



DEVELOPING LEASING IN GEORGIA

PROGRESS REPORT OF CAPACITY BUILDING
FINAL

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USAID ECONOMIC PROSPERITY INITIATIVE (EPI)

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DELOITTE CONSULTING LLP

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DATA

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ABSTRACT

This report explores and analyzes the activities performed following capacity building trainings of the Georgian leasing industry for relevant government officials. These capacity building exercises focused on applying the recently adopted Georgian leasing laws to achieve sustainable capital formation and facilitate access to financing while promoting Georgian foreign investment. These activities highlighted knowledge acquisition and applied skills development for private sector corporations and government officials.

ABBREVIATIONS

| | |
|---------|--|
| AG | Alliance Group |
| AGL | Alliance Group Leasing |
| DCA | Development Credit Authority, a tool that provides USAID missions the authority to issue loan guarantees to private lenders or lessors. Such guarantees cover up to 50% of the credit risk of the lender and the lessor. |
| EPI | USAID Economic Prosperity Initiative |
| EBRD | European Bank for Reconstruction and Development |
| GDP | Gross Domestic Product |
| GEL | Georgian currency- Lari |
| GLA | Georgian Leasing Association |
| GLC | Georgian Leasing Company, a subsidiary of the Bank fo Georgia |
| GeoStat | National Statistics Office of Georgia |
| IAS 17 | International Accounting Standard No.17 issued by the International Accounting Standard Board: Accounting for Leases |
| IFC | International Finance Corporation, the private arm of the World Bank Group |
| IMF | International Monetary Fund |
| JSC | Joint Stock Companies, a form of legal organization with similar status of a “C” |

| | |
|-------------------------|--|
| | Corporation in the United States of America |
| LEASEEUROPE | European Federation of Leasing Company Associations |
| LEVERAGED LEASING | A leasing structure whereby a leasing company creates transactions retaining a given percentage of interest in the lease and assigning the lease to a Special Purpose Vehicle that funnels interests to equity participants or non-recourse lenders. |
| NON-RECOURSE LENDERS | Banks and other investors that take interest on the lease receivables and potential proceeds of underlying lease assets by agreeing to provide funds to a Special Vehicle holding the rights assigned by the leasing company. The banks and other investors waive the right to enforce any remedy against the leasing company that originated the lease and agreeing to restrict their interest to the subject of the Special Purpose Vehicle. |
| ROA | Return on Assets (Net profits/total assets) |
| ROE | Return on Equity (Net profits/total equity) |
| SPECIAL PURPOSE VEHICLE | A financial structure that may be a legal entity, such as a corporation or a trust that becomes the assignee of certain interest on all lease receivables and maintains an interest in the underlying equipment under a lease originated by a leasing company. |
| TBC LEASING | A subsidiary of TBC Bank |
| TRUST | A legal structure operating as an autonomous estate or pool of assets that is entitled to transfer interests to investors via loans and participation agreements. |
| UNCITRAL | United Nations Commission on International Trade Law |

UNIDROIT

International Institute for the Unification of
Private Law

USAID

United States Agency for International
Development

VAT

Value Added Tax

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I. EXECUTIVE SUMMARY

The Economic Prosperity Initiative (EPI), managed by Deloitte Consulting, identified leasing as a key component for supporting economic development in Georgia. In early 2011, EPI implemented a plan to improve the legal guidelines and framework for the equipment leasing industry in Georgia. This plan is also intended to develop the capacity of the Georgian leasing industry to provide more access to capital goods in the Georgian economy. The plan resulted in the successful adoption of the Law Amending the Civil Code of Georgia and the Law Amending the Tax Code of Georgia. The Georgian Parliament adopted these Laws in the beginning of November 2011.

To substantiate the long-term effects of the legislative and regulatory changes, EPI engaged consultants to provide in-depth capacity building trainings to Georgian stakeholders. These exercises were offered to the existing Georgian leasing companies, the capital goods vendors, the clients of leasing services, Georgian Government (GoG) employees from the Ministry of Finance (MoF), the Georgian Revenue Service (RS) and the Ministry of Justice (MoJ) as well as auditors and legal advisors. The first series of workshops and seminars were conducted in June 2011, and will be reinforced by additional workshops, strategic support services and advocacy efforts that are subject to this report.

In order to effectively implement these deliverables, the consultant assessed the degree of understanding and application of the new legal framework by the various Georgian stakeholders. This assessment led to: (a) specific suggestions and recommendations for the existing leasing companies to implement disciplined strategic plans to adopt policies and procedures aligned with the best practices of international leasing companies; (b) identifying the need for a funding institution to ensure the flow of resources to leasing companies to support the expansion of the Georgian leasing industry; (c) initiating a constructive and continuous policy dialogue with relevant GoG staff members and Ministries to ensure the correct application of the new legal reforms to support the leasing industry's future growth; and (d) reinforcing the capacity of Georgian professionals, such as auditors and lawyers, to support the sustainable growth of the industry.

One of the consultant's key findings is that the legal reforms were welcomed by most of the industry's stakeholders. While some systemic deficiencies exist, such as in the tax field, the leasing industry has the foundational knowledge and institutional framework to develop and progress. Another key finding is that the financial system is not prepared to give leasing companies funding, while the Georgian capital market is too underdeveloped to support any industry progress. The main challenge moving forward is to create and implement a sustainable funding strategy to ensure that leasing companies are financially supported by a variety of funding sources. These sources include Georgian banks, international investors such as banks and other commercial investors, as well as government sponsored investors and multilateral organizations such as the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).

The consultant provides the following recommendations in this report:

- EPI should provide a continuous support to the Georgian leasing companies, which will facilitate growth of the Georgian Leasing Association (GLA). The GLA will then undertake a self-regulatory process to prevent systemic and regulatory risk derived

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from potential practices by non-reliable players and ensure compliance to the best practices of the leasing industry.

- EPI must encourage the creation of new Georgian leasing companies and their integration into the current system.
- Furthermore, leasing companies must align their risk management policies and procedures with international best practices to ensure a continuous flow of funding and investments from international markets. EPI should support the industry's progress towards the best practices and ensure that the leasing portfolios are well structured and sound.
- In addition, EPI must host continuous educational workshops for all banks operating in Georgia to discuss leasing and their revenue generating capacity for the Georgian economy. These trainings should be made available to other potential institutional investors such as insurance companies and pension fund managers among others.
- The consultant highly recommends that EPI should facilitate the creation of a funding institution for the leasing companies. EPI's next steps should be to define the institutional syndication structures of leases, vet their legal and economic feasibility, and support a funding institution's fundraising efforts.
- EPI should support a continuous dialogue between the stakeholders to effectively evaluate the long-term impacts of the new legislative reforms on economic development. These impacts may include: a. the marginal effect of leasing growth on tax revenue collection due to the growth in economic activity through the acquisition of additional capital goods (generating VAT revenues); b. the increase of revenues for small and medium sized business (taxable through income tax); c. the number of businesses receiving financing would increase availability of financing sources for SMEs; d. the equipment types (whether these are motor vehicle, technology equipment, agricultural machinery or other types); and e. an estimation of jobs created due to increased financing to the leasing industry, which normally is measured not only by the jobs created by the lessee, but also for the effect that the acquisition of capital goods produces in driving work to suppliers, transportation entrepreneurs, customs agents, and sales persons among others.

II. APPENDICES

- A. BACKGROUND**
- B. METHODOLOGY**
- C. FINDINGS**
- D. RECOMMENDATIONS**
- E. ADDITIONAL INFORMATION**

A. BACKGROUND

STATUS OF DEVELOPMENT OF LEASING IN GEORGIA

LEGAL ENVIRONMENT

1. Georgia reportedly has 123 companies registered in the Commercial Registry that have stated corporate purposes to operate in the leasing business, although data from only 22 companies could be retrieved for this project's research. Out of these 22 companies, three companies are the most active, namely: a. JSC Georgian Leasing Company, a wholly owned subsidiary of the Bank of Georgia; b. JSC TBC Leasing, a wholly owned subsidiary of TBC Bank; and c. Alliance Group Leasing Ltd. an independent leasing company whose stockholders own the Alliance Group . In this report, any reference to "lessor" or "leasing companies" must be understood as referring to any of these three companies.

2. As EPI detected and stated in three previous reports on this subject, the Georgian leasing industry was stagnating until early 2011. The leasing companies faced a "perfect storm" of operating challenges that were aggravated by confiscatory taxes and some were close to exiting the market due to these challenges.

3. The operational challenges were attributed to an unsupportive legal environment. While the 2002 Law on the Promotion of Leasing Activities was well intentioned, its drafters neglected to foresee the long-term implications for many of its provisions. For instance, one provision allowed lessees to default and claim payments for the difference between the theoretical market value of the leased asset and their outstanding debts. Therefore, lessees were able to make financial gains by failing to honor their obligations. As a result, leasing became a risky financial activity with the non-performance portfolios of leasing companies achieving figures unprecedented, such as over 30% of total assets, and repossession of good assets became impossible. This created a reactionary credit culture amongst lessors, which was also perceived by the banks that were either the lessors' shareholders or funding providers. As such, the legal system became hostile to lessor offering leasing services to benefit the economy. Fortunately, the consultants' suggestions and recommendations were well received by the Georgian Government (GoG), and on October 13, 2011 the Georgian Parliament enacted the Law Amending the Civil Code of Georgia while also fixing other deficiencies in leasing regulation by abolishing the Law on Promotion of Leasing Activities adopted in 2002.

4. In the current legal environment, lessor and lessees frame their rights and obligations based upon the principles of trust, mutual respect, justice and equity. While the new law provides direct remedies for lessees regarding suppliers of equipment, the role of lessors is to provide a financial service. As such, lessors are entitled to payments mutually agreed upon and designed to compensate the lessors' investments in capital goods. In addition, lessees are entitled to the use of equipment, accountable for maintaining assets in the same condition as received, save "fair wear and tear", and to bear the risks associated to the destruction, loss or malfunction of equipment. The Law allows for financial remunerations only to restore equity and not to reward parties that have wrongfully behaved. The Civil Code's provisions preserve contractual equation while also preventing abuses by any of the parties that could result in unjust enrichment or gross disparities.

5. The confiscatory taxes were due to a general lack of understanding in Georgia towards the leasing business and were not the intent of Georgian economic policy makers. The

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systemic juridical deficiencies in place, prior to the Civil Code Amendments of October 13, are as follows:

- Lessors were not allowed to calculate and deplete their taxable revenues according to economic reality, i.e. claiming costs, deductions and tax credits (a process that technically is called “depletion”). Typically, revenues of leasing companies are based upon the gross income of the lessors, and this amount is calculated by deducting the amortization amounts applicable to each lease. In certain legal environments, this amortization is treated as a depreciation claimed by lessors. A leasing company’s revenues should correspond to the difference between the outstanding balance of the lease, or the net present value of minimum payments, at the beginning of the taxable period, such as a calendar year, and the outstanding balance of the lease at the end of the taxable period. The basis for calculating the amortization value and or the net present value is to establish a lease’s real rate. Prior to the October 13 Civil Code Amendments, leasing companies were forced to calculate such values based upon an unreal and imposed rate. This rate was presumed and could be 55% of a bank’s lending rate regardless of the real implicit rate. This created an artificial imposition as taxable gains and income became higher than the real gross spread earned by leasing companies. From October 13, 2011 onwards, leasing companies apply the real rate of the leases to calculate the actual spread that is the starting variable to calculate taxable earnings.
- Prior to the October 13, 2011 Civil Code Amendments, leasing companies were denied the right to claim alternative depreciation or “bonus depreciation”. Before these Amendments, the system allowed all tax payers to claim up to 100% depreciation during the first year of acquisition of fixed assets. While this provision may seem advantageous to leasing companies, it proved to be a double edged sword. Any claim for depreciation of assets during the first year was reversed in the subsequent years when the asset became wholly depreciated. Such accelerated depreciation of assets requires conciliation accounting and the creation of reserves for deferred depreciation and deferred taxes. This process may be detrimental if the given company stops new originations, such as new purchases of equipment, under leasing agreements (also called “volume generation”).
- Before the Civil Code Amendments, the leasing companies’ costs were not deductible based upon their economic reality as the Law created a ceiling for the interest amounts that could be deducted by leasing companies. For instance, all interest corresponding to debts, which in aggregate values, should not be greater than three times the leasing company’s actual equity. While the consultant suggests exempting leasing companies, similar to all other financial institutions under the Georgian Tax Code, the Civil Code Amendment extended the limit to a ratio of 5:1. This ratio is not sufficient, as leasing companies need to operate with leverage ratios of between 7:1 to 10:1. As indicated below, the EPI consultant suggested to both the Georgian RS authorities and the auditors to interpret article 123 (1) of the Tax Code in a way that the leverage ratio for thin capitalization shall not apply to leasing companies because these are financial services companies. If this interpretation prevails, then the purpose of submitting the calculation of leasing companies’ profit taxes based upon economic reality should be achieved. Thus, the expenditures for leasing companies would be deductible when calculating profit tax. According to the consultant’s assessment, both scenarios would preclude “unfairness” since none of the existing leasing companies are expected to reach a leverage ratio over 5:1 within the next couple of years;

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- Another critical element to determine the taxable earnings of leasing companies is the “bad debt reserve” or the preventive coverage for credit losses. Prior to the October 13 Civil Code Amendments, lessors were not allowed to take tax deductions for bad debt reserves. However, Georgian leasing companies often held non-performing portfolios, such as past due accounts, reached up to 30%. Therefore, the denial of such deductions was imposing taxes on the financial losses of leasing companies. The October 13 Civil Code Amendments helped leasing companies and Part 3 of Article 109 of the Tax Code currently states that leasing companies may claim deductions for bad debt reserves. On January 13, 2012, the MoF issued an instruction entitled Order #17, which provides certain instructions for implementation of the new tax rules. Order #17 cites that leasing companies can deduct up to 80% of their reserves created from accounts past due more than 60 days. While this provision will provide good coverage to leasing companies, it requires good tax planning and the formation of parallel accounting structures for tax and financial accounting. As leasing companies are entitled to claim deductions up to 100% of alternative depreciations, they must maintain parallel accounting records for both tax and financial purposes.

