

**MFSA**

---

**MALTA FINANCIAL SERVICES AUTHORITY**

**BANKING SUPERVISION UNIT**

**POLICY DOCUMENTS**

*POLICY DOCUMENT ON THE REGULATORY PROVISIONS FOR  
THE UNDERTAKING OF FINANCIAL LEASING ACTIVITIES BY  
INSTITUTIONS AUTHORISED UNDER THE  
FINANCIAL INSTITUTIONS ACT 1994*

Ref: FI/PD/02/2011

**POLICY DOCUMENT ON THE REGULATORY PROVISIONS FOR THE  
UNDERTAKING OF FINANCIAL LEASING ACTIVITIES  
BY INSTITUTIONS AUTHORISED UNDER THE  
FINANCIAL INSTITUTIONS ACT 1994**

**INTRODUCTION**

1. In terms of Article 3(1) of the Financial Institutions Act 1994 ('the Act') an institution may be licensed to carry on the business of a financial institution through the undertaking of activities that are listed in the First Schedule to Article 2 of the Act. One of the activities included in the list is financial leasing<sup>1</sup>.
2. Article 3(3) of the Act states that:

*"In the event of reasonable doubt as to whether an activity constitutes the business of a financial institution, or whether the business of a financial institution is or is not being transacted in or from Malta by any person, the matter shall be conclusively determined by the competent authority."*
3. Article 13(1) of the Act states *inter alia* that:

*"It shall be the duty of the competent authority ... to ensure that financial institutions carrying on business in Malta comply with this Act ... and with the conditions of their licences..."*
4. In view of these statutory obligations and responsibilities the competent authority ('the authority'), therefore, deems it appropriate to state its general views on the undertaking of finance lease activities by institutions licensed under the Act.
5. The views expressed in this policy document should not be interpreted as replacing the responsibilities of the authority as defined in paragraph 2 above. The authority therefore advises financial institutions and other corporate/non-corporate persons intending to undertake such activities to consult the Act in cases of doubt.

**PURPOSE OF THE POLICY DOCUMENT**

6. This policy document is being issued:
  - a) to convey the views of the authority as to what distinguishes a finance lease from other activities associated with leasing in general;
  - b) to facilitate awareness by financial institutions as to how a finance lease differs from other leasing activities;

---

<sup>1</sup> For the purpose of this document the term 'Financial Leasing' and 'Finance Lease' are considered to be interchangeable and equivalent.

- c) to create awareness of the financing options that could be availed of by financial institutions to fund finance lease operations; and
- d) to enable financial institutions to ensure compliance with the conditions of their licence through knowledge of the implications in relation to items (a) to (c) above.

It is recommended that financial institutions pay particular attention to the various concepts, definitions and provisions included in this policy document.

#### **FINANCE LEASE ACTIVITIES**

- 7. The authority deems finance lease activities for the purposes of the Act as being contracts having characteristics included in paragraphs 9 to 16 below. Financial institutions are therefore encouraged to take note of these characteristics when undertaking such an activity.
- 8. Finance lease involves the substantial transfer of all risks and rewards incidental to ownership. Title may or may not eventually be transferred. Therefore, examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
  - (i) the lease transfers ownership of the asset to the lessee by the end of the lease term;
  - (ii) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
  - (iii) the lease term is for the major part of the economic life of the asset even if title is not transferred;
  - (iv) at the inception of the lease the present value of minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
  - (v) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

- (i) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- (ii) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

