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Leasing

An Underutilized Tool in Rural Finance



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Cover art

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Foreword

Rural enterprises—farm and nonfarm alike—face inadequate access to financial services as a major constraint to increasing their productivity. Access to investment finance is particularly scarce. This paper examines the potential of leasing as a financing tool that can be used to acquire productivity-enhancing assets even when regular bank financing is unavailable. It reviews the experience of several entities across the world that provide leasing services to rural enterprises and the legal, regulatory, and policy environments required for the development of leasing markets. It makes several recommendations for World Bank support to expand access to leasing in rural areas.

Addressing the challenge of increasing access to financial services in rural areas requires efforts on several fronts and the use of various approaches. Supporting the development of innovative tools and their adoption by financial service providers is a crucial part of this strategy. This paper introduces readers to an underutilized financing tool that could significantly improve the access to investment financing for farms and other rural enterprises.

I encourage task managers at the World Bank and other development practitioners to look at leasing and other innovative tools as a means to enhance access to investment finance for rural enterprises.

A handwritten signature in black ink, appearing to read "K. Cleaver", with a horizontal line extending to the right.

Kevin Cleaver
Director, Agriculture and Rural Development

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Acronyms and Abbreviations

ALM	Asset Liability Management
ANED	Asociación Nacional Ecu�mica de Desarrollo
CALP	Central Asia Leasing Project
CECAM	Caisses d'Epargne et de Credit Agricole Mutuels- Savings Bank and Agricultural Credit Union
DEG	German Development and Investment Company
DFCU	Development Finance Company of Uganda
DFID	Department of International Development
EBRD	European Bank for Reconstruction and Development
FAO	Food and Agriculture Organization of the United Nations
FMO	Netherlands Development Finance Company
FERT	Formation pour L'Esp�nouisement et le Renouveau de la Terre (Education for Growth of the Earth)
IAS	International Accounting Standard
IFC	International Finance Corporation
MFO	Micro-finance Organization
MIS	Management Information System
NLCL	Network Leasing Corporation Limited of Pakistan
PEP	Private Enterprise Partnership
RFP	Rural Finance Project in Romania
SECO	State Secretariat for Economic Affairs in Switzerland
SME	Small and Medium sized Enterprises
USAID	United States Agency for International Development
VAT	Value-Added Tax

Executive Summary

Farms and other rural enterprises often lack access to long-term credit needed to acquire equipment because they do not have the required collateral. Most assets that rural enterprises own cannot be used as collateral: titles to land are often nonexistent and movable assets such as livestock and warehouse receipts are not legally permissible as collateral. Leasing is a financing tool that overcomes this constraint. In leasing, the provider (lessor) owns the equipment and permits the client (lessee) to use the equipment in exchange for periodic payments (lease payments). For most rural enterprises, leases are also a means of acquiring equipment (and not just its use) and ownership is transferred to the lessee at the end of the lease period, either automatically or at a token price.

The objective of this paper is to examine the potential of leasing as a rural finance tool. The paper analyzes the utility of leasing for rural enterprises as a means to acquire equipment and reviews the experience of a cross-section of entities providing leasing in rural areas. Additionally, the paper provides an overview of leasing (types, advantages, risks, and enabling environment) and reviews World Bank and International Finance Corporation (IFC) experience in supporting development of the leasing sector. The paper concludes by providing recommendations for enhancing World Bank support to expand access to leasing in rural areas.

Leasing offers several advantages over loans, both to the lessees and to the lessors. For lessees, the most important benefit is access to a source of finance. For farms and other rural enterprises with no access to bank loans, this could be their only means. In addition to access, leases may be more affordable than loans because down payments are lower than bank requirements and additional collateral is seldom required. From the lessor's perspective, the lessor has a stronger security position compared to that of the lender. In a lease, the lessor owns the equipment. In contrast, in a secured loan transaction, the borrower owns the equipment; the lender only has a charge on the collateral (which usually includes the equipment). In the case of default, repossessing a leased asset is much easier than repossessing a collateral. In many countries, creditor rights are weak and a lender is forced to be involved in lengthy court proceedings in order to take possession of collateral, while the lessor, as the owner of the asset, can repossess a leased asset without going to court.

Leasing is also likely to incur lower transaction costs compared to loans. Transaction costs involved in creating, perfecting, and enforcing security interests can be costly because of poorly functioning asset registries and inefficient judicial systems, particularly in rural areas. The lower transaction cost for leasing is likely to benefit both lessors and lessees.¹ Tax benefits, the second potential benefit in leasing, are not available to loans, but these are generally less relevant in the rural context in developing countries. In several countries, leasing also has the advantage of not being constrained by restrictions such as interest rate ceilings and sector quotas for credit allocation.

The leasing survey for this study covered 10 lessors from Africa, South Asia, Central Asia, and Latin America. They included three microfinance organizations (one bank, one NGO, and one cooperative), six private leasing companies, and one state-owned company. The private companies included one specializing in microleases and one equipment manufacturer. In 2002/2003, the surveyed lessors provided over US\$125 million in leases to rural enterprises with over 75 percent for agricultural or agricultural processing equipment. While these data are not indicative of the size or nature of the global rural leasing

¹ The process of establishing a charge over the asset that is used as a collateral, establishing this claim, and the enforcing (repossessing the collateral) it in the case of default.

because the survey was neither exhaustive nor representative, it indicates the significance of the sector and the potential of leasing as a rural finance tool.