6. Currently, leasing companies are not subject to either control or supervision by the National Bank of Georgia (NBG), which regulates banks and non-bank financial institutions. While leasing companies perform financial services, they are not allowed to raise deposits from the public. This was discussed in detail with the NBG’s staff responsible for financial supervision, but all parties decided leasing companies are not “per se” subject to the NBG’s supervision. The exceptions are those leasing companies that are owned subsidiaries of banks and whose financial statements are consolidated with those of the parent banks. Therefore, there are neither licensing nor minimum capital requirements to enter the leasing market. The details of these discussions are compiled hereinafter.

STATE OF THE INDUSTRY

The GLA compiled data about the leasing industry’s financial solvency based upon the reports from 2004 until mid- 2011. The chart below summarizes their findings:

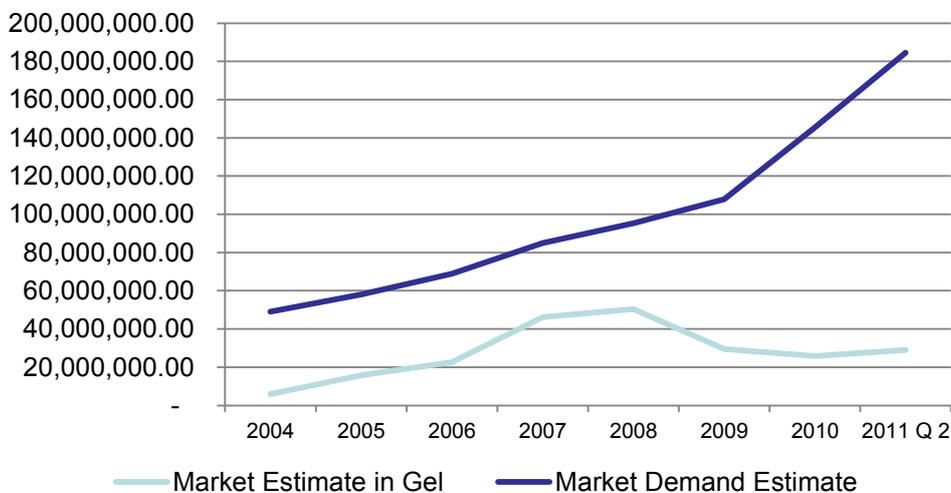


Figure 1: The Georgian Leasing Market

Source: The GLA

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During his recent visit, the EPI consultant gathered more relevant data in order to reassess the market potential for leasing in Georgia. In his first report, the consultant used data provided from the International Monetary Fund (IMF)'s forecasts of GDP, penetration of investment and different scenarios for the leasing market's penetration. However, as the actual GDP figures differ from the IMF data, the consultant used the latest data from the National Statistics Office of Georgia (GeoStat) for this recent report.

Table 1: Georgian Imports of Main Capital Goods

| Georgian Imports of Main Capital Goods | | | |
|---|--|-------------|-----|
| (Per Thousands of USD) | | | |
| Code | Name of Position | Est. 2011 | % |
| | Total Imports | 4,129,170.1 | |
| 8703 | Motor cars | 836,183.8 | 20% |
| 8517 | Telephone sets, including telephones for cellular networks or for other wireless networks | 235,469.1 | 6% |
| 7308 | Structures and parts of structures made of iron or steel | 175,480.3 | 4% |
| 8471 | Automatic data processing machines and units | 129,106.3 | 3% |
| 8544 | Insulated wire, cable and other insulated electric conductors | 122,628.1 | 3% |
| 8704 | Motor vehicles for the transport of goods | 115,430.2 | 3% |
| 8418 | Refrigerators, freezers and other refrigerating or freezing equipment | 103,257.6 | 3% |
| 8504 | Electrical transformers, static converters and inductors | 93,496.7 | 2% |
| 9403 | Other furniture and parts | 88,039.8 | 2% |
| 8528 | Television receivers | 77,098.2 | 2% |
| 8802 | Other aircraft, spacecraft and spacecraft launch vehicles | 69,263.0 | 2% |
| 8429 | Self-propelled bulldozers, graders, levelers, scrapers, tamping machines | 68,759.9 | 2% |
| 8415 | Air conditioning machines | 56,360.7 | 1% |
| 7302 | Railway or tramway track construction materials made of iron or steel | 54,077.6 | 1% |
| 8708 | Parts and accessories of the motor vehicles | 53,094.6 | 1% |
| 9018 | Instruments and appliances used in medicine | 53,005.1 | 1% |
| 8450 | Household or laundry-type washing machines | 51,328.6 | 1% |
| 9405 | Lamps and lighting fixtures | 51,219.5 | 1% |
| 8702 | Motor vehicles for the transport of ten or more persons | 48,224.0 | 1% |
| 9401 | Couches and convertible beds | 45,088.8 | 1% |
| 8430 | Other moving, grading, extracting or boring machinery for earth, minerals or ores | 41,632.3 | 1% |
| 8481 | Taps, cocks, valves and similar appliances for pipes | 41,571.3 | 1% |
| 8516 | Electric, instantaneous or storage water heaters as well as space and soil heating apparatus | 39,160.5 | 1% |
| 8413 | Pumps for liquids and liquid elevators | 37,814.8 | 1% |

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|------|---|----------|----|
| 8701 | Tractors | 37,785.5 | 1% |
| 8705 | Special purpose motor vehicles | 35,275.1 | 1% |
| 8536 | Electrical apparatus for switching electrical circuits for a voltage not exceeding 1000 | 34,269.7 | 1% |
| 8421 | Centrifuges as well as filtering or purifying machinery for liquids or gases | 34,181.0 | 1% |
| 8537 | Boards, panels and other bases for electrical apparatus | 34,074.0 | 1% |
| 8428 | Other lifting, handling, loading or unloading machinery | 33,420.5 | 1% |
| 8431 | Parts for hoisting machinery | 32,493.3 | 1% |
| 8414 | Air or vacuum pumps as well as air or other gas compressors and fans | 32,094.4 | 1% |
| 8479 | Machines and mechanical appliances | 31,411.1 | 1% |
| 8474 | Machinery for sorting or kneading earth and other mineral substances into solid form | 30,862.9 | 1% |
| 8443 | Printing machinery | 29,841.5 | 1% |
| 8438 | Machinery for the industrial preparation or manufacturing of food or drink | 29,689.3 | 1% |
| 8525 | Transmission apparatus for radio-telephony and radio-telegraphy | 27,191.7 | 1% |
| 8607 | Parts of railway or tramway locomotives or rolling-stock | 26,804.7 | 1% |
| 8419 | Machinery, plant or laboratory equipment, whether or not electrically heated | 26,195.4 | 1% |
| 8716 | Trailers and other vehicles not mechanically propelled | 25,361.1 | 1% |
| 8535 | Electrical apparatus for switching electrical circuits for a voltage exceeding 1000 | 25,156.0 | 1% |
| 8507 | Electric accumulators, including separators therefore, whether or not rectangular | 24,358.4 | 1% |
| 8502 | Electric generator sets and rotary converters | 24,286.1 | 1% |
| 8422 | Dish washing machines and similar machinery | 23,345.0 | 1% |
| 8470 | Calculating, accounting and similar machines | 22,467.5 | 1% |
| 8302 | Base metal mountings, fittings and similar articles | 21,901.5 | 1% |
| 8523 | Prepared unrecorded media for sound recording or recording of other phenomena | 21,378.2 | 1% |
| 8473 | Parts and accessories suitable for use with typing or calculating machines | 19,627.5 | 0% |
| 8542 | Electronic integrated circuits and micro assemblies | 18,770.4 | 0% |
| 9028 | Gas, liquid or electricity supply or production meters | 17,710.3 | 0% |

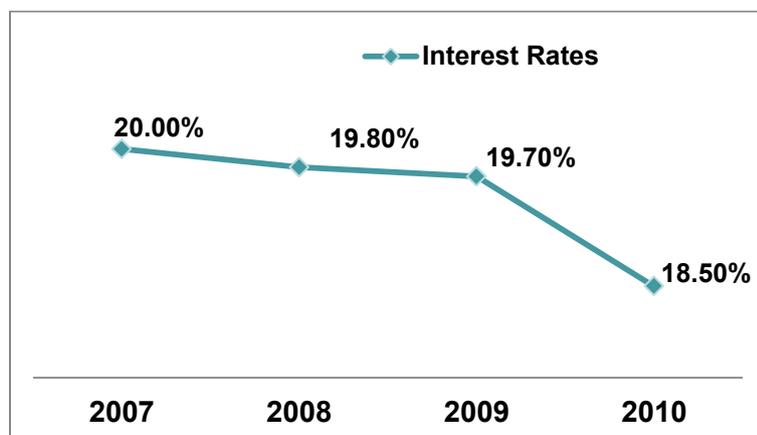
As most of the capital investment in Georgia is in imported goods, Table 1 estimates the real financial potential in the Georgian leasing market. However, based on information received, the volume of motor vehicles imports does not reflect the actual purchases of motor vehicles for final use in Georgia. Rather, almost 50% of cars imported into Georgia are re-exported to other markets, mainly Kazakhstan. This would reduce the annual capital investment in Georgia to an approximated amount of 3.7 billion USD.

Whatever penetration percentage is given to leasing in connection with the purchase of imported capital goods, which exceeds 1%, would indicate an important growth potential. This report will address the current barriers that affect the leasing industry to reach higher

penetration rates. If the leasing sector paid for one out of every ten equipment items sold in Georgia, or had a 10% market penetration rate, this sector would finance up to 370 million USD in capital imports. In order for the leasing sector to freely invest in the Georgian capital goods market, the current market barriers to growth must be addressed.

Table 2 details the implicit rates of leases in Georgia:

Table 2: Implicit Rates of Leases in Georgia



The terms and conditions within Georgian leases are also barriers inhibiting faster growth and reflect a risk culture that is more compatible with conservative banking principles. These terms and conditions waste the privileges granted by leasing under the law.

As described by the GLA, the standard product offerings are as follows:

- Financial lease- 90%
- Financial lease with end of term options – 5%
- Operational lease- 5%
- Typical structure: monthly payments with a 20% down payment for a maximum five-year term.

The requirement of a 20%, or more, down payment prevents faster growth in the Georgian leasing sector. In more mature leasing industries, the down payment requirements have been removed by standardizing the competitive advantage of leasing companies by financing up to 100% of the equipment costs. This feature is due to the prevailing credit culture that drives the existing Georgian leasing companies and will be addressed in the Findings section of this report.

B. METHODOLOGY

CAPACITY BUILDING FOR THE LEASING COMPANIES

The consultant designed and conducted a capacity building training with the three Georgian leasing companies. The consultant started this strategic planning activity by requesting that each leasing company prioritize their operational needs for capacity building. Please find below their narratives:

JSC TBC LEASING

This company requested six full days of training and additional follow-up planning time. The EPI consultant allotted this time to JSC TBC Leasing and the original plan contained the following items:

The Consultant's Scope of Work:

Table 3: Work Plan with TBC Leasing

| No. | Deliverables | Action | Comments | Results |
|-----|--|---|--|---|
| 1. | Review of current strategy, organizational structure & benchmarking with best practices. | | Main concern is the existing structure's cost efficiency | The agency's strategic plan and organizational structure were reviewed. Both were subject to critique and then up-dated. The organizational structure should be adjusted after applying the balance scorecard. |
| 2 | Review the legal ramifications for the existing company practice. Also evaluated new strategic opportunities, reported session's conclusions, and had an open question time. | TBC Leasing prepared a list of concerns that were discussed with the consultant in a group discussion. The conclusions were written down. | Discussions to answer questions and concerns. | The new law creates the following challenges and opportunities: (a) Challenges are (i) tax planning and (ii) reengineering risk management. (b) Opportunities are more growth and the implementation of a strategy based upon vendor relationships. |

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|----|--|---|--|---|
| 3. | Review of funding opportunities and analysis of investment memorandum used by TBC company. | TBC Leasing presented its proposal memo to the consultant. The consultant outlined its gaps and provided feedback comments. | | Funding opportunities are currently limited as the parent group does not provide financial support while other groups refuse to offer financing without a parent bank's guarantees. The proposed funding facility will break this vicious circle. |
| 4 | Review of the new strategic and operational plans including corrected concepts and draft contracts. | TBC Leasing provided general project frameworks, including three basic concepts and six particular projects. | | Projects and contracts were reviewed and amended according to the consultant's suggestions. |
| | Compared the concept papers and benchmarks to best practices | | | Vendor relationships include blanket leases to provide inventory financing. While this practice matches the "Extended Payment Programs" used by major lessors, it has challenges and requires careful application since it carries financial and tax risks as well as credit concentration. |
| | Reviewed how this project will fit within the new legal framework, including civil and tax applications. | | | The project fits within the new legal framework but requires additional contractual and business practices for which the company is not yet ready. |

| | | | | |
|---|--|--|--|--|
| | Analyzing internal gaps and external risks. | | | TBC Leasing's current policies and processes are in line with best practices. Some improvements are still needed but additional enhancements would place the company beyond the policies and processes of the parent bank and the NBG. While this is not bad, it would create negative relationships within the Georgian financial system. |
| | Developing risk mitigation concepts. | | | An "expected losses concept" was developed and some mitigation ideas were suggested. |
| | The company's legal counsel developed draft contracts for the strategic projects. | | | The contracts were reviewed with suggested amendments made. These changes were discussed at length with senior management personnel and legal counsel. |
| 5 | <p>Analysis of Tegeta Motors' (TGT) vendor program that has been in place for three months:</p> <ul style="list-style-type: none"> - Reviewing concept - Reviewing legal documents, or at least the term sheet - Interviewing TGT | | | The MoU with TGT was reviewed but time constraints prevented a personal meeting with TGT. |

In general terms, the meeting with TBC Leasing was mutually satisfactory. The company and its employees implemented the teachings and suggestions from the June 2011 capacity building session. As a result, the company currently has policies and processes to allow it to efficiently manage a leasing portfolio.