- (iii) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

#### **CHARACTERISTICS OF A FINANCE LEASE**

9. A finance lease is frequently referred to as a full payment lease. This means that, during the course of the lease, the lessor will, at least, recoup not only his charges and other costs but also the full cost of the asset purchased. Consequently, under a finance lease, substantially all the risks and rewards incidental to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal and finance income to reimburse and reward the lessor for its investment and services.
10. Therefore, the lessee will ultimately be paying to the lessor:
  - (i) the costs of buying the asset in the first place (such costs often including installation costs and training);
  - (ii) interest charges, since funds may have to be borrowed ahead of rentals being received; and
  - (iii) contribution to overheads and ultimately profits.
11. The lessee will select his asset in a normal way and will arrange for goods to be invoiced direct to the financial institution. The lease will run its term with the lessee paying his rental regularly as necessary.
12. The period of the lease is known as the *Primary* or *Basic Lease Period* and roughly would equate to the period in a lease purchase agreement. It will be no longer than the estimated useful working life of the asset.
13. When the *Basic Lease Period* has expired, the lease does not necessarily terminate or expire but may continue into what is known as a *Secondary Lease Period*. At this stage the lessor would have recouped the capital cost of the asset and all his charges but, of course, will still own the asset that would be located on the premises of the lessee.
14. At this stage, there appears to be two possible ways forward:
  - (i) the asset is sold; or
  - (ii) the lease continues.
15. Since the lessor is the ultimate owner of the asset that has been leased, only the lessor can sell the asset. However, the lease agreement could sometimes contain provisions that would allow the lessee, as appointed agent of the lessor, to sell the asset himself.

16. If the *Basic Lease Period* is extended into a *Secondary Lease Period*, a rent that is substantially lower than market rent will usually be payable.

#### ACTIVITIES FALLING WITHIN THE DEFINITION OF FINANCE LEASE

17. In general the authority considers the under-mentioned activities as falling within the definition of a finance lease:
- a) Lease with nominal purchase options: where the lease contains an option for the lessee to purchase the asset for a small amount at the end of the lease term.
  - b) Lease with advance rentals and nominal purchase option: where a specified number of rentals are paid on the commencement date of the lease and there is a corresponding rental holiday at the end of the lease term (the advance rentals are the rentals as may be negotiated by the contracting parties).
  - c) Lease with initial rental and nominal purchase option: where the lessee makes a down payment followed by equal monthly payments.
  - d) Lease with substantive purchase option: where the lessee may purchase the asset at the end of the lease term at a percentage of the original cost. If the asset does not have any value at the end of the lease term, the option is normally not exercised. Usually the term solicited is such that the leased item will retain a value in excess of the option price. To guard against any shortfall where the lessor takes into account the receipt of the option price in calculating the monthly rental, either a balloon rental or a put option is sometimes included (a put option requiring the lessee to purchase the asset).
  - e) Lease with advance rentals and substantive purchase option: where advance rentals, apart from the monthly rentals and substantive purchase options, are included.
  - f) Lease with residual sharing arrangement: where the lessee has two different options granted at the inception of the lease:
    - (i) to renew the lease at the expiry of the lease term for a further term (the secondary period) at a nominal rental;
    - (ii) to require the asset to be sold at the expiry of the lease term (normally by the lessee acting as the agent of the lessor) and receive a rebate of rentals calculated by reference to a stipulated percentage of the net sales proceeds.

The lessee normally enjoys both options. Option (ii) is often exercisable not only upon expiry of the primary lease term, but also at any time during the secondary period.

- g) *Lease with stepped rentals*: where the lessee's rental payments are structured to account to his anticipated cash flow requirements to allow, for instance, for a gradual increase in the revenue generated by the asset or to cater for the impact of inflation, leaving a nominal purchase option price.
18. Although the authority considers such activities as standard, this list is however not exhaustive. Therefore, these activities do not necessarily reflect all possible business propositions and options. It is recommended that, as a general rule, the substance of each activity under consideration be thoroughly evaluated to determine whether it is a finance lease transaction by definition.

#### **HIRE PURCHASE, LEASE PURCHASE AGREEMENTS, OPERATING LEASES AND SIMILAR ARRANGEMENTS**

19. Hire purchase, lease purchase agreements, operating leases and similar arrangements do not fall under the definition of finance lease activities as detailed above and as included in the Schedule to the Act. The undertaking of such activities by financial institutions is without prejudice to the provisions of Article 5(6) of the Act as potential application for such activities shall be determined by the authority in the light of the said provision. Paragraphs 20 to 25 below are intended to highlight the features that distinguish these activities from a finance lease.

#### **CHARACTERISTICS OF HIRE PURCHASE AND LEASE PURCHASE AGREEMENTS**

20. A hire purchase agreement is an agreement under which an owner lets assets of any description out on hire and further agrees that the hirer may either return the assets and terminate the hiring or elect to purchase the goods when the payments of hire-rent have reached a sum equal to the amount of the purchase price stated in the agreement or upon payment of a stated sum.