Both farm and nonfarm rural enterprises acquire equipment through leasing and farm equipment leasing is the largest segment of leases. In 2002, John Deere, Mexico provided more than US\$25 million in agricultural equipment leases and DFCU Leasing, Uganda provided more than US\$4 million. In 2003, AgroMash Leasing, Kazakhstan provided US\$1 million in farm equipment leases. Leased equipment included tractors, power tillers, water pumps, rice hullers, dairy processing equipment, and maize-milling equipment. Leased nonfarm equipment included computers, welding units, vehicles, and solar photovoltaic units.

In terms of scale, both micro-enterprises and small and medium enterprises (SMEs) in rural areas benefit from access to leasing. Grameen Bank in Bangladesh is the largest provider of leases to microenterprises; CECAM in Madagascar, NLCL in Pakistan, and ANED in Bolivia are the other providers of microleases. CECAM and NLCL also offer leases on used equipment, and as these are less costly leases, they are more affordable for many lessees. Most rural SMEs are located in small towns and include both agriculture-based enterprises such as milk-processors and cold storages and other industrial enterprises. Orix Leasing in Pakistan and DFCU Leasing in Uganda serve such enterprises. Around 10 percent of leases provided by Orix Leasing in 2003 (approximately US\$10 million) and 47 percent of DFCU Leasing's lease portfolio (US\$7.5 million) were for enterprises in small towns. DFCU's special initiative, the Uganda Energy Fund (US\$4 million), targets rural SMEs.

As for all economic activity, an enabling environment is important for the development of the leasing sector. The two critical elements are a clear legal basis and minimal regulation. Use of internationally accepted accounting standards and a tax code that is not biased against leasing would also enhance the development of the leasing sector. Elements of a good legal framework for leasing include: clear definitions of a lease contract, leased assets, and responsibilities and rights of parties to a lease contract; clarity in allocating responsibility for liability of third-party losses arising out of the operation of leased assets; priority of lessor's claim over leased asset; and a framework for easy and fast repossession of leased assets.

For an enabling regulatory environment, two key issues are whether leasing warrants prudential regulation, and whether institutions subject to prudential regulation (particularly banks) should be permitted to provide leasing services. It is generally accepted that leasing companies should not be subject to prudential regulation if they do not obtain public deposits (they rarely do). As for the latter, it has been argued that they should be permitted to provide finance leases (leases that amortize the full costs of the equipment leased) because these are not significantly riskier than loans.

Within the World Bank group, IFC has significantly more experience in leasing than the World Bank. Over the past 25 years, IFC approved US\$1.04 billion in 179 projects in 56 countries. These have included both investments in leasing companies, through debt and equity finance, and in projects with an exclusive focus on technical assistance. The Russia Leasing Development Group (RLDG) Project and the Central Asia Leasing Project (CALP), two technical assistance projects reviewed for this paper, are IFC projects. In comparison, only three World Bank projects involving leasing could be identified: the Microenterprises Development Project in Pakistan (completed), the Rural Finance Project (RFP) in Romania (ongoing), and the Micro, Small, and Medium Enterprise (MSME) Project in Nigeria (proposed). Of these five projects, only the Romania project has an exclusive rural focus.

IFC has made equity investments in three of the surveyed lessors: DFCU Leasing in Uganda, Uzbek Leasing in Uzbekistan, and Orix Leasing in Pakistan, and provided a guarantee for NLCL in Pakistan. Under the RFP project, leasing companies are eligible to access loans; the Nigeria MSME project envisages start-up grants for leasing companies. The Russia Leasing Development Group (RLDG) project and the Central Asia Leasing Project (CALP), and the RFP have also significantly contributed to

improving the environment for leasing by improving the legal, accounting, and taxation framework, and by providing technical assistance to lessors.

The paper makes four recommendations for World Bank involvement in enhancing access to leasing in rural areas of developing countries. First, the World Bank should increase the availability of information on the demand and supply of leasing (by banks and other institutions) in rural areas. Analytical work on rural finance should incorporate assessments of access to leasing. Second, the World Bank should incorporate operational support (technical and financial assistance) for leasing into rural finance projects and other projects that have rural finance components. Credit lines for rural finance should not discriminate between lenders and lessors, and projects with policy reform components should include reforms specific to leasing. Third, the World Bank should also consider creating, in cooperation with IFC, regional leasing development facilities along the lines of RLDG and CALP to provide technical assistance for both policy reforms and leasing providers. Fourth, developing collaborative arrangements with other development agencies (such as the USAID and DFID) and development investors (such as the Netherlands Development Finance Company (FMO) and the German Development and Investment Company (DEG)) that have significant experience in supporting leasing development could also be beneficial. This could be done within existing and new projects.

1. Introduction

Rural enterprises, both farm and nonfarm, require equipment to increase their productivity. The development of rural infrastructure also depends on availability of equipment. However, access to long-term finance needed to acquire equipment is limited in rural areas of most developing countries. The objective of this paper is to explore the potential of leasing as a financing tool to help rural enterprises acquire productivity-enhancing equipment. Towards this purpose, the paper analyzes the relevance of leasing in the rural context and reviews the experience of a cross-section of entities providing leases in rural areas. Additionally, the paper provides an overview of leasing in general (advantages, risks, enabling environment) and reviews World Bank and International Finance Corporation's (IFC) experience in supporting the development of leasing. The paper concludes by providing recommendations for World Bank support for enhancing access to leasing in rural areas.