During these capacity building training sessions, the EPI consultant focused the discussion on the basic concepts of a projected profit and loss statement and referenced the table below:

Table 4: Elements of Proforma P&L for Strategic Planning Purposes

| Components of the P&L Item | P&L Item |
|---|--|
| (Portfolio Size x PMT x 12) + Residual Gains (New concept under the new law) | Revenues, |
| Financial amortization imputable to all PMT | Less: Fiscal Depreciation |
| Resulting in: | Gross Spread |
| (Financial Liabilities x Average Interest Rate) + Fees + Cost of Hedge (Foreign exchange and Interest Rates) + Cost of cushion to manage Liquidity Risks | Less: Cost of Funds |
| Resulting in: | Net Spread which is also the Profit on Sales |
| (EAD x PD x LGD) + Residual Losses (New concept under the new law) | Less: Expected Losses |
| Salaries, Offices and other overhead costs | Less: Operating expenses (SGA) |
| Resulting in: | Profit Before Taxes |
| Based upon a proforma tax liquidation based upon the new law such as with conciliation of alternative depreciation, and bad debt reserves | Less: Estimated Taxes |
| Resulting in: Profit After Taxes that must be consistent with a Target ROE. TBC Leasing defined a target ROE of 18% per year. | Profit After Taxes |

Out of the definition of the target 18%, then the average pricing sets defined. TBC Leasing stated that their average gross spread is 6% p.a. The consultant suggested reviewing the pricing components and the company's leverage to vet whether or not this would be consistent with the pursued goal. With a leveraged ratio of 3:1, the 6% spread would not be enough to cover other expenses and credit losses to deliver a 18% Return on Equity (ROE). Since the company's tier 1 capital is GEL 5 million, or approximately 3 million USD, as the 2012 strategic plan's internal goal is 19 million USD, the expected leveraged ratio would be 6.3:1.

The analysis concluded the following:

- The company must grow faster so that the leverage ratio increases and provides more room to deliver the expected ROE; and or
- The company must generate enough fee income and or residual gains in order to deliver the expected ROE.

In addition, according to the law eliminating the “delta”, or the financial amount allocated to the lessee whether or not the lessee complied with the lease, leasing companies can legitimately forecast residual gains out of the recovery and resale of leased assets. This provides more room for additional operating leases. While operating leases carry more risks, they also provide more potential profits if correctly managed.

As TBC Leasing’s goals and objectives were clarified, a need to ensure continuous funding access emerged as the most important priority for this company. As such, TBC Leasing should establish a special purpose vehicle to fund deals via syndication structures such as participation agreements and/or non-recourse loans.

In addition to creating this funding source, TBC Leasing inquired how they might evaluate the execution of the strategic plan. A methodology based upon the Balance Scorecard system was suggested to TBC Leasing. The basis for such a Balance Scorecard was initially explained but implementation is still required. A Balance Scorecard system is a management technique that consists of implementing a computer based control of execution of a strategic plan, and measuring the performance of each employee according to his/her contribution to the execution of the strategic plan. The Balance Scorecard system was originally developed by Robert Kaplan and David Norton from Harvard University

TBC Leasing requested assistance for developing a resource development strategy as well as approaching major international donors. The consultant held meetings with the CEO of TBC Bank, the International Finance Corporation’s (IFC) country representative and with members of the Credit and Risk Management Committee at TBC Bank. The EPI consultant provided additional supervision to support TBC Leasing’s fundraising activities from larger financial institutions such as the Komerční Bank (Czech Republic), the Republic Bank of the Societe Generale Group, the Halyk Bank and the Kore Standard Bank. TBC Leasing’s management reported that these activities demonstrated the need to educate the banks regarding the nature and risks associated with lending for leasing companies and funding leasing transactions.

JSC GEORGIAN LEASING COMPANY (GLC)

This capacity building process used a different format as GLC did not indicate beforehand on which issues its staff wanted to focus. In addition, its strategic plan is dictated by the overall policies of the Bank of Georgia, its parent bank. However, funding is not a great challenge for this company. Therefore, the consultant met with the company’s senior management personnel to identify which issues to focus on during capacity building training activities. This approach was effective as staff members openly inquired how the capacity building process and additional evaluation mechanisms would improve their internal procedures.

GLC’s senior staff members highlighted the following interest areas:

- **Vendor Contracts and Relationships:** The consultant and senior staff members discussed the objectives and goals for the “vendor and lessor relationships”. Following these discussions, the participants drafted a template for an MoU that

should be used by the leasing managers, or the account managers who report to GLC’s CEO, to negotiate agreements with the vendors. In general, GLC’s in-house counsel provides legal advice for the basic terms and conditions of these agreements;

- **Pricing:** The strategic planning discussion raised questions about how to define pricing guidelines. As a result, the consultant and GLC’s CFO trained staff members to properly define and monitor the cost of achieving GLC’s stated objectives and goals for delivering value to shareholders in the form of a ROE. This ROE was defined as 20% per year;
- **Asset Management:** This discussion focused on the following issues: The area of inventories held by the company. The consultant suggested to try to clean the financial statements even at the expense of unexpected losses, by disposing immediately and assuming losses in the disposition of equipment with the corresponding write offs that would release non-revenue generating assets out of the disclosure of assets in the balance sheet. Most of the repossessed equipment was cannibalized by clients, who used it after default with the expectation of being rewarded by the “delta” of the difference between the appraised fair market value and the outstanding balance due by the lessee. In the meantime, the lessees cannibalized the equipment by removing critical parts and pieces for resale or other usages. Several suggestions were made in order to define and implement policies and procedures for good asset management, including the assessment of both the value of use and the market value of the assets. The consultant suggested various cases, illustrations and methodologies.
- **Organizational Issues:** GLC should focus on establishing best practices for properly compensating its employees. The consultant suggested that GLC implement a performance based compensation system and link employees’ compensation to their execution of roles and responsibilities detailed in the strategic plan. Unfortunately, GLC’s senior management had difficulty receiving approval for this new compensation structure from the Bank of Georgia as the latter does not compensate employees based on performance. The theme of compensation based on performance is one that needs to be reinforced through educational training sessions to the banks.

The consultant dedicated five working days to activities with the GLC, which was two more days than originally scheduled.

ALLIANCE GROUP LEASING LTD. (AGL)

AGL belongs to Alliance Group Holdings which includes: AG Microfinance (Corporate, SME and Micro Loans), AG Capital (Boutique Investment Banking), Alliance Energy, AG Property (Property Management), AG Food Trading, AG IT that provides IT and software consultancy, and the National Credit Information Bureau (NCIB).

AGL was awarded ISO 9001 certification, and therefore must comply all its procedures and operational activities with these standards.

AGL highlighted several issues during their capacity building training sessions, which are summarizes in the following table:

| ITEM | DELIVERED |
|------|-----------|
|------|-----------|

| | |
|--|---|
| <p>1. Portfolio diversification according to assets and sectors</p> | <p>The AGL's executives developed a matrix that defined the targets for the following target areas: (a) equipment types; (b) economic sectors; and (c) vendor relationships</p> |
| <p>2. Fundraising, targeting potential investors and funds as well as on-line communication</p> | <p>The participants gave the following suggestions: (a) support and feed with new leasing originations the proposed funding facility; (b) negotiate credit lines with banks with AGL and create leasing division within the banks; (c) create a portfolio for project financing as well as small and medium ticket financing.</p> |
| <p>3. Leasing philosophy, such as the provider-distributor-financer chain</p> | <p>The participants held a discussion of how to establish relationships with equipment vendors. For instance, Alliance Group Company (AGC) may represent equipment vendors not represented in Georgia, provided that such representation does not require certain additional resources or expertise that AGC lacks. As regards to those vendors with representation in Georgia, establish strategic alliances through the local channels or distributors;</p> |
| <p>4. Attracting new markets including first steps and recommendations such as targeting existing economic tendencies or identifying new ways to become market leaders</p> | <p>After analyzing both the matrix and Georgian macroeconomic data, the consultant suggested reviewing dynamic markets that are not well covered that can justify better spreads. Agriculture is one of them, but it requires a degree of sophistication lacking in AGC.</p> |
| <p>5. Best practices in agricultural and SME leasing, particularly in developing countries</p> | <p>It was discussed that the use of the DCA facility that AGC already has is a good start, but since this works on an ultimate loss basis, the key suggestions were to reinforce risk management while at the same time creating alternative pricing strategies, matching the expected cash flows of farmers with the schedule of payments under a lease, and offering operating leases, again subject to strict risk management policies and processes.</p> |
| <p>6. Innovative fields in the leasing sector</p> | <p>The participants discussed implementing management services with IT providers such as Avaya, Cisco, IBM and other;</p> |

| | |
|--|--|
| 7. Organizational structure, motivational and bonus programs aligned with best practices | The organizational structure was discussed at length. The structure should be aligned to the main strategic objectives and goals with employee and officers' roles and responsibility aligned with the needs of leases. Additionally, employee performance goals should be based upon agency needs and evaluated according to the strategic plan with compensation, personal performance, and the achievement of work goals. |
|--|--|

The main challenge for AGC further expansion is funding and this is detailed in the Findings section.

AGC also reported that it obtained a reversal, through the Georgian Supreme Court, for an adverse court decision regarding a sale and lease-back transaction.

DISCUSSION OF POLICY WITH THE NATIONAL BANK OF GEORGIA

One of the EPI consultant's key activities was to conduct a workshop for the NBG's senior officers and managers tasked with supervising and monitoring financial institutions. These workshops were co-hosted by the consultant's Georgian counterpart, Mr. Irakli Kordzakhia, who is an attorney. Prior to the workshop, EPI's coordinators asked the NBG's senior officers for areas of interest to be addressed in the workshop. Their feedback was the main source of material for the training sessions.

The workshop addressed the best practices for supervising leasing companies and portfolios and focused on the details of leasing transactions as a financial service. The consultant emphasized risk management analysis, the formation of credit loss reserves, capital adequacy, customer protection, funding vehicles for leasing companies, value of leases as collaterals, and the effects of leasing on bankruptcy. The discussion was contextualized within the new legal environment created by the October 2011 Georgian Civil Code Amendments.

This workshop used power point materials as well as diverse interactive practice exercises. The power point presentation is an addendum to this report.

At the end of the second day, the consultant led a practical exercise through which participants were divided into groups and asked to formulate a solid policy platform of whether leasing companies should be subject to the supervision of the NBG. Participants were also required to describe the most effective nature of such supervision. The participants were given several models to choose from, such as the the "traffic cop" model in which the NBG would act as a filter and means to deliver information from leasing companies to investors and the general public. An alternative model was called the "swat model" in which the NBG would impose absolute authority and micro-manage all leasing companies.

The results of this exercise are expanded upon in the Findings section of this report. The general consensus was that the leasing market needs a few more years before its reaches a maturity level requiring supervision. Most participants agreed that supervision should use the "traffic cop" approach as leasing companies do not raise public funds.

PROGRESS REPORT ON CAPACITY BUILDING

Additional findings detail the NBG's opinions concerning non-recourse loans to leasing companies and the value of lease receivables as collateral.

DISCUSSION OF POLICY WITH THE MINISTRY OF FINANCE AND THE GEORGIAN REVENUE SERVICE

During a one-day session, the EPI consultant conducted a workshop for relevant officers from the MoF and the RS. The purpose of this training session was to find a common ground between the banks, leasing companies and GoG officials and ensure the correct interpretation and application of the Georgian Civil Tax Code Amendments.

Prior to the session, the EPI consultant asked both the MoF and the RS to provide information on key concerns and or areas of interest to be discussed. The workshop focused on the issues highlighted by both these agencies and included interactive exercises and a power point presentation.

The session was interactive and it included a comparative analysis between the tax rules in place prior to the October 13, 2011 reforms, and the current legislation. The most important outcome of the workshop was that participants developed a better understanding of the economic realities facing the leasing industry, its potential to generate wealth and an appropriate measure of the sector's contribution to public finances. As discussed in the Findings session, there was consensus that the tax reforms were not adequately supporting a sustainable leasing industry, but the improvements were laudable.

TRAINING FOR JUDGES

A second training session for judges was conducted in the High School of Justice in Tbilisi. The trainings focused on the short and long-term effects of the Civil and Tax Code reforms on the juridical system as well as ensuring that judges understand the full applications of these new changes. The event had good attendance and excellent participation. This led the consultant to the conclusion that Georgia has efficient and sound juridical enforcement abilities.