A lease purchase agreement or commitment may include a provision to adjust the lease payments for changes in the construction or acquisition cost of the leased property or for changes in some other measure of cost or value, such as general price levels, or in the lessor's costs of financing the lease, during the period between the inception of the lease and the commencement of the lease term.

#### **CHARACTERISTICS OF AN OPERATING LEASE**

21. An operating lease is one in which the lessee pays rentals only for the period the asset is used by him. Such period could be shorter than the useful economic life of the asset. By definition, the lessor will find that, at the end of the rental period, when the lessee has honoured his obligations, the lessor will have an outstanding capital sum to be covered by the sale of the asset.

22. The asset will be returned to the lessor. If the lessor sells it and does not realise sufficient funds at the time, he will incur a capital loss. In this case there is no recourse to the lessee. The asset cannot be sold to the lessee specifically unless agreed otherwise separately and there is no secondary lease period.
23. Under an operating lease, the risks and rewards incident to ownership of an asset remain with the lessor. An operating lease can also include the provision of additional services (e.g. the lessor of a beverage vending machine may supply coffee, tea, sugar etc, while the charter of ships and aircraft may include the provision of crew and other support services).
24. In operating leases, the rental is based on how much the asset will depreciate over the rental period since, as indicated above, at the end of the period, the lease will expire and the lessor will have to sell the asset or find a new lessee.
25. In the case of operating leases, considerable expertise would be required in estimating the useful life of the asset, its depreciation rate and its estimated resale value at the end of the rental period.

#### **SALE AND LEASEBACK TRANSACTIONS**

26. The authority recognises that a sale and leaseback activity may or may not fall within the definition of a finance lease. In order to determine the type of activity being undertaken financial institutions should refer to paragraphs 9 to 16 above.
27. A sale and leaseback transaction occurs when the lessee sells to the lessor an asset which the lessee had previously acquired and the leasing back of the same asset by the lessor to the lessee. Therefore sale and leaseback transactions refer to those situations where the asset is already in the ownership of the prospective lessee, and where the transaction may usually be a cash raising exercise. As a result, in such cases, new cash is introduced into the business but a *new* asset would not have been introduced into the business.
28. Sale and leaseback transactions are normally synonymous with immovable property transactions. However, it is recognised that there could be instances where a person purchases machinery or equipment without having initially considered possible financing through a finance lease agreement.
29. Should a financial institution decide to engage in sale and leaseback transactions, the authority has the discretion to evaluate such activities on a case-by-case basis.

#### **ACCOUNTING TREATMENT OF FINANCE LEASE TRANSACTIONS**

30. In their accounting treatment of finance lease transactions, financial institutions are required to adhere to the International Financial Reporting Standards as adopted by the EU, and any subsequent amendments thereto.

31. Financial institutions are however urged to seek professional advice on both the accounting and local tax treatment for finance lease transactions.

#### **THE FEASIBILITY BEHIND FINANCE LEASE TRANSACTIONS**

32. In establishing whether it is feasible to engage in finance lease transactions, as a minimum, financial institutions are expected to take the following factors into consideration:
- (i) the internal resources of the institution, since finance lease is a specialised product;
  - (ii) the extent of risk reductions vis-à-vis possible repossession following a default by the lessee;
  - (iii) tax provisions and obligations;
  - (iv) the effect on the existing business relationships of the institution with third parties;
  - (v) simplicity of documentation in contrast with complexities of comparable borrowing and capital raising arrangements; and
  - (vi) the ease of closure of the finance lease contract.

#### **MISCELLANEOUS PROVISIONS**

33. In their undertaking of finance lease transactions, financial institutions are to ensure compliance with any Banking Rule that may be applied to them in terms of Financial Institutions Rule FIR/02. In this respect, particular attention is drawn to the provisions of the Large Exposures Rule (BR/02) as may be applicable to financial institutions. The authority considers finance lease transactions as *exposures* for the purpose of the Large Exposures Rule (BR/02).
34. The provisions in this Policy Document generally apply to both domestic and cross-border transactions. In considering cross-border transactions financial institutions are to comply with any relevant licence conditions as may be set by the authority and/or as may be applicable in the relevant jurisdictions.
35. Financial institutions are also to ensure that all finance lease contracts are legally enforceable particularly when establishing the right of recourse and where cross-border contracts are undertaken.