Previous literature has analyzed the development impact of leasing in emerging markets (Carter 1996), assessed the relevance of leasing to micro and small enterprises (Gallardo 1997; Mutesasira, Osinde, and Mule 2001), analyzed leasing as a tool for equipment financing by microfinance organizations (Westley 2003), provided guidelines for designing leasing programs in developing countries, and examined leasing in the context of term finance for agriculture (Deelenand others 2003; FAO and GTZ 2004). The scope of this study is restricted to examining the potential of leasing as a rural finance tool. The methodology for this study involved a survey of literature, interviews with selected respondents, and structured questionnaires to collect outreach, product, and financial data from leasing service providers. Wherever possible previously published information on leasing in rural areas has been updated. Selected World Bank and IFC projects on leasing have been reviewed in detail.

The paper is organized as follows: this chapter defines and describes different types of leasing, and the advantages of and risks in leasing; Chapter 2 analyzes the relevance, extent and potential for leasing in rural areas, and discusses company level issues for equipment leasing; Chapter 3 discusses elements of an enabling environment for leasing; Chapter 4 reviews donor, particularly World Bank Group, experience in supporting leasing development; and lastly, Chapter 5 summarizes the conclusions of the study and makes recommendations for further World Bank work in this area.

Leasing—An Overview

In most industrial countries, leasing is a key source of investment financing provided by equipment manufacturers, banks, and independent leasing companies. Starting out as a manufacturer's tool for increasing sales, it has evolved into a specialized service that serves most sectors of the economy including agriculture (farm equipment leasing contributes to over 10 percent of the US\$242 billion U.S. leasing industry).² In most developing countries equipment leasing is in its infancy. However, in countries where it has developed significantly, its development impact is estimated to be significant. Appendix 1 gives an overview of the global leasing market and its development impact in emerging markets.

Brealey and Myers (2003) define a lease as a rental agreement that extends for a year or more and involves a series of fixed payments. More formally, leasing is a contract between two parties, where the party that owns an asset (the *lessor*) lets the other party (the *lessee*) use the asset for a predetermined time in exchange of periodic payments. In leasing, as in the case of simple rentals, legal ownership and use of

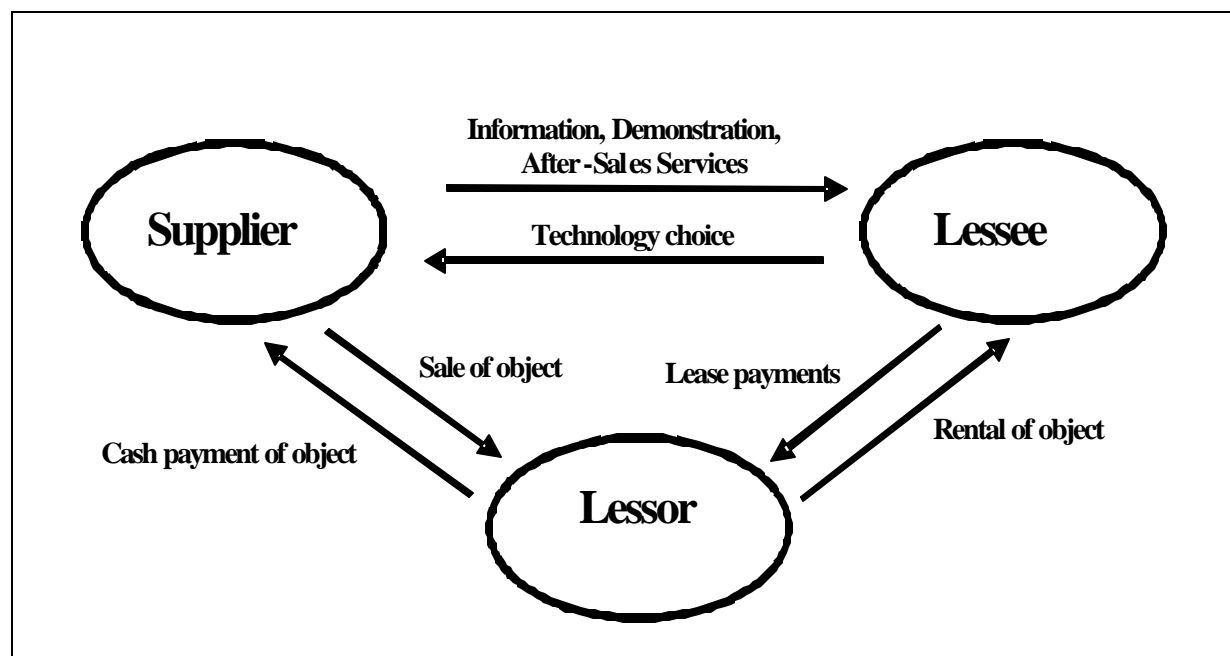
² All amounts are in U.S. dollars.

an asset are separated. Leasing allows enterprises that either do not wish to purchase equipment (because leasing is cheaper) or cannot do so (because they do not have the required funds and lack access to bank finance) the opportunity to use equipment without having to own it. The business philosophy that underlies leasing is that profits are earned through the use rather than the ownership of assets (Gallardo 1997).