The work-shop discussion focused on the judicial logic for eliminating the "delta" or the amount to which the lessee in default would be entitled when the courts ordered the repossession of the leased asset by the lessor. The participants also debated returning to the general rules of contractual equity and fair compensation of damages that are currently reflected in Articles 414 and 420 of the Civil Code. The consensus was that justice is well served if the lessee is entitled to the asset's upside gains, or gains on the sale of repossessed goods. However, this is provided when the lessee complies and honors its commitments and is not to be a reward for wrong doing and failure to honor his or her word. The concern about lessors abusing their rights is addressed by Articles 414 and 420 of the Civil Code and entitles the courts to apply equity to prevent future abuses.

TRAINING FOR AUDITORS

A one-day session took place to train staff members from audit companies. The purpose of this training and workshop was two-fold. First, some of the participants perform tax audits, and therefore need to understand the correct applications of accounting principles and tax rules. The second purpose was to teach auditors the specific tax and accounting codes applicable to both lessors and lessees.

PROGRESS REPORT ON CAPACITY BUILDING

The session was also interactive. Participants performed practical exercises and case study analysis.

C. FINDINGS

INSTITUTIONAL IMPROVEMENTS

1. Georgia is globally recognized as a country that supports businesses. This is recently demonstrated by the October 2011 Civil and Tax Codes Amendments for the Georgian leasing industry. The Georgian political and legal environment supports businesses in the following ways:
 - a. Low market entry barriers: A leasing company can be created overnight and does not require a license, as in other countries, or face legal barriers.
 - b. Improving access to credit information: While this institutional aspect of the business environment is still underdeveloped, leasing companies have been experiencing progress in accessing credit information. Still, the Credit Information Bureau has limited coverage as it serves only 16.4% over total adult population. But its penetration is growing at an annual rate of over 30%. Currently, the challenge is to assess the financial information of potential lessees, such as small and medium sized businesses. However, the environment in Georgia progressing.
 - c. Currently, Georgia's legal environment supports creditors' and lessors' rights. After the Civil and Tax Code Amendments were implemented, a court decree for repossession was issued in between one and two weeks while the elimination of the "delta" allowed lessors to focus on efficient asset management and disposal of repossessed assets. The Georgian legal environment will further improve after the additional trainings of judges, legal representatives, and attorneys.
 - d. In addition, the Tax Code has become easier to manage for both leasing companies and lessees, which has promoted better tax compliance. For instance, lessees may now deduct their rents from business expenses. However, the Civil and Tax Codes are still complicated and require careful tax planning on the parts of leasing companies. Tax planning is a key area in which leasing companies will require additional support from EPI. The following tax related issues are the most pertinent:
 - i. While leasing companies may either apply depreciation to the actual amortization of their lease, the application of alternative depreciation, while it may appear to generate tax savings, triggers the creation of deferred taxes and deferred depreciation reserves, which could have a cost impact should the pace of growth of the company being reduced;
 - ii. While all expenses are tax deductible, many challenges exist for applying the thin capitalization rules to leasing companies. In general, leasing companies should be excluded from the thin capitalization rule;
 - iii. The deduction of credit reserves is subject to complicated ad-hoc formula set forth on January 13, 2012 in Order #17 of the Georgian Civil and Tax Codes. While the deduction calculation does not

generate an additional burden for lessors, it is a complex formula potentially resulting in errors and tax disputes;

- e. While access to capital from domestic sources is very limited, the ease of doing business and the general implementation of best practices is opening up funding sources. This area is a critical one for the effective development of the Georgian leasing industry and will require focused efforts in the future.
 - f. The Georgian business environment is open to foreign trade and the import of capital goods. While this facilitates the leasing industry's growth, Georgia needs to adopt a policy for domestic assembly or manufacturing of certain capital goods to generate a multiplier effect in the economy. The leasing industry may collaborate with the GoG in this area.
2. The GoG recently implemented more open policies for the leasing industry. A few crucial government institutions, such as the NBG, the MoF and the MoJ, are interested in supporting the development of the Georgian leasing industry.
 3. The NBG supports the Georgian leasing industry and will allow companies to operate without the NBG's supervision. However, the NBG must implement a system of checks and balances to hold all leasing companies accountable for their businesses practices to avoid systemic and reputational risk or the risk when the reputation of financial institutions within the general public may be harmed due to the isolated actions of a few bad players. As suggested in the Recommendations section, the NBG should create an ethics committee to oversee all leasing companies and their relations with customers and funding sources.

CRITICAL FACTORS FOR BUSINESS PROGRESS

1. The three Georgian leasing companies have made progress in their business practices, implementing some of the EPI's consultant's recommendations from last year. They have improved their sales strategies and processes, risk management policies and processes, documentation, and back office resources among others. While additional growth can to be made, Georgian leasing companies have made progress for improving their institutions and operations.
2. One of the weaknesses in the Georgian leasing system is the limited number of actors. This affects the markets in a numbers of ways as lessees have few choices as industry fundraising is difficult and the development of industry talent is restricted. The GoG and EPI should collaborate in order to expand the Georgian leasing industry through creating more captive lessors as well as bank affiliated leasing companies. The GoG should create a legal environment conducive to easy market entry of well-capitalized independent companies with sound business plans.
3. Another weakness of the leasing system is the current value proposition of leasing companies towards their clients. Typically, leasing is addressed to provide 100% financing of capital goods to businesses. It is understandable that under the former legal framework lessors should mitigate their risk exposure to the asset's values. However, the reality is that in the current legal environment, the demand of 20% down payment needs to be eliminated as fast as possible. Obviously, in order for this elimination to take place, leasing companies and their risk management organization must be clear in their credit risk exposures, mitigations and remedies. This requires further education in best practices and further experience.

PROGRESS REPORT ON CAPACITY BUILDING

4. The key bottleneck for the leasing industry's development is access to funding. This is demonstrated in both the limited capability of leasing companies to raise funding from their own parent banks, as well as the limited funding available from both the Georgian banks and capital markets. Both the banking and capital markets sectors are underdeveloped and operationally incapable of processing debt instruments for leasing companies or securitizations. The current impediments are:
 - a. Currently, banks lack best practices for assessing the credit risks of leasing companies. The EPI consultant accessed an internal credit assessment performed by a bank on its own leasing company, which inconsistently and inaccurately applied financial ratios and scoring criteria. In addition, leasing companies are evaluated on the size of their current portfolios and not on their abilities to generate sound portfolios. In the future, EPI should train bank employees and officers in proper evaluation of leasing companies and what types of collaterals carry fewer risks. Such trainings will open banks as source of funding to lessors;
 - b. The collateral value of leasing portfolios needs to be clearly defined to support the flow of credit to leasing companies;
 - c. Currently, non-recourse financing institutions do not have defined roles in regards to leasing companies. While these institutions can help the leasing industry overcome the constricted market size there is no consensus, either within the NBG or the GoG, regarding their viability;
 - d. International funding sources will not be available until the Georgian banking system and the leasing industry together build sound credit portfolios that match international best practices;

D. RECOMMENDATIONS

INSTITUTIONAL REINFORCEMENT

1. EPI should provide technical assistance to support the GLA as its durability is critical for the leasing industry's development. The GLA should adopt the following roles and responsibilities:
 - a. Educating the market through the following three basic approaches:
 - i. Comprehensive education about the leasing industry through various public events such as conferences. These events that must highlight the importance of the leasing industry and its actors;
 - ii. Press, public relations and publications;
 - iii. Producing research data and information about the industry and its positive impact on the Georgian economy. The GLA should trace the long-term effects of the recent tax reforms on economic growth and tax revenues.
 - b. Self-regulation of the industry: The GLA should supervise the industry members to ensure that all have social responsibility and are focused on Georgian public welfare. In order to support industry self-regulation, the following institutions should be established:
 - i. An ethics committee to ensure compliance with the highest level of ethical standards by the leasing industry members. The ethics committee should create a code of conduct to be adopted by the GLA and all industry members;
 - ii. A legal committee to liaison with representatives from the MoJ and advocate for the GLA as necessary;
 - c. Advocacy: The GLA should liaison with the GoG and advocate for a legal and regulatory environment that is both receptive and supportive of needs of the Georgian leasing industry.
 - d. Business development: The GLA should support networking opportunities for all industry stakeholders such as equipment vendors, leasing companies, funding sources, equity investors, and service providers among others.
2. EPI should follow-up to ensure that the leasing laws and regulations support a friendly environment for foreign investors. This is an industry that could attract foreign investment through portfolio purchases, sales and retail investments by US based equipment vendors. This industry also has the potential to develop opportunities for private equity funds and institutional investors.

EDUCATING BANKS ABOUT LEASING

3. One of the main findings is that despite the legal and regulatory improvements, the Georgian banks are not equipped to be either funding sources or controlling shareholders of the leasing companies. EPI should host an educational workshop series designed to teach

PROGRESS REPORT ON CAPACITY BUILDING

Georgian banks about the leasing business, accurate risk and reward equations, the legal and economic nature of leasing deals, the value of leases as collaterals, and the potential of leases to generate profits and to enhance the creditors rights position of the banks, i.e. to both reduce the probability of lessor of the underlying obligors-lessees, and minimize the loss given a default, due to the fact that the collateral asset might have a potential value in the secondary markets and can be disposed in an orderly and efficient manner. These trainings should include an initial immersion about the leasing industry followed by continuing educational opportunities discussing the details of the leasing industry.

FUNDING FACILITY

4. The main recommendation to EPI is focus on the conceptualization, feasibility, and implementation of a funding strategy for leasing companies. This resource development plan should be based upon the general concept of leasing syndication. A leasing syndication allows leasing companies to access funding through the origination and assignment of new leases to a single investor or a pool of investors. The syndication also supports the simple assignment of leases already under the company's portfolio. There are several forms of syndication, and an extension of this model may catalyze the creation of a securities market. For a fundraising plan to be successful, it must detail a sound legal and financial structure while aligning the practices of leasing companies to the risk management practices of the target investors. In principle, the main target investors should be the largest American, European and other international lessors, as well as institutions such as OPIC, IFC or the EBRD. This resource development strategy should provide short-term and long-term solutions to the funding needs of all current leasing companies in Georgia while accounting for future industry actors.

E. ADDITIONAL INFORMATION

The power point materials prepared for the workshops and training are attached below.

Leasing Regulatory Issues

Best practices around the World

National Bank of Georgia
01/23/2012

Objectives of Leasing Legislation and Regulation

- The Law must pursue the common welfare of society
- The Law must provide for juridical security so that the members of society can trust each other, and
- The Law must provide justice and equity
- In the context of leasing, the common welfare is attained through economic development

New Civil Law Regulation

Law on Promotion of Leasing Activities was abolished and amendments were made to the Civil Code. Such amendments are based mainly on UNIDROIT Model Law on Leasing (2008) as the most recent harmonized legal framework reflecting the best practice in the industry.

New Civil Law Regulation

Main changes:

- Leasing has a self-contained regulation that defines its role as a financial service
- Remedies of lessors have improved their credit risk position:
 - Hell or high water
 - No refund of gap between fair market value and due amounts
- Lessors are not subject to additional liabilities that would affect their role as a conduit for capital investment
- Assignment of leases are clearly permitted and that leads to mobilized capital into new equipment leased.

Objectives of Leasing Legislation and Regulation

- The Central Question is: Who must take care of Leasing and its practitioners?
 - The NBC? or
 - The Market?

If the NBS regulates, how to police Financial Institutions?

- As a SWAT team?



Auditing and co-managing everything

If the NBG regulates, how to police Financial Institutions?

- Or...as a traffic cop?



**Gathering and distributing information
Helping the flow of business**

If the Government

- Regulation should be prudential but not absolute
- Latitude to freedom of contract and free flow of capital
- Focus on funneling relevant information to capital markets as opposed to treating investors as not professionally informed

Prudential Regulations

- Background and objectives of the Regulation of Leasing Companies
- Registration for Leasing Companies
- Special approval procedure for Banks to be engaged in financial leasing business
- Capital requirements

Prudential Regulations

- Risk Management
 - Credit Risk Management
 - Residual Risk Management
 - Liquidity Risk Management
 - Market Risk Management
 - Operational Risk Management
 - Legal Risk management
 - Reputational Risk management
 - Strategic Risk Management

Prudential Regulations

- Measures that the NBG may apply in connection to Leasing Companies Risk management:
 - Risk rating
 - Preventive supervision
 - Transparency
 - Fair business practices
 - Market continuity and order in the exit of failed leasing companies

Methodology of Asset Evaluation

| Value of Use | Market Value |
|---|--|
| Customer plan for generating revenues | Brand- specifications |
| Value of use for other customers | Origin |
| How critical is the asset to the lessee | Dealer (Rate the dealer) |
| | Benchmark research (Imports by HS #) |
| | Get the name of at least 5 to 10 clients already using the equipment |
| | Track the asset (Wear and tear) |
| | Build the collateral curve to value at risk |

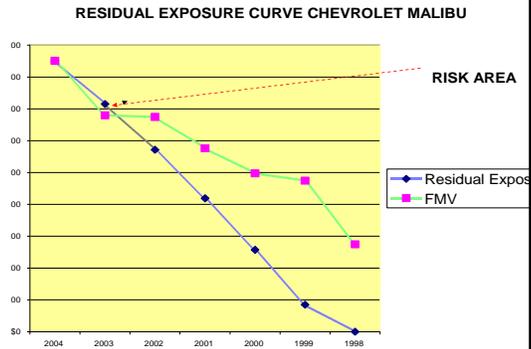
Lease to Exposure Curve

Lessors are confronted with residual risks, not only at the end of the lease, but also during the term of the financing.

