry, with price adjustments and other mitigation measures.

- Extrajudicial Enforcement:

  It would be desirable to have extrajudicial enforcement for the product, but the assets are generally long-term durable assets and can be properly identified, without needing extrajudicial enforcement in all cases.

- Secondary Market:

  Given the product nature (the fact that the rental payment consists on the difference between the asset original price and its residual value, plus financing cost and fees), it is strictly necessary to have a liquid secondary market in the country, so that the lessor can properly assess the asset's future value and can price the operating lease accordingly. It is also necessary for disposition of the asset in the event of default or at the end of lease term, in cases where the lessee returns possession to the lessor.

- Banking Regulation:

Having favorable banking regulation is not strictly necessary to implement an operating leasing product successfully in any country. Its absence will, however, have an impact on pricing, making operating leases more expensive. Basel has advised that for regulatory capital purposes, a right to use asset (RoU), such as machinery or equipment, asset should not be deducted from regulatory capital so long as the underlying asset being leased is a tangible asset. Where the underlying asset being leased is a tangible asset, the RoU asset should be included in the risk-based capital and leverage denominators. The RoU asset should be risk-weighted at 100%, consistent with the risk weight applied historically to owned tangible assets and to a lessee's leased assets under leases accounted for as finance leases in accordance with existing accounting standards.