Leases are broadly of two types: *finance leases and operating leases*. In a *finance lease*, the lease period typically extends for a significant period of the equipment's economic life and risks of equipment obsolescence, maintenance, and insurance are borne by the lessee. Finance leases are usually noncancelable, making them similar to term-loans (both bind the equipment user to a series of future payments—lease payments in the case of a lease, and interest and principal in the case of a loan). When a lease amortizes full equipment cost, the lease is a *full payout lease*; such leases usually establish a token price, such as US\$1, at which the lessee can purchase the equipment at the end of the lease term.

The typical *finance lease* is a three party deal (see figure 1) and operates in the following manner in a market with a developed leasing sector. The equipment user first chooses the supplier after comparing brands, price, warranty, maintenance, etc, offered by different suppliers. The supplier provides a price quote to the equipment user, who then chooses a lessor after comparing lease terms (equity required, lease period, purchase options at the end of the lease term, etc) offered by different lessors on the given price quote. After the equipment user (now the lessee) and the lessor sign a lease agreement, the lessor purchases the equipment from the specified supplier. The supplier delivers the equipment to the lessee.

Figure 1. A typical finance lease



Source: Adapted from FAO and GTZ (2004).

In an *operating lease*, the lease is over a period that is substantially less than the asset's economic life. The lessee does not intend to purchase the asset. The lessor recovers the asset cost through multiple leases and the equipment's final sale. Hence, estimation of residual value of the asset (value at the end of a lease term) is important in operating leases. Maintenance costs and obsolescence risks lie with the lessor. To

provide operating leases, lessors may also need additional institutional infrastructure such as warehouses and maintenance personnel. Thus, operational leasing bears additional risk over and above financial leasing. Table 1 presents the broad differences between the two major leasing types and loans.

Table 1. Differentiating loans, finance leases, and operating leases.

<i>Criteria</i>	<i>Loan</i>	<i>Finance Lease</i>	<i>Operating Lease</i>
Legal ownership of equipment	Borrower	Lessor	Lessor
Securing the transaction	Typically chattel mortgage on equipment and additional collateral	Equipment ownership	Equipment ownership
Equity / Security Deposit	High	Medium	Low
Responsibility for maintenance and insurance	Borrower	Usually Lessee	Usually Lessor
Risks (damage, residual value risk etc)	Borrower	Usually Lessee	Usually Lessor
Cancellation Option	NA	Usually not available	Usually available

Source: Authors.

The types of leases available in a market depends on the maturity of the leasing sector in that market (Amembal 2000). At the nascent stage, the major type is usually a simple finance lease—primarily a mechanism to buy equipment. As the market develops, creatively designed finance leases and operating leases catering to market niches become more common. While operating leases are used for only large and costly items (ships and airplanes) in emerging markets, leasing for equipment and vehicles becomes common as the sector matures. Not surprisingly, the majority of leases provided by firms reviewed in this study are finance leases.

Lease vs. Borrow: The Client Perspective of Leasing

Leasing and purchasing are alternative means of acquiring equipment. However, purchasing is a feasible option for most enterprises only if they have access to credit. This is often not the case for many because they lack credit history, do not have assets that can be used as collateral, or have insufficient funds for the equity contribution required for loans. In contrast, leasing usually does not require additional collateral and requires a lesser down payment (than required by banks). This is possible because of the stronger security position of the lessor compared to that of the lender. In developed leasing markets, the down payment required in finance leases is often between one to four percent, significantly less than the 20 to 30 percent equity banks typically expect.

When borrowing is a feasible option, the recommended method to make a ‘lease versus borrow’ decision is to use Net Present Value (NPV) analysis. If leasing has a tax-advantage, the lease payments could be lower than equivalent loan payments (interest and principal) because lessors transfer a part of their tax-benefits to the lessee in the form of lower lease payments. The NPV of lease payments could also be lower because of a lower down-payment, and if the lessee is a tax payee, because lease rentals offer a larger tax-shield (compared to interest and depreciation in the case of a loan). Appendix 2 demonstrates an example of using NPV analysis to chose between a finance lease and a loan.

Lease vs. Lend: The Provider Perspective of Leasing

From a providers’s perspective, leasing has significant advantages over lending. These include:

- ❑ *Stronger security position:* This is perhaps the most important advantage in developing countries, where unclear property rights, poorly functioning asset registries, and weak laws of secured transaction constrain lending. In case of default, legal ownership of the equipment allows a lessor to repossess equipment more easily than it is for a lender to take possession of a collateral (in case of loan repayment defaults). The nature of asset ownership in a lease transaction also has an advantage if the lessee declares bankruptcy. Under bankruptcy, lease payments have priority over loan payments and typically, the lessee is allowed to continue making lease payments. Furthermore, even if the lessee is not permitted to make the lease payments, the lessor can always repossess the equipment (unlike lenders who have to wait for the decision of a bankruptcy court before they can take possession of the collateral).
- ❑ *Lower transaction costs:* Anecdotal evidence suggests that transaction costs of contracting a lease is likely to be lower than that of executing a loan contract since the cost of creating, perfecting, and enforcing security for loans is avoided.³ In most developing countries, asset registries are not computerized and are fragmented geographically or by type of asset. This makes security perfection a long and costly process. Similarly, enforcing security is typically a cumbersome process and costly process. In contrast, repossession of leased equipment is usually faster and cheaper. Westley (2003) reports that in Bolivia and Ecuador leased goods are recovered typically in one to two months while it takes a year or more to recover loan collateral.
- ❑ *Lighter regulation:* In most countries, leasing companies are not subject to prudential regulation, and to other restrictions such as interest rate caps and sector-specific credit allocation common in several developing countries. This allows them more leverage in raising funds and flexibility to charge market interest rates, thereby reaching client segments that might be too risky and costly for banks to reach.
- ❑ *Tax benefits:* In a typical tax-treatment of leasing, lessors benefit from being able to take capital allowances on the leased equipment. However, the availability of tax benefits depend on whether the typical tax treatment of leases is available to all leases or are restricted to some leases. Chapter 3 discusses tax issues in further detail. Appendix 1 demonstrates this in more detail. Also, the net impact of taxes on leasing depends on other applicable taxes (value-added tax, capital gains tax, property tax, etc), whether the lessor and lessee are tax-paying entities, and on the length of lease terms (Westley 2003).
- ❑ The risks vary significantly depending on whether the lease is a finance lease or an operating lease. The risks for finance leases are not significantly larger than that that for loans because residual value risk is rarely involved and because the liability and litigation risk is offset by the lesser portfolio risk.
- ❑ *Portfolio risk:* This is the risk of lessees not making the lease payments as scheduled. However, the stronger security position of the lessor (compared to a lender) makes this risk likely to be less costly than that to a lender. Lessors use credit/lease history of the client to estimate this risk, and

³ Security creation is the process by which an asset owned by the borrower is converted into collateral for a loan. Security perfection involves making the existence of the security interest public, for example, through registration with an asset registry, and establishing its priority. Enforcement of a security interest involves taking possession and recovering the loan receivables through sale of a collateral when the borrower fails to repay.

compensate for high risk associated with a lessee by requiring additional collateral or higher equity (security depositor down-payment) or charging a higher lease payment.

- ❑ *Residual value risk*: This is the risk in wrongly estimating the value of equipment at the end of lease period. If the lessee maintains the equipment poorly, the equipment may be worth less than the expected residual value. This risk is less relevant for finance leases because they amortize all or most of the equipment cost, unlike in operating leases where lessors recover their costs through multiple leases.
- ❑ *Liability and litigation risk*: Since the lessor is the owner of a leased asset, the lessor is often liable for third-party losses arising out of the operation of leased assets. This risk is particularly important in the case of assets such as vehicles. Leasing also tends to have higher litigation risk since the difference in ownership and use rights makes it more complex than a loan. This makes the potential for legal disputes greater for leases than for loans. This is especially true in the case of more specialized leases such as retroleases (see box 1).
- ❑ *Changes in tax regulations*: This is the risk that if the tax-regulations change during the course of the lease period, and the expected tax-saving is not realized. This risk is relevant if the lessors depend significantly on the tax benefits typically available in leasing.

Box 1. Variants of a finance lease

Retro lease, also called *sale/leaseback*, is a variant of a finance lease where the client initially owns the equipment, sells it to the lessor in order to acquire working capital funds, and then signs a lease contract for the use of the equipment. Retro-leasing is a useful way of raising liquidity from existing assets.

Hire-purchase is a form of leasing where the lessor and the lessee share asset ownership, and with each payment, the lessee retains a higher share of equipment ownership. When the lessor completes making all agreed payments, the lessee automatically becomes the full owner of the asset. *Hire-purchase* is common in several countries for retail financing of smaller items, such as motorcycles, sewing machines, refrigerators, etc.

Source: Authors.

2. Leasing as a Rural Finance Tool

This chapter presents the rationale for supporting the development of leasing as a rural finance tool, and supports it with information collected from selected lessors providing leases in rural areas. Information from ten lessors (from eight countries) is presented. The first section presents the relevance of leasing in the rural context; the second section reviews experience of leasing in four major rural sectors; the third section compares the advantages and constraints of different institutional forms of lessors; and the last section discusses company-level issues relevant to leasing in rural areas. In addition to references made to lessors in the relevant sections, appendix 3 provides a comparison matrix of their leasing services and appendix 4 provides profiles of the lessors.

In 2002/2003, the leasing providers surveyed for this study had provided over US\$125 million in leases in rural areas (including small towns). More than 75 percent was for agricultural or agricultural processing equipment. The cases of rural leasing reviewed span several regions—Africa, South Asia, Central Asia, and Latin America, and several institutions—three microfinance organizations (one bank, one NGO, and one cooperative), six private companies, and one state-owned company. The private companies include one specializing in microleases and one equipment supplier. Nine out of the 10 lessors reviewed provided finance leases or its variants (retroleases and hire-purchase leases); only one provided operating leases. The data is not indicative of the size or nature of the rural leasing sector because the survey was neither

exhaustive nor representative; however, it indicates the significance of the sector and the potential of leasing as a rural finance tool.

Relevance

Leasing has the potential of partially addressing the market failure in rural credit. Access to credit is limited in rural areas of most developing countries. Commercial banks have poor rural outreach. Credit unions and microfinance organizations (MFOs) too have limited outreach in rural areas and generally provide short-term credit. Failure of most state-owned development banks has further exacerbated availability of term-loans in rural areas. Credit available from informal sources (money lenders, family, friends, etc.) is usually both short-term and too costly for investment-financing.