The player who proves able to develop consistent secondary market information and accurate residual risk curves will be the winner.

The curves must also consider the changes in technology and how they influence secondary markets of any given equipment.

The good news in emerging markets like Georgia is that there are second and third layers of customers for used equipment .



Corporate Structures and Control

- Three kind of players in developed leasing industries:
 - Bank affiliated
 - Captives
 - Independent

USA: The 10 largest

| 2009 | 2008 | | | Originations |
|------|------|------------------------------------|---|--------------|
| 1 | 1 | GE Capital | | USI 21,091.9 |
| 2 | 2 | John Deere Credit | * | CAP 16,876.9 |
| 3 | 4 | IBM Global Financing | | CAP 12,515.0 |
| 4 | 6 | Banc of America Leasing | | USB 9,653.0 |
| 5 | 8 | De Lage Landen Financial Services | | FOR 8,094.0 |
| 6 | 3 | Caterpillar Financial | | CAP 7,623.0 |
| 7 | 9 | CNH Capital | | CAP 6,824.0 |
| 8 | 5 | CIT Group | | USB 6,338.0 |
| 9 | 11 | Hewlett-Packard Financial Services | * | CAP 5,210.4 |
| 10 | 7 | Wells Fargo Equipment Finance | | USB 4,602.0 |

USA: New Market Segmentation

| Company Name | YE | Segment | New Business Volume 2009 | Avg. |
|----------------------------|----|---------|--------------------------|----------|
| Top 50 Companies | | | 143,983.8 | |
| Bottom 50 Companies | | | 5,486.8 | |
| Total 100 | | | 149,470.6 | |
| Captive | 17 | CAP | 61,557.6 | 3,621.0 |
| Foreign Bank | 8 | FOR | 12,486.1 | 1,560.8 |
| Independent | 25 | IND | 5,582.0 | 223.3 |
| Not Elsewhere Categorized | 5 | NEC | 3,852.4 | 770.5 |
| US Bank | 42 | USB | 44,900.6 | 1,069.1 |
| US Industrial | 1 | USI | 21,091.9 | 21,091.9 |

Players that must coexist

- Banks and bank affiliated leasing companies
- Captives and distribution channels affiliated companies
- Independent companies

Banks doing leasing

Strengths

- Funding capabilities
- Customer base
- Credit management infrastructure
- Distribution channels (i.e. branch system)

Weaknesses

- Lack of specialization
- Lack of focus on equipment customer needs (looking to sell other bank products)
- Poor credit skills to manage leasing deals
- Waste of channels for lack of focus in originating leases
- Conflict of interests

Banks doing leasing

- An additional way that banks can get involved in the leasing business is by funding leasing companies
- Banks in Georgia need to learn about the MUSTS in risk assessment in asset based financing and vet the following factors in leasing companies' originated portfolios:
 - Obligor's risk
 - Collateral risk collectability
 - Liquidity of collateral (Leases are much more liquid as collateral than real estate)
 - Legal risks (Mitigated with the new law)

Source: Managing Credit Risk: The Next Great Financial Challenge, John B. Caouette, Edward Altman, Paul Narayanan
Professors of NY University Stern School of Economics, Wiley Publishing

Banks doing leasing

- An alternative for banks to grow in leasing is to finance leasing portfolios through non-recourse loans:
 - The originating leasing company assigns the lease receivables, and eventually the asset, to a trust or any other legal vehicle;
 - The trust issues promissory notes that are payable by the proceeds of the leases assigned to the trust;
 - The originating leasing company retains a portion of the risk and keeps billing, collecting, managing taxes and managing the assets;
 - Lease rentals go to the banks to an escrow account held by the trustee;
 - Since there is no recourse against the leasing company, there shall not be risk concentration issues;
 - Banks must undertake due diligence to evaluate the credit risks of the underlying leases.

Bank affiliated leasing companies

Strengths

- Funding capabilities
- Customer base added to affiliate focus on customer's equipment needs
- Credit management infrastructure added with special unique skills in asset and customer management
- Distribution channels (i.e. branch system)
- Specialization

Weaknesses

- Funding subject to group concentration limits, but possible to mitigate by non-recourse assignment of receivables (end-user credit risk)

Captives

Strengths

- Strong origination/sales power
- Customer base
- Credit risk skills based upon knowledge of the asset and industries
- Distribution channels (agents and re-sellers)
- Specialization

Weaknesses

- Funding
- Risk concentration in type of assets and industries
- Subordination to corporate policies and practices of the parent

Independent

Strengths

- More flexible, more creative
- Ability to build best practices without the restrictions applicable to banks and manufacturers
- Traditional drivers of growth (US Leasing, CIT, etc.)

Weaknesses

- Funding
- Potential poor corporate governance
- Volatility, more vulnerable to economic cycles

Controls

- Who are the stakeholders that must be protected in the event of mismanagement of a lessor?
 - It depends on the funding structure of lessors
 - Banks creditors
 - Institutional investors, or
 - The public at large, and
 - Shareholders
 - And also depends on the regulations that provide an orderly market exit of the inefficient company
 - In a system where leasing companies are difficult to liquidate, lessees may also suffer, in addition to creditors and shareholders

Metrics and alarm signals to exercise control of Lessors

Financial Measures

Times Interest Earned
ROA
ROE
Asset Growth Rate
Income Growth Rate
Net Margin
Provision for Credit Losses
Charge-offs to Assets
SG&A to Assets
Other Assets to Total Assets
Residual Write-downs
Year-end Share Price
Average Cost of Funds

Best Practices

- In the United States, there is a system of checks and balances imposed by the market:
 - For small players, bank creditors exercise control and measure efficiency;
 - For medium and large players, the Securities and Exchange Commission makes sure that the markets are informed and the analysts and credit rating agencies control the efficiencies; and
 - Finally, Bankruptcy Law provides an orderly exit of the inefficient companies and reasonable recoveries of creditors.
 - There is no Central Bank or Federal Reserve System Control for Leasing Companies (Changing under the Dodd-Franks Act for Bank Affiliated Leasing Companies).

Best Practices

- In developing countries, perhaps the best examples are Brazil and Mexico:
 - The system of checks and balances is transmitted by the Central Bank to the market;
 - The Central Bank exercises reasonable control and no co-management of the companies, as in other countries;
 - Only when the alarm signals are triggered does the Central Bank intervene to correct the deficiency, if possible;
 - If the deficiency is not curable, then it liquidates the companies; and
 - Liquidation must be very fast, generally through the immediate sale of portfolio to other market players.

Leasing and The New Basel Accord

- The Basel Accord is a set of regulations published by the Bank of International Settlement (BIS).
- It aims to ensure that banks hold adequate capital reserves to cover risks inherent in their business and protect their depositors.
- It also encourages banks to improve their risk management capabilities by lowering the capital requirement for more advanced methods of risk management and introducing a stronger supervisory and market disclosure rule.
- The Accord introduced a three-pillar approach to achieve its objectives

Three Pillars of Basel II

| | |
|--|--|
| Pillar I – Minimum Capital Requirements | Stipulating capital charges to motivate banks to improve their risk management and measurement capabilities |
| Pillar II – Supervision | Creating a supervisory framework to encourage best risk practices and to 'mop up' other risks (e.g. strategic, reputational) |
| Pillar III – Market Discipline | Requiring banks to disclose, in detail, capital structure, risk exposures and capital adequacy |

Under Basel, leasing is a financial asset of minimum risk exposure

10. Requirements for recognition of leasing

523. Leases other than those that expose the bank to residual value risk (see paragraph 524) will be accorded the same treatment as exposures collateralised by the same type of collateral. The minimum requirements for the collateral type must be met (CRE/RRE or other collateral). In addition, the bank must also meet the following standards:

- Robust risk management on the part of the lessor with respect to the location of the asset, the use to which it is put, its age, and planned obsolescence;
- A robust legal framework establishing the lessor's legal ownership of the asset and its ability to exercise its rights as owner in a timely fashion; and
- The difference between the rate of depreciation of the physical asset and the rate of amortisation of the lease payments must not be so large as to overstate the CRM attributed to the leased assets.

Basel Committee
on Banking Supervision

524. Leases that expose the bank to residual value risk will be treated in the following manner. Residual value risk is the bank's exposure to potential loss due to the fair value of the equipment declining below its residual estimate at lease inception.

The discounted lease payment stream will receive a risk weight appropriate for the lessee's financial strength (PD) and supervisory or own-estimate of LGD, which ever is appropriate.

The residual value will be risk-weighted at 100%.



International Convergence
of Capital Measurement
and Capital Standards
A Revised Framework

June 2004

Glossary of terms:

CRE: Commercial Real Estate
RRE: Residential Real Estate
PD: Probability of Default
LGD: Loss Given Default

Basel III made additional changes

- Increase the base capital that financial institutions must have
- Requires checks and balances for liquidity risks

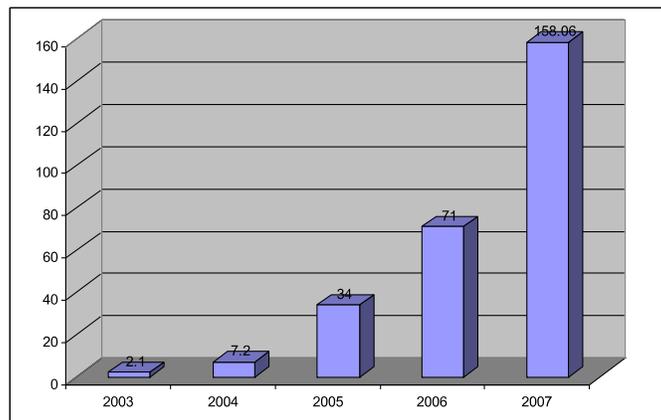
| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|------|---------------------------|---|------|----------------------------|-------|-----------------------|------------------------|------|
| Leverage ratio | | Supervisory monitoring | Parallel run 2013-17 Disclosure starts January 1, 2015 | | | | Migration to Pillar 1 | | |
| Minimum common equity capital ratio | | | 3.5 | 4.0 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 |
| Capital conservation buffer | | | | | | 0.625 | 1.25 | 1.875 | 2.50 |
| Minimum common equity plus capital conservation buffer | | | 3.5 | 4.0 | 4.5 | 5.125 | 5.75 | 6.375 | 7.0 |
| Phase-in deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs, and financials) | | | | 20 | 40 | 60 | 80 | 100 | 100 |
| Minimum Tier 1 capital | | | 4.5 | 5.5 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| Minimum total capital | | | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 |
| Minimum total capital plus conservation buffer | | | 8.0 | 8.0 | 8.0 | 8.625 | 9.25 | 9.875 | 10.5 |
| Capital instruments that no longer qualify as noncore Tier 1 capital or Tier 2 capital | | | Phased out over 10-year horizon beginning 2013 | | | | | | |
| Liquidity coverage ratio (LCR) | | Observation period begins | | | Introduce minimum standard | | | | |
| Net Stable Funding Ratio (NSFR) | | Observation period begins | | | | | | Introduce min standard | |

Source: BCBS, Press Release, September 12, 2010.

In summary

- A **Lessor** shall always be considered a financial services provider and can be either:
 1. A bank affiliated company,
 2. An independent company or
 3. A captive company.
- A **Lessor** must be registered and just subject to light control.

Case Study: Azerbaijan



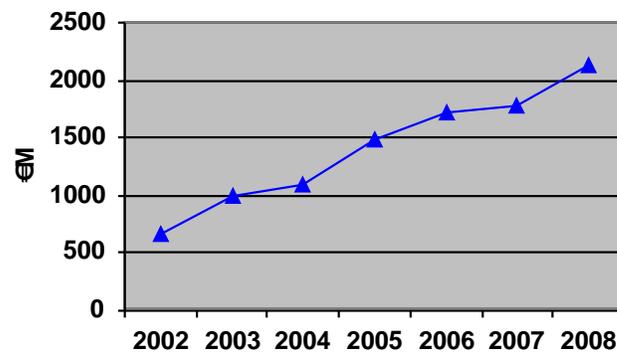
Leasing in Azerbaijan: The legal reforms of 2003 sent back on track Leasing in Azerbaijan and attracted foreign investors. Source: IFC, World Bank Group

Case Study: Slovenia

- Slovenia adopted a Leasing Law in the mid-1990s but just implemented it until 2003
- Nowadays Slovenia has:
 - 14 specialized leasing companies:
 - Aleasing Celje (Slovenian Independent)
 - Daimler AC Leasing (German Captive)
 - DBS Leasing (Slovenian Bank Affiliate)
 - Hypo Leasing (Austrian Bank affiliated)
 - Immorent Ljubljana Leasing (Austria Indepent)
 - KBM-Leasing (Slovenian Bank affiliated)
 - NLB Leasing (Slovenian Bank Affiliated)
 - Porsche Leasing (German Captive)
 - Probanka Leasing (Greek Bank affiliated)
 - SKB Leasing (France Bank affiliated), Societe Generale Group

Case Study: Slovenia

Slovenia Leasing Growth



Source: EBRD, 2009

Credit Loss Reserves

- Basic calculation of Credit Loss Reserves

$$EL = EAD \times PD \times LGD$$

EL = Expected Losses
EAD= Exposure at Default
PD = Probability of Default
LGD= Loss Given Default

Credit Loss Reserves

- How and when the reserve must be created:

| Past due days | Reserve (For the amount of the EL) |
|---------------|------------------------------------|
| 0-30 | 0% |
| 30-60 | 1% |
| 60-90 | 5% |
| 90-180 | Stop accruals |
| 180 and more | 100% |

Insolvency: Rehabilitation and bankruptcy

- Bankruptcy of Lessor:
 - Civil Code provides that in the event of bankruptcy of Lessor, the estate safeguards the rights and obligations.
 - If the leased assets are sold, then the purchaser assumes the same extent of rights and obligations on the leased assets and receivables as the Lessor had (Art.578 §2).