Leasing is an alternative to borrowing for rural enterprises to acquire equipment needed to modernize production and thereby increase productivity. Apart from the benefit of access to a means of financing equipment, leasing is also likely to be more affordable to rural enterprises than are loans. Farmers and rural enterprises are particularly constrained by the lack of assets that can be used as collateral. Leasing overcomes this constraint because it requires no additional collateral or less collateral than typically required by loans. Most of the surveyed lessors do not require additional collateral or require this only from a small proportion of lessees.

The lower down payments typically required by leases compared with the equity required by loans also makes leases more affordable to rural enterprises that have limited funds or access to borrowed funds. While the down payments required by the surveyed lessors are significantly higher than those required in developed leasing markets (15 to 25 compared to 1 to 4 percent), this is still lesser than the 30 to 40 percent equity required by banks in these contexts.

From the lessor's perspective, not having to obtain collateral is particularly advantageous in a rural context. While the difficulties involved in creating, perfecting, and enforcing security are applicable in both urban and rural contexts in most developing countries, it is more severe in rural areas where enterprises are less likely to hold titles to their asset, asset registries are less likely to be functional, and judicial systems more likely to be inefficient. They are also likely to benefit from not being restricted by interest rate ceilings and sector specific credit allocations—factors that have traditionally constrained rural lenders.

The tax-advantage of leasing is likely to be a less important factor in rural leases. Most lessees in rural areas do not pay taxes because of exemptions or because their incomes are lower than the minimum taxable levels. Hence, rural lessees are unlikely to benefit from the use of lease rentals as a tax-shield. They are more likely to benefit from reduction in lease rates if lessors can avail of tax-benefits (lessors using the capital allowances on assets as a tax-shield). This, in turn, would depend on whether the typical tax treatment is available to finance leases since most leases in rural areas are likely to be of this type. Rural lessees would also benefit if lease payments are exempted from value-added taxes (VAT) since most rural enterprises are unlikely to be able to use VAT credits.

Review of Sub-Sector experience

Agricultural equipment leasing

This is a large segment in emerging leasing markets in Eastern Europe, Central Asia, and Latin America. The availability of enabling legal framework and the commercialization of agriculture probably explains the significance of farm equipment leasing in these markets. Agriculture machinery leases in Russia in

2001 were over US\$64 million. Several multinational leasing companies such as Alpha-leasing, Raiffeisen-leasing, and John Deere have a presence in Russia (World Leasing Yearbook 2003).⁴ Box 2 lists major providers of agricultural equipment leasing reviewed in this study. Leased equipment include tractors, power tillers, water pumps, rice hullers, dairy processing equipment, and maize-milling equipment.

Farm equipment leasing, like lending to the agriculture sector, is constrained by the cyclical cash flow caused by seasonality and weather, and production and market-related covariant risks. In economies where the level of commercialization is high, higher cash incomes and risk-management mechanisms soften the effect of these factors. Their absence in economies with less commercialized agriculture could explain reluctance of leasing companies to grant leases to the agricultural sector (Mutesasira, Osinde, and Mule 2001). Nevertheless, the experience of DFCU, Grameen, ANED, and CECAM suggests that leases for agricultural equipment could be viable in less commercialized agricultural economies.

Box 2. Cases of agricultural equipment leasing.

- AgroMash Leasing in Kazakhstan provided US\$1 million in farm equipment leases in 2003.
- John Deere, Mexico provided over US\$25 million in agricultural equipment leases in 2002.
- DFCU Leasing in Uganda provided over US\$4 million in farm equipment leases in 2002. Lease equipment include rice hullers, dairy processing equipment, and maize-milling equipment.
- ANED in Bolivia has 53.2 percent its leasing portfolio for tractors.

Source: Leasing Survey 2003.

Microenterprises

Among the providers of leases in rural microenterprises, Grameen Bank in Bangladesh is the largest. Others include CECAM in Madagascar, NLCL in Pakistan, and ANED in Bolivia (see table 2). Comparing the average lease sizes and the per-capita GDP of these countries (Bangladesh US\$380, Madagascar US\$240, Bolivia US\$900, and Pakistan US\$420), leases provided by Grameen and ANED appear to serve the lower-tier, CECAM the middle-tier, and NLCL the upper-tier of microenterprises. Microenterprises often prefer used equipment since this is more affordable; CECAM and NLCL offer leases on used equipment. DFCU Leasing has recently started a pilot program for bee keeping and mushroom growing microenterprises (minimum US\$300 each), targeting 1,000 farmers over a two-year period.

⁴ However, since a significant share of this was from state-owned leasing companies, there was a significant decrease in leasing of agricultural machinery in 2001 following reduction of budget support.

Small- and medium-sized enterprises (SMEs)

Leasing and supplier credit are often the only source of finance available to SMEs (Carter 1996). They are usually too large for traditional microfinance and too small for commercial bank lending. In Uganda and Tanzania, Mutesasira, Osinde, and Mule (2001) identify these SMEs as those requiring between US\$1500 and US\$100,000 in funding. Apart from agricultural processing machinery, nonfarm equipment leased to SMEs include computers, welding machinery, and vehicles.

SMEs located in small towns are likely to have significant impact on rural development because economic linkages between rural areas and small towns. They include both agriculture-based enterprises such as milk-processors and cold storages, as well as other industrial enterprises. Orix Leasing in Pakistan and DFCU Leasing in Uganda serve such enterprises (see table 3). Around 10 percent of leases provided by Orix Leasing in 2003 (approximately US\$10 million) were for enterprises in small towns (population of less than 500,000). DFCU Leasing had 47 percent of its total portfolio (US\$7.5 million) in leases in small towns (population of less than 100,000). DFCU Leasing's Small Unit Leasing initiative (GBP 4 million) focuses on leases in the range of US\$1000 to US\$25,000, and its Uganda Energy Fund (US\$4 million) targets rural SMEs.