Insolvency: Rehabilitation and bankruptcy

- Bankruptcy of Lessee:
 - Does the Lease contract terminate in the event of bankruptcy of the Lessee?
 - Yes
- Rehabilitation of Lessee:
 - Does the Lease contract terminate in the event of rehabilitation of the Lessee?
 - The contractual termination is valid because is not forbidden by the law.
 - If there is no contractual termination, then the following shall apply:
 - Automatic stay applies to past due rentals but not future rentals since the date of the court resolution that admission of the insolvency petition;
 - Rentals accrued after the petition, are payable as preferred operating expenses, such as all other operating expenses under reorganization (salaries, utilities, etc.)
 - The Lessee may ask the court to accept the rejection of the leases or may agree to terminate the lease and return the assets to the lessor, but pre-petition rentals shall be paid according to the reorganization plan.

New Leasing Legal Environment in Georgia

Accounting Impact

Audit Companies
01/26/2012

What the new laws brought

- ✓ Clarity and certainty
- ✓ Simplicity
- ✓ Apply equity to leasing financing vis-a-vis other forms of financing, in particular commercial bank loans
- ✓ No tax exemptions for leasing were proposed nor enacted, beyond the general tax incentives

New Civil Law Regulation

- The Civil Code was amended.
- Such amendments are based mainly on UNIDROIT Model Law on Leasing (2008) as most the recent harmonized legal framework reflecting the best practices in the industry.

Leasing Legislation

- Background:
 - Since the adoption of the French Leasing Law in 1966, further to a disastrous judgment of the Cour de Cassation Française, there has been a movement for the unification of Leasing Law worldwide.
 - At present the International Institute for the Unification of Private Law adopted a Model Law that incorporates best practices in leasing regulation and conciliate the tendencies of Common Law systems and Civil Law systems

Leasing Legislation

- The Model Law of Leasing:
 - It adopted and improved the general principles contained by the 1988 UNIDROIT Ottawa Convention on International Financial Leasing.
 - It defines leasing as a tri-party transaction where the parties are the supplier, the lessor and the lessee.
 - Defines the roles of the parties, and in particular the role of the Lessor as a professional investor in capital equipment for the interest and benefit of the lessee.
 - It shall provide for efficient remedies and actions to preserve the rights of the parties.
 - But it neither regulates the tax aspects of the leasing transaction, nor the structure and control of lessors.

Regulation of Leasing

- Each country must apply its own rules for the corporate structure, control and regulation of Lessors:
 - According to the degree of development of its capital markets;
 - According to the structure of the economy; and
 - According to the definition of the stakeholders that need to be protected from abuses, negligence or poor practices.
- Each country must apply its own Tax Rules according to:
 - The situation of public finances;
 - The economic reality; and
 - A clear understanding of how leasing can be used as a propeller for generation of additional revenues collections via continuous investment.

New Civil Law Regulation

Main changes:

- Leasing has a self-contained regulation that defines its role as a financial service.
- Remedies of lessors have improved their credit risk position:
 - Hell or high water
 - No refund of gap between fair market value and due amounts
- Lessors are not subject to additional liabilities that would affect their role as a conduit for capital investment.
- Assignment of leases are clearly permitted and that leads to mobilized capital into new equipment leased.

Tax Reform

- ✓ Lessors will be able to depreciate the leased assets according to their economic reality;
- ✓ Lessors shall be entitled to the alternative depreciation method that applies to all other tax payers;
- ✓ Leasing transactions must not be subject to anti-avoidance provisions, such as thin capitalization or market value adjustments;
- ✓ Funding via sale and lease back shall be available to all Georgian businesses without imposing them excessive taxation on them; and
- ✓ Property taxes will apply to leasing companies based upon economic reality and shall be final and expeditious.

Depreciation or deductibility of rentals: The Case for Georgia

- Before the changes in regulations, the tax system for leasing companies was highly discriminatory,
- All taxpayers were allowed to claim a 100% bonus depreciation, except leasing companies.
- The new regulation leveled the playing field between leasing companies and all other tax payers providing financing.
- The normal depreciation system applies economic reality for leasing companies by adjusting depreciation to the depletion of the net present value of future rentals and residual value.

Bad debt relief: The Case for Georgia

- Two basic aspects associated with bad debts:
 - Possibility of leasing companies to deduct bad debt reserves. This is now possible up to an 80% for past due over 60 days. Downside: Leasing companies may have a potential tax cost when the reserve exceeds 80% (Good practices suggest after 180 days); and
 - Late charges and penalties associated with a defaulted lease are now based in the cash accounting system for tax purposes.

Anti-avoidance rules: The Case for Georgia

- Leasing companies were subject to certain anti-avoidance provisions
 - Thin capitalization (Article 123 of the Tax Code). This was reformed.
 - Market Value Adjustment (Article 147 of the Tax Code). This was removed.

Anti-avoidance rules: The Case for Georgia

- Leasing companies are subject to certain anti-avoidance provisions:
- Thin capitalization (Article 123 of the Tax Code)
 - Unless leasing companies are officially recognized as financial institutions, thin capitalization would be wrong because it seems to start from the premise that leasing is a tax avoidance tool. Nothing could be more isolated from the truth.
 - Leasing companies can play their role as providers of capital, if they can raise debt capital to at least 7 to 8 times their equity.
 - Provisions imposing thin capitalization based upon a prescribed maximum leverage rate of 5:1 still discourages investment in leasing companies and is still an impairment for capital formation in Georgia.

Indirect Taxation

- For Georgia: Property Tax
- Tax burden was relieved representing a 0.6% of the initial book value.
- Still this is a 0.6% burden to the return of assets (ROA) of such a company.

Indirect Taxation

- This means that the impact of such Property Tax on the Return on Equity of such a company, assuming an 8:1 leverage ratio, can be assessed at an 4.8% burden (Impact on pricing and profits).
- In other jurisdictions, Property Tax operates as an Alternative Minimum Tax to the equivalent of the Profit Tax. However, in the case of Georgia, this is not possible, because Property Tax is a local tax.
- This improvement is still a potential deterrent to foreign investors or may lead to higher costs of leased equipment.
- Still there is room for improvement.

Taxation on Cross Border Leasing

- Apply to both direct leases and subleases
- Two (2) systems apply globally:
 - Exception to the territoriality principle and elimination of double taxation, following OECD guidelines of 1983;
 - Taxation at the base rate (No surcharges):
 - In financial leasing only the financial component of the rental;
 - In operating leasing the whole of rentals;
- In Georgia, the withholding tax rate should be 10% for both financial leases and operating leases, provided that the lessor does not have a permanent establishment in Georgia.

Taxation on Cross Border Leasing

- Permanent establishment:
 - For leasing purposes, Article 29 was reformed by presuming permanent establishment in the case that the lessor monitors assets and performance through an agent or employee.
 - In such a case, the foreign lessor can file a tax return and claim deductions, but should pay taxes at a 15% rate.

Taxation on Cross Border Leasing

- Value Added Tax
 - All lease payments are subject to 8% VAT which must be withheld by the resident lessee simultaneously with the remittance of the lease payment.
 - The same lessee may claim a VAT credit for the amount withheld in case the lessee is a VAT payer. Otherwise, the VAT should be an additional expense.

Taxation on Cross Border Leasing

- Export Leases:
 - Lease payments are subject to general taxation for income tax purposes.
 - VAT shall be exempt on the grounds that the lease should be treated as an export of services and connected to an export of goods.

Double Taxation Treaties

- Under the OECD rules, Double Taxation Treaties intend to avoid double payment of taxes for international transactions.
- Georgia has a Double Taxation Treaty with more than 30 countries.
- Corporate residents are subject to taxes over their worldwide income.

Accounting perspective of leasing

- In the beginning, leasing was an off-balance sheet transaction:
 - The Lessor, as the legal owner, recorded the Asset in its Fixed Assets Book entries.
 - The Lessee recorded neither any assets nor liabilities in its balance sheet.
 - The Lessor recorded its rentals in its P&L as soon as they accrued, and if unpaid, they were recorded as accounts receivables only when accrued. Pending rentals remained in a footnote
 - Lessee only charged its P&L when rentals became due. Pending rentals should also be in a footnote

Accounting perspective of leasing

- In 1949, the U.S. Accounting Research Bulletin 38 required lessees to disclose “material obligations under leases and the principal terms of sale and lease back.”
- In 1964, the Accounting Principles Board (APB) Opinion No. 5 required lessees “in circumstances” where they were bound to report leased assets with owned assets. Leases should be recorded by the value resulting from the rental flow discounted.
- In 1966, APB No. 7 defined such “circumstances” as those where lessee assumed the risks and rewards of ownership of the asset.
- In 1973, the SEC requested the newly formed FASB to issue a standard. The task was completed in November 1976 with the issuance of FASB No. 13.
- Since the adoption of FASB No. 13, accounting has differentiated between finance and operating leases according to 4 main criteria.

Accounting perspective of leasing

- In 1982, the International Accounting Institute, (today the International Accounting Standards Board) issued IAS 17, based mainly on FASB No.13 (though with some slight differences).
- In 1983, within LEASEEUROPE, the European Continental countries based on Civil Law, issued the “Declaration of Seville” rejecting IAS 17.
- In 1986, the Latin American countries supported the “Declaration of Seville” approach adopting the “Declaration of Caracas.”

Accounting perspective of leasing

Europe had 4 main accounting approaches:

- Legal ownership prevails: France, Italy
- Economic ownership prevails: UK, Belgium, Portugal
- Denmark offers the option to enterprises to choose any of the two approaches (Legal or economic).
- Spain requires the lessor to capitalize the tangible asset, while requiring the lessee to record the lease contract as an intangible asset.

Accounting perspective of leasing

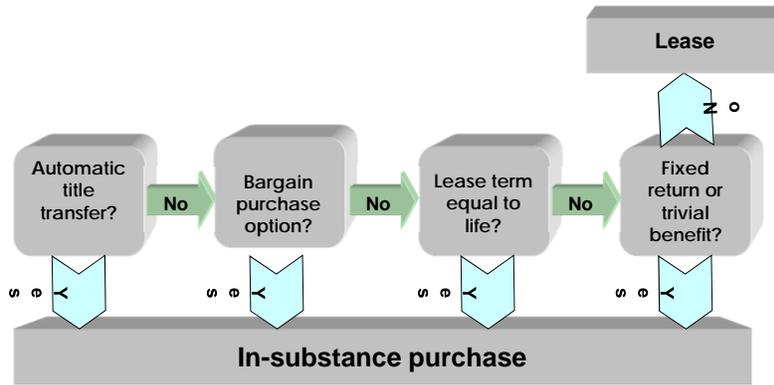
- In 1996, the G4+1 group published a proposal (The McGregor paper) requiring capitalization only for non-cancelable leases.
- In 2001, the Enron and Tyco scandals led to the enactment of the Sarbanes-Oxley Act and the hard line over accounting to avoid to the extent possible any off-balance sheet structure.

Accounting perspective of leasing

- Today the FASB and the IASB are working jointly in preparing an International Financial Reporting Standard (IFRS) for leases. Their alternative approaches are:
 - Financial Components Approach: Lessees shall capitalize only material leases at the value of the lessee's rights and obligations under the lease, i.e. PV of minimum lease payments discounted at the incremental borrowing rate of lessee (G4+1 approach);
 - Whole Asset Approach: All leases must be capitalized at the fair market value of the asset, while recording two liabilities: one for the PV using the same discount rate, and the other being the obligation to return the asset (Residual);
 - Risk and Rewards Approach (Current model);
 - The Executory Contract Approach (Not popular because it opens the door to off-balance sheet); and
 - Variable Interest Approach (FIN-46 whoever controls and bears risk of loss shall record the asset).

Accounting perspective of leasing

- Under FASB 13, these are the currently four criteria. A lease is a finance lease when:
 - Contract provides for automatic transfer of title
 - Contract provides for a bargain purchase option
 - Lease term is greater or equal to 75% of the economic lifetime of the leased asset
 - Present value of minimum lease payments over 90% of fair market value of equipment
- Under IAS 17, these are the criteria:
 - If the lease transfers ownership of the asset to the lessee by the end of the lease term;
 - If the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised;
 - If the lease term is for the major part of the economic life of the asset, even if title is not transferred;
 - If at the inception of the lease, the present value of the minimum lease payments amounts to, at least substantially all of the fair value of the leased asset; and
 - If the lease assets are of a specialized nature such that only the lessee can use them without major modifications being made.



Exposure Draft Standard

- The draft adopts the executory contract perspective. In principle it proposes:

| Lessee's rights | Lessee's obligations |
|---|--|
| Use the good during the term of the lease | <ul style="list-style-type: none"> • Pay the rentals throughout the term of the lease • Return the equipment at the end of the lease |

IASB proposal

- The IASB's Framework for the Preparation and Presentation of Financial Statements and the FASB's Concepts Statement No. 6 Elements of Financial Statements (CON 6)* have the following characteristics of an asset in common:
 - a) The entity controls an economic resource or benefit.
 - b) It arises out of a past event.
 - c) Future economic benefits are expected to flow to the entity.
- Liability definitions contain the same basic characteristics:
 - a) There exists a present obligation of the entity.
 - b) The obligation arises out of a past event.
 - c) The obligation is expected to result in an outflow of economic benefits.

IASB proposal

- Based upon the foregoing, the right to use is an asset, because:
 - a) The lessee controls the right to use the leased item during the lease term because the lessor is unable to recover or have access to the resource without the consent of the lessee (or breach of contract).
 - b) The control results from past events – the signing of the lease contract and the delivery of the item by the lessor to the lessee. Some think that the lessee's right to use the machine described in example 1 is conditional on the lessee making payments during the lease term. In other words, if the lessee does not make payments, it may forfeit its right to use the machine (this is similar to the situation that would arise if an entity failed to make payments on an installment purchase). However, unless the lessee breaches the contract, the lessee has an unconditional right to use the leased item.
 - c) Future economic benefits will flow to the lessee from the use of the leased item during the lease term.
- The lessee's financial obligation to pay the rentals is a liability because:
 - a) The lessee has a present obligation to pay rentals.
 - b) This obligation arises out of past events—the signing of the lease contract and the delivery of the item by the lessor to the lessee.
 - c) The obligation is expected to result in an outflow of economic benefits (usually cash).

IASB proposal

- The obligation to return the leased item at the end of the lease term is not a liability, because:
 - There is no outflow of economic benefits from the lessee when it returns the leased item.
 - Although the lessee has physical possession of the leased item, it has no right to use the item once the lease term expires. The position of the lessee at the end of the lease term is like that of an asset custodian. The lessee is holding an asset on behalf of a third party but has no right to the economic benefits embodied in that asset.

IASB proposal

Therefore:

- a) Assets and liabilities arising out of leases nowadays classified as “operating leases” should thereafter be recorded in the lessee’s financial statements.
- b) The new approach applies the same accounting rules for all leases, which is deemed to ease the comparison of similar contracts or deals.
- c) This reduces the possibility that certain financing transactions may go through without recognition in the financial statements (e.g. Enron). This makes it easier to understand the financial statements of all lessees.
- d) The new approach is consistent with all pronouncements and GAAPs currently in force.

IASB proposal

- Lease contracts are frequently more complex than the simple lease described above. Lease contracts can convey a range of rights and obligations to the lessee. For example, a lease contract may include:
 - a) Options to extend the lease on payment of additional rentals
 - b) Options to terminate the lease early
 - c) Options to purchase the leased asset on payment of an additional amount
 - d) Obligations to pay variable rentals or contingent rentals
 - e) Obligations to compensate the lessor if the value of the leased asset declines below a specified value (residual value guarantees).
- The proposal is:
 - All options, whether an option to renew or extend the lease or a purchase option, shall be recorded as a lessee's liability.
 - Both contingent as seasonal rentals, as well as residual value guarantees, must be recorded as a lessee's liability.

How to record them?

- The economic entity must consider a range of possible outcomes and their probability to happen:
 - If the probability to purchase the good is higher than the probability to extend the leases, then the lessee shall record as an asset, the net present value of the purchase option price.
 - If the probability to extend the lease is higher than the probability to exercise the purchase option, then the lessee shall record as an asset, the net present value of the rentals to be accrued in the extended term, during the estimated term of the extension.
 - Each year, all these criteria must be reassessed.
 - For contingent rentals (e.g. mileage payments) then the lessee must weigh the relative probability of its happening.

Initial measurement

- The liability to pay rentals shall be measured by the net present value of the foreseen payment flows, discounted at the rate of the lease (if known), or otherwise, at the incremental borrowing rate of the lessee (“hurdle rate” according to IAS 17’s definition).
- The right to use the good value shall be measured at its cost, which is different to the cost of the good. Therefore, the cost of the right-to-use must be the net present value of the minimum payments (rentals) discounted at the incremental borrowing rate of the lessee.

Subsequent measurements

- While time goes by, the lessee must update the measurement of the right-to-use values that are assets, and the rental payment liabilities.
- Both IASB and FASB propose to prepare amortization tables at the incremental borrowing rate and register in the table the balance in each period.

Measurement of special agreements

- Renewal option:
 - It must be added to the cost of the asset (right-to-use), the net present value of the future rentals of the extended period discounted at the incremental borrowing rate in force at the time, when the lessee decides to exercise such an option.
 - In such cases of open renewals or extensions, or if a purchase option is exercised, the term that must apply should be the most probable term of use of the good, based upon objective cost-benefit analysis, rather than probability and qualitative analysis.

For the lessor

- The lessor shall record its rights on the leased good measured by the net present value of (i) rentals to be accrued for the lease term, plus (ii) the residual value of the good, taking as such the fair market value of the good. The discount rate must be the implicit rate of the lease.
- For all such leases, where risks and benefits are retained by the lessor, this must be recorded as a liability, the performance obligation to guarantee quiet possession of the good.
- In all other cases, it shall be understood that all the lessor's obligations were performed when the lessor purchased the good from the supplier and delivered it to the lessee.

Latest developments

- Some of lessor's accounting obligations, such as capitalizing short term leases, were relieved.
- There are still some open points, while it seems that the lessee's accounting is not subject to changes.
- It is expected that the ED will come into force on January 2015, and in that case, it will not accept any grandfathering of the current accounting rules, i.e. financials for 2014 must be also be re-expressed.

Process

Exposure
Draft

Deliberations

Re-exposure

Bifurcated model

Single model

Dual model

Single model

Theory

- All leases within the scope of the proposed new lease standards would apply a single approach – the receivable and residual approach.
- Boards are attempting to align lessor accounting with the joint revenue recognition project and lessee accounting.

- Lease receivable for right to receive lease payments
- Allocate book value of asset between leased portion and retained (residual) portion $\text{Asset BV} \times \frac{\text{Lease receivable}}{\text{FV of Asset}} = \text{Derecognition Amount}$
- Recognize profit if reasonably assured or indicated loss
- Profit = Lease receivable – Derecognition Amount
- Receivable amortized on effective interest method at rate charged by lessor
- Residual accreted at rate lessor is charging lessee

Leasing Legislation and Regulation

Best practices around the world

High School of Justice (Civil Judges)
01/27/2012

Objectives of Leasing Legislation and Regulation

- The Law must pursue the common welfare of society;
- The Law must provide for juridical security so that the members of society can trust each other; and
- The Law must provide justice and equity.
- In the context of leasing, the common welfare is attained through economic development.

Leasing Legislation

- Background:
 - In modern times, leasing surged in the 1950s in the United States and expanded first to Canada and the United Kingdom.
 - It then expanded to Continental Europe in beginning of the 1960s.
 - The shape of legal relationships was modeled on the Anglo-Saxon Common Law

Leasing Legislation

- Background:
 - Since the adoption of the French Leasing Law in 1966, further to a disastrous judgment of the Cour de Cassation Française, there has been a movement for the unification of leasing law worldwide.
 - At present, the International Institute for the Unification of Private Law is working on drafting a Model Law that must incorporate the best practices in leasing regulation and conciliate the tendencies of Common Law systems and Civil Law systems.

Leasing Legislation

- The Model Law of Leasing
 - Adopted and updated the general principles contained in the 1988 UNIDROIT Ottawa Convention on International Financial Leasing
 - It defines leasing as a tri-party transaction where the parties are the supplier, the lessor and the lessee.
 - Defines the roles of the parties and ,in particular, the role of the lessor as a professional investor in capital equipment for the interest and benefit of the lessee
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- Each country must adopt its own Tax Rules according to:
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 - The economic reality.
 - A clear understanding about how leasing can be used as a propeller for generation of additional revenues collections via the continuous investment.

Anatomy and physiology of a leasing transaction

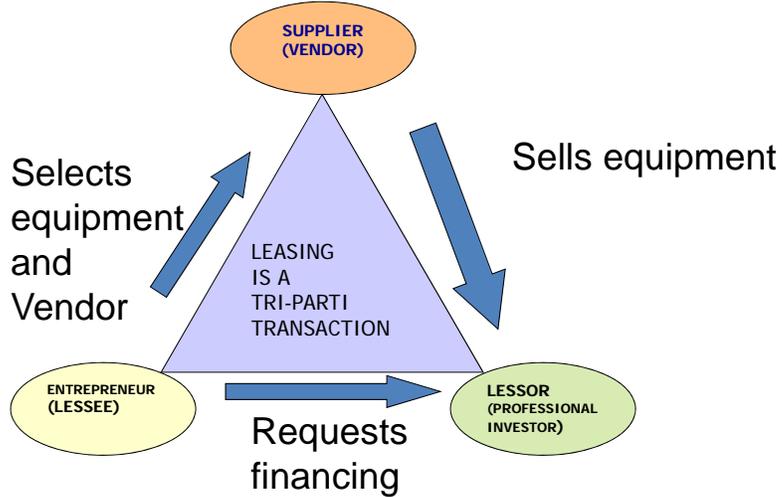
- Anatomy:
 - Structure of a leasing transaction
 - Parties
 - Roles of the parties
- Physiology:
 - Normal organic behavior of the parties under the transaction
 - Description of abnormalities
 - Remedies

Anatomy of leasing

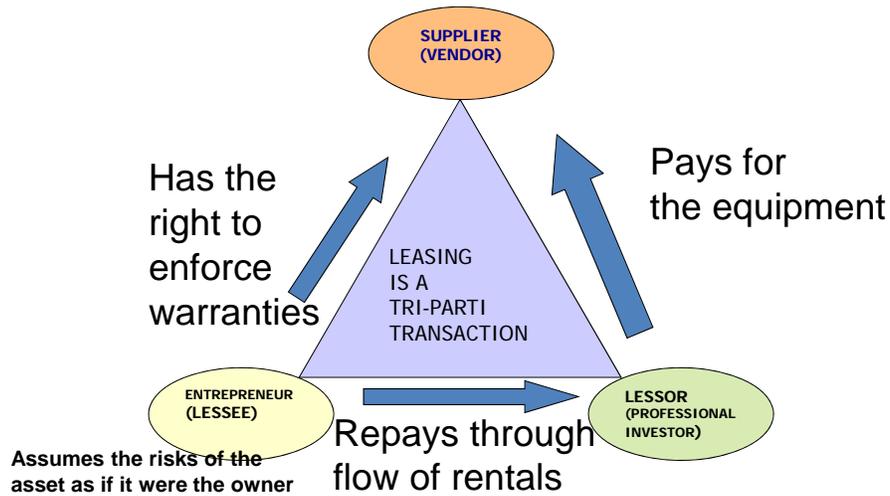
- Leasing is a financial transaction that provides capital investment goods for the benefit of entrepreneurs and the economy.



How does leasing work?



How does leasing work?



Why is leasing different to any other form of financing?

- Because the lessor shall have the ability to assume larger credit risks:
 - Since lessor has the equipment ownership, and
 - Shall be able to recover the value invested through:
 - Repossessing the equipment, and
 - Reselling the equipment in the secondary market

Improving the Leasing Framework

- Adopting a leasing law in line with global best practices:
 - Based in the 2008 UNIDROIT Model Law on Leasing
 - The new law reforms the Civil Code and will repeal the Law on Promotion of Leasing Activities. In particular this incorporates:
 - a) The tri-partite nature of the leasing transaction;
 - b) The fair distribution of risks and rewards amongst the parties;
 - c) The balance equation of the role of the lessor as an investor in capital goods and the lessee as the beneficiary of the use of productive, revenue generating assets;
 - d) Adequate remedies to enforce the rights of the parties; and
 - e) Equitable measures to avoid gross disparity between the parties.

New Regulation on Leasing Civil Code

Definition of Leasing – Art. 576

- Self-contained regulation, independent from rent and hire
- Economic and accounting concepts have no impact over rights and obligation of the parties.
- It is three party transaction provided that:
 - a) The lessee identifies the assets and selects the supplier from which the assets will be purchased or *otherwise obtained*; and
 - b) The lessor purchases assets for leasing and the supplier is well aware of this fact.
- Exceptions from three party rule
- Limitations with regards to the lease assets

New Regulation on Leasing Civil Code

Obligations of Supplier – Art.577, 580, 580¹

- Imperative sharing of the obligations of supplier towards the lessee as well
- Imperative obligation of the lessor to assign rights towards supplier to the lessee, however without right to amend or terminate them
- *Other provisions of the law generally follow the Freedom of Contract principle.*
- Only the supplier is liable for defect, non-delivery or late delivery of the leased asset, not the lessor.

New Regulation on Leasing Civil Code

Hell or High Water Clause – Art. 579

- The lessee has to perform under the lease unconditionally.
- The lessee does not have the right to terminate the lease even if the lessor breaches its obligations, *except for the case where the lessee cannot enjoy quite possession over the leased asset.*

Leasing Legislation

Assignment – Art. 580²

- Assignment of all rights of the lessor under the lease is permitted without the possibility of the lessee to assert against the new possessor all those defenses that he had against the initial lessor
- Assignment of rights without transfer the title over leased asset is also allowed.

Leasing Legislation

Claim for Damages – Lessor

- The lessee has no rights to the proceeds from the sale of a leased asset if the termination occurred due to the lessee's default.
- The amortized value of the lease asset generally is not relevant anymore.
- The general rule under Article 414 shall be taken into consideration together with Article 420 when defining the amount of damage to the lessor.