Rural infrastructure

Leasing is a potential source for financing equipment in rural road construction, nongrid electricity provision, and rural water-supply schemes. Several surveyed lessors—DFCU Leasing, CECAM, and Grameen Bank have provided leases for solar photovoltaic equipment as part of their regular leasing program. Some efforts to use finance leases under specific programs have been previously documented. In the case of rural road construction, state-owned leasing firms and equipment pools in Burkina Faso and Tanzania attempted operational leasing of road construction equipment. These initiatives failed because rental rates were often not high enough to cover costs of maintenance and amortization, and equipment was usually not properly maintained. The World Bank-funded Uganda Transport Rehabilitation Project had a financial leasing arrangement (see box 3). However, the lack of participation by private lessors makes it an unsustainable model.

Table 2. Major lessors providing leases to rural microenterprises

<i>Lessor</i>	<i>Leases Volumes (US\$ in 2002/2003)</i>	<i>Avg. lease size (US\$)</i>	<i>Approx. rural share in portfolio (%)</i>
Grameen, Bangladesh	25.3 million	364	100
NLCL, Pakistan	5.2 million	3000	20-30
CECAM, Madagascar	2.8 million	945	90
ANED, Bolivia	400,000 (portfolio)	1200	90

Source: Leasing Survey 2003.

Table 3. Major Lessors providing leases to rural SMEs

<i>Lessor</i>	<i>Leases Volumes (US\$ in 2002)</i>	<i>Avg. lease size (US\$)</i>	<i>Approx. rural share in portfolio (%)</i>
Orix Leasing, Pakistan	64.9	21,000	10
DFCU Leasing, Uganda	16 (portfolio)	27,375	47

Source: Leasing Survey 2003.

Box 3. Uganda: Transport Rehabilitation Project (1994-2000)

The leasing arrangement was a tripartite agreement between the government, an international consultancy firm (Norconsult), and a commercial bank (East African Development Bank). Norconsult was responsible for administration of the lease services while East African Development Bank was responsible for financial and business management services. The government procured the equipment and provided it to the contractors under finance leases for 48 months. The contractors were responsible for maintenance and insurance of the equipment, but were not required to pay the lease payments if the government failed to provide the contractor work during the lease period. When the project was completed, the effective lease periods were 38 and 21 months for 2 sets of leases. The average lease recovery was over 75 percent despite the shorter lease periods.

Source: Deelen and Osie Bonsu 2002.

Analyzing the constraints in providing equipment finance for small public works contractors, Deelen and Osie Bonsu (2002) identify the following as constraints to leasing: 1) high monitoring costs; 2) high maintenance costs because of distance to supplier shops and workshops; and 3) high cost of repossession because of the distances involved. However, in most developing countries, the main constraint is the lack of steady and predictable budget funding for public works (partly because of its dependence on donor funding) and lack of transparency in distribution of contracts. These factors make public-works contractors unattractive clients for leasing companies and dissuade contractors from committing themselves to a lease that requires regular lease payments.

Cabraal, Cosgrove-Davies, and Schaeffer (1996) analyze leasing of photovoltaic systems in household electrification projects. None of the four pilot initiatives (one in Indonesia and three in Sri Lanka) aimed at full-cost recovery; the Indonesian initiative had 0 percent interest rate and the Sri Lankan initiatives had interest rates ranging from 0 to 10 percent while prime lending rate was 17 percent.

Review of Lessors

Lessors surveyed for this paper include independent leasing companies, equipment manufacturers, cooperatives, and MFOs. Table 4 gives a comparative analysis of the advantages and disadvantages of different institutional providers of leasing.

Strategic linkages between leasing firms operating primarily in urban areas and development agencies operating in rural areas have the potential of increasing leasing outreach in rural areas. DFCU Leasing and the Gatsby Trust, a local NGO, in Uganda have such an agreement. The agreement is based on equal risk sharing whereby each partner supplies 50 percent of the cost of financing. If the possibility of effective linkages exists, MFOs might be better off developing them rather than starting a leasing program because of cost considerations.

Private leasing companies

Leasing companies are usually treated as nonbank financial institutions (NBFIs), which are subject to less stringent regulations than banks. This allows NBFIs to leverage more resources (higher debt/equity ratios), to be exempted from credit allocation requirements, and to use of market rates of interest. Because of their specialization, leasing companies also have better technical and financial skills required for leasing as leasing officers are better informed than bank officers about new equipment on the market, and have better skills in assessing value of used equipment and potential residual values.

Most specialized leasing companies, however, are urban-based, with a cost-structure that makes it uneconomic to provide services in rural areas. Yet, the experience of the leasing companies in this study indicates that providing rural services might be possible. Five of the ten providers are privately-owned

independent leasing companies (DFCU Leasing in Uganda, NLCL and Orix Leasing in Pakistan, Agromash Leasing in Kazakhstan, and Uzbek Leasing in Uzbekistan). In 2002, 47 percent of DFCU Leasing's portfolio, 20-30 percent of NLCL's portfolio, 6 percent of Uzbek Leasing's portfolio, and 100 percent of Agromash Leasing's portfolio were in rural areas. Orix Leasing had 10 percent of its leasing contracts in 2003 in rural areas.