Question: How shall the time for the performance of lease payments be taken into account if acceleration of the payments is requested by the lessor during early termination of the lease due to the lessee's default?

Leasing Legislation

Claim for Damages – Lessee Art. 580⁶.2

- The lessee is entitled to claim damages from the lessor if incurred due to:
 - The lessor repossessing the asset unlawfully.
 - The lessor has not provided for an additional period commensurate with Part 1 of Article 405 of this Code, except for the case, when there is no need to provide for such an additional period under Part 2 of Article 405.
- However, the lessee shall not be entitled to demand the restitution of possession over the leased asset.

Break



**If you like to deal with taxes, you are
welcome to stay...**

Improving the Leasing Framework

- The new law will provide some reforms of the Tax Code as far as leasing is concerned.
 - Inspiration Principles:
 - Clarity and certainty
 - Simplicity
 - More potential revenues for the Government: **We did not ask for fiscal sacrifices**
 - Reflective of the economic reality
 - Applies equity to leasing financing vis-a-vis other forms of financing. In particular, levels the playing field

Improving the Leasing Framework

- Adopted changes:
 - a. Lessors will be able to depreciate the leased assets according to their economic reality.
 - b. Lessors shall be entitled to the alternative depreciation method that applies to all other tax payers
 - c. Lessees shall be entitled to deduct their rentals in full.
 - d. Lessors shall be entitled to deduct interests according to their economic reality, neither subject to legal limits nor subject to presumptions of minimum rates.

Improving the Leasing Framework

- Adopted changes (cont'd):
 - e. Leasing transactions must not be subject to anti-avoidance provisions, such as thin capitalization or market value adjustments.
 - f. Funding via sale and lease back shall be available to all Georgian businesses without imposing on them excessive taxation.
 - g. Property taxes will apply to leasing companies based upon economic reality and shall be final and expeditious to provide stable revenue generation to the Georgian Treasury. Property tax exemptions shall be based in the economic nature and purpose of the asset and not the quality of the owner.
 - h. Leasing companies must be allowed to deduct bad debt reserves according to their financial nature.

Depreciation or deductibility of rentals: The Case for Georgia

- Before the changes in regulations, the tax system for leasing companies was highly discriminatory.
- All Taxpayers were allowed to claim a 100% bonus depreciation, except leasing companies.
- The new regulation leveled the playing field between leasing companies and all other tax payers providing financing.
- The normal depreciation system applies economic reality for leasing companies by adjusting depreciation to the depletion of the net present value of future rentals and residual value.

Bad debt relief: The Case for Georgia

- Two basic aspects associated with bad debts:
 - Possibility of leasing companies to deduct bad debt reserves. This is now possible up to an 80% for past due over 60 days. Downside: Leasing companies may have a potential tax cost when the reserve exceeds 80% (Good practices suggest after 180 days)
 - Late charges and penalties associated to a defaulted lease are now based in the cash accounting system for tax purposes.

Anti-avoidance rules: The Case for Georgia

- Leasing companies were subject to certain anti-avoidance provisions:
 - Thin capitalization (Article 123 of the Tax Code). This one was reformed.
 - Market Value Adjustment (Article 147 of the Tax Code). This one was removed.

Anti-avoidance rules: The Case for Georgia

- Leasing companies are subject to certain anti-avoidance provisions:
- Thin capitalization (Article 123 of the Tax Code):
 - Unless leasing companies are officially recognized as financial institutions, thin capitalization would be wrong because it seems to start from the premise that leasing is a tax avoidance tool. Nothing could be further from the truth.
 - Leasing companies can play the role of providers of capital if they can raise debt capital in at least seven to eight times their equity.
 - Provisions imposing thin capitalization based upon a prescribed maximum leverage rate of 5:1 still discourages investment in leasing companies and still is an impairment for capital formation in Georgia.

Indirect Taxation

- For Georgia: Property Tax
- Tax burden was relieved representing a 0.6% of the initial book value.
- Still this is a 0.6% burden to the return of assets (ROA) of such a company.

Indirect Taxation

- This means that the impact of such Property Tax on the Return on Equity of such a company, assuming an 8:1 leverage ratio, can be assessed at an 4.8% burden (Impact on pricing and profits).
- In other jurisdictions, Property Tax operates as an Alternative Minimum Tax to the equivalent of the Profit Tax. However, in the case of Georgia, this is not possible, because Property Tax is a local tax.
- This improvement is still a potential deterrent to foreign investors or may lead to higher cost of equipment leased.
- Still there is room for improvement.

Taxation on Cross Border Leasing

- Apply to both direct leases and subleases
- Two (2) systems apply globally:
 - Exception to the territoriality principle and elimination of double taxation, following OECD guidelines of 1983
 - Taxation at the base rate (No surcharges):
 - In financial leasing, only the financial component of the rental
 - In operating leasing, the whole of rentals
- In Georgia, the withholding tax rate should be 10% for both financial leases and to operating leases, provided that lessor does not have a permanent establishment in Georgia.

Taxation on Cross Border Leasing

- Permanent establishment:
 - For leasing purposes, Article 29 was reformed by presuming permanent establishment in the case that the lessor monitors assets and performance through an agent or employee.
 - In such a case, the foreign lessor can file a tax return and claim deductions, but should pay taxes at a 15% rate.

Taxation on Cross Border Leasing

- Value Added Tax
 - All lease payments are subject to 18% VAT, which must be withheld by the resident lessee simultaneously with the remittance of the lease payment.
 - The same lessee may claim a VAT credit for the amount withheld in the case where the lessee is a VAT payer. Otherwise, VAT should be an additional expense.

Taxation on Cross Border Leasing

- Export Leases:
 - Lease payments are subject to general taxation for Income Tax purposes.
 - VAT shall be exempt on the grounds that the lease should be treated as an export of services and connected to an export of goods.

Double Taxation Treaties

- Under the OECD rules, Double Taxation Treaties intend to avoid double payment of taxes for international transactions.
- Georgia has Double Taxation Treaty with more than 30 countries.
- Corporate residents are subject to taxes over their worldwide income.

Tax effects of the new regulation of leasing

Overall Discussion

Ministry of Finance, Revenue Service
01/30/2012

Leasing and Capital Investment

- Leasing is responsible for a share of capital investment in all developed and emerging markets.
- In emerging markets, leasing fills the space open by the under development of other investment vehicles, such as venture capital, bank lending and others.
- Therefore, leasing trends and opportunities are tied to overall investment trends and opportunities in emerging markets.

Linkages between Leasing and Economic Development

Equipment Investment and Economic Growth: J.B. De Long & Lawrence H. Summers, Harvard University

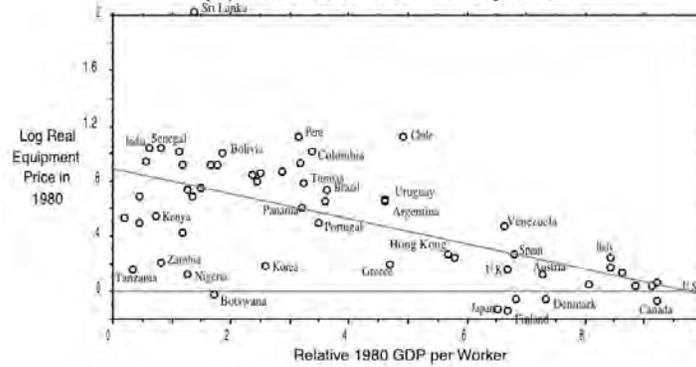
- “Equipment investment is a cause of rapid productivity growth.”
- “Fast-growing countries are those with favorable supply conditions for producers’ equipment.”
- “The richest countries (are) those that were first in inventing and applying capital intensive technologies.”

Linkages between Leasing and Economic Development

- “Countries which adopt the price and quantity structure of more affluent nations are more likely to grow.”
- “Nations which invested heavily in equipment relative to other nations at the same stage of development enjoyed rapid growth over 1960-1985.” (Japan vs. Argentina)

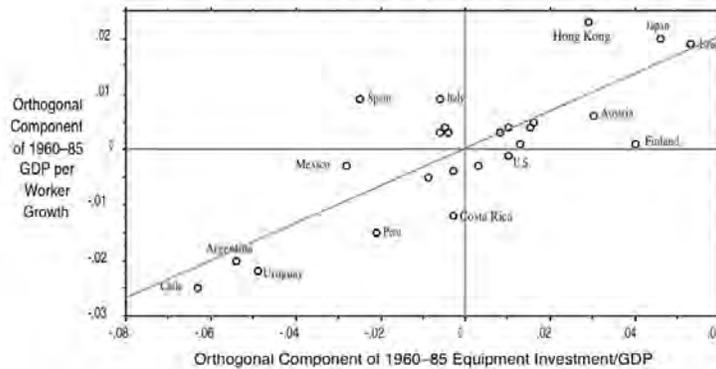
Linkages between Leasing and Economic Development

Figure 1
Equipment Prices and Productivity in 1980



Linkages between Leasing and Economic Development

Partial Scatter of Growth and Equipment Investment, 1960-85



Why Promoting Leasing is Important

- Leasing increases access to financing of equipment.
- The secondary market enables new players to acquire equipment.
- If Georgia wants to achieve a GDP growth rate of 10%+, the leasing industry must grow at least 25% annually.

Incentives to leasing

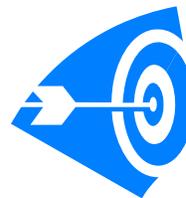
- There is evidence that leasing is the cause of greater economic development.
- How must leasing be incentivated?
 - DeLong and Summers respond that by creating the economic conditions to make capital equipment comparatively cheap for entrepreneurs...
 - If some elements of cost, such as the exchange rate, and the effects of technology cannot be controlled in the short term, the best known propellor is the tax and fiscal policy.

International Experience

- The world's largest leasing industries (USA, UK, Japan, Europe, Brazil, Mexico, etc.) have developed their leasing industry by providing certain tax incentives

Objectives of Tax Incentives for Leasing

- Stimulate the access of SMEs to capital goods
- Allow leasing companies to develop risk-balanced portfolios
- Encourage foreign investment
- Generate more tax revenues by enhancing the economic taxable base
- Rationalize VAT management
- Motivate cross border or international financial leasing



Tax approaches that have developed Leasing industries

- Investment Tax Credit (ITC)
- Depreciation and/or deductibility of rentals
- Indirect taxes (VATs and others)
- Cross border leasing taxation

Tax Incentives to Leasing

- The Investment Tax Credit is a tax credit or lesser value to pay once the tax payable has been determined:
 - Long history in the United States since its introduction by President Kennedy in 1962;
 - Extended to Europe, Asia Pacific and Latin America
- Application of ITC:
 - Revenues
 - Less: Cost
 - Equal: Gross Income
 - Less: Deductions (Including depreciation)
 - Equal: Income before taxes
 - Times: Tax rate (30%)
 - Equal: Tax payable
 - Less: Tax Credits
 - Equal: Tax due to TRA

Tax Incentives to leasing

- Countries such as Belgium, Chile Finland, Slovakia, Russia and Turkey have applied investment tax credits.

Source: LEASEUROPE and The Alta Group

Tax Incentives for leasing

- Chile grants an Investment Tax Credit of 4% “of the value of the physical goods to become fixed assets, which have been acquired as new or finished to be built during the fiscal year... with the top of 500 Tax Units (each Tax Unit equal to US\$ 45 today)...This incentive is applicable to leased assets. In such cases the tax credit is calculated over the total rentals under the lease.”



- In addition, to all new capital goods manufactured in the country, the first purchaser has the right to receive a tax credit equal to 73% of the corresponding Customs duty rate determined on the net price of the invoice and applicable to the Harmonised System classification of the corresponding equipment.

Depreciation or deductibility of rentals

- Full deductibility of rentals has the same effect of granting accelerated depreciation to the lessee.
- Accelerated depreciation:
 - United States:
 - 1954: Accelerated Depreciation Rate (ADR) case by case, substituted by...
 - 1981 (ERTA) the Accelerated Cost Recovery System (ACRS), until...
 - 1986 when it was changed to the Modified Accelerated Cost Recovery Systems (MACRS).
 - In 2003, “bonus depreciation” of 100% for the first year (In force until December 31, 2012) for qualified property

Depreciation or deductibility of rentals

| EUROPEAN COUNTRIES WITH ACCELERATED DEPRECIATION | |
|--|--|
| COUNTRY | SYSTEM |
| BELGIUM | At taxpayer discretion if certain conditions are met |
| CZECH REPUBLIC | At taxpayer discretion if certain conditions are met |
| DENMARK | Double declining balance system |
| FINLAND | Double declining balance system |
| FRANCE | At taxpayer discretion if certain conditions are met |
| GERMANY | At taxpayer discretion if certain conditions are met |
| IRELAND | Depreciación acelerada para ciertos tipos de equipos |
| LUXEMBOURG | At taxpayer discretion if certain conditions are met |
| NETHERLANDS | Accelerated depreciation for certain kind of equipment |
| POLAND | Accelerated depreciation for certain kind of equipment |
| PORTUGAL | At taxpayer discretion if certain conditions are met |
| RUSIA | Accelerated depreciation for certain kind of equipment |
| SPAIN | At taxpayer discretion if certain conditions are met |
| SWEDEN | At taxpayer discretion if certain conditions are met |
| SLOVAKIA | At taxpayer discretion if certain conditions are met |
| SWITZERLAND | At taxpayer discretion if certain conditions are met |

Fuente: LEASEUROPE, Informe a 2002

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