State-owned leasing companies

State-owned leasing companies appear to have weaknesses similar to that of state-owned development banks. While their outreach appears significant, a large proportion of the leases are provided at subsidized interest rates with detrimental effects for organizational sustainability. Uzelkozmasleasing is the largest lease provider in Uzbekistan with more than US\$40 million in leases in 2002. Rosagroleasing, a state-owned leasing company (not surveyed for this paper), is the largest provider of farm equipment leases in Russia.

Commercial banks/commercial bank subsidiaries

The major advantage of a commercial bank providing leasing is its access to cheaper resources (retail deposits). A review of IFC's leasing investments found that banks are generally strong sponsors and have operational synergy in the form of local currency funds, distribution through branch network, market knowledge, operational expertise, cross-product pricing flexibility, and leverage on lessees (IFC 2003). In many countries, however, banks are not permitted to directly provide leasing services and can only do so by forming subsidiaries. Commercial banks with a significant number of rural branches have the advantage of being able to use their existing infrastructure to provide leasing services.

Microfinance organizations

MFOs reach a clientele not usually reached by commercial banks or independent leasing companies. As in the case of banks, MFOs have an existing clientele and the potential for operational synergies: ANED in Bolivia uses microleasing to finance assets while microcredit finances working capital requirements; savings services provided by CECAM in Madagascar help potential microlease clients build up the required down payments. The major constraint associated with MFOs providing leasing is the possibility that their limited resources and skills would be insufficient to handle the risks involved. Still, as Westley (2003) rightly argues, it may not be advisable for MFOs to set up leasing subsidiaries to provide leases given the relative costs and benefits of doing so. The costs of setting up a subsidiary are unlikely to be justified for most MFOs given the relatively small share of leases in typical MFO portfolio (8 percent in Grameen and 7 percent in ANED, although it is 27 percent in CECAM) and the MFO's leasing portfolio is unlikely to be riskier than its loan portfolio (if, as in the case of all the MFOs reviewed, these are finance leases).

Grameen Bank had a leasing portfolio of US\$22 million in 2003, all of it in rural areas. In 2002, CECAM provided US\$1.9 million (100 percent in rural areas) in leases and ANED had a leasing portfolio of US\$400,000 (90 percent of this estimated to be in rural areas).

Equipment manufacturers

Equipment manufacturers usually provide leasing as a value-added service through captive leasing companies. To the client, the advantage is that equipment purchase and financing are integrated. Multi-national equipment suppliers, such as John Deere, provide cross-border leases as well as operate domestic subsidiaries. John Deere in the U.S. has written cross-border leases in Latin America, Asia, and Eastern Europe. In 2002, its subsidiary in Mexico had a lease portfolio of nearly US\$58 million (85percent in agricultural equipment).

Table 4. Institutional types of lessors—advantages and disadvantages

<i>Institutions</i>	<i>Organizations in this review</i>	<i>Advantages</i>	<i>Disadvantages</i>
<ul style="list-style-type: none"> ▪ Private Leasing Companies 	<ul style="list-style-type: none"> ▪ Orix Leasing, Pakistan ▪ Network Leasing, Pakistan ▪ Agromash Leasing, Kazakhstan ▪ Uzbek Leasing, Uzbekistan ▪ DFCU Leasing, Uganda 	<ul style="list-style-type: none"> ▪ Specialized leasing companies have the advantage of specialized knowledge of the leasing technology and focused portfolios ▪ Less regulatory requirements 	<ul style="list-style-type: none"> ▪ Higher vulnerability to adversity than banks because of lower availability and higher cost of funds (IFC 2003)
<ul style="list-style-type: none"> ▪ State-owned leasing companies 	<ul style="list-style-type: none"> ▪ Uzelkozmalhoshleasing, Uzbekistan 	<ul style="list-style-type: none"> ▪ Significant outreach and institutional infrastructure 	<ul style="list-style-type: none"> ▪ Political interference in operations ▪ Culture of providing subsidies, and hence dependence on budget subventions
<ul style="list-style-type: none"> ▪ Banks / Bank Subsidiaries 		<ul style="list-style-type: none"> ▪ Access to cheaper funds ▪ Existing bank-branch network could be used to sell leasing products 	<ul style="list-style-type: none"> ▪ Need to comply with stricter regulatory requirements
<ul style="list-style-type: none"> ▪ Equipment Suppliers 	<ul style="list-style-type: none"> ▪ John Deere, Mexico 	<ul style="list-style-type: none"> ▪ Potential cost savings because lessor and supplier functions merged 	<ul style="list-style-type: none"> ▪ Single brand focus
<ul style="list-style-type: none"> ▪ Microfinance Organizations 	<ul style="list-style-type: none"> ▪ Grameen Bank, Bangladesh ▪ ANED, Bolivia ▪ CECAM, Madagascar 	<ul style="list-style-type: none"> ▪ Better knowledge of microenterprise finances and relatively low staff costs ▪ Synergy between microcredit and microlease 	<ul style="list-style-type: none"> ▪ Limited access to long-term funds ▪ Limited operational resources

Source: Authors.

Factors Affecting Supply and Demand of Leasing in Rural Areas

This section discusses company-level issues that have particular relevance in rural areas and issues that the surveyed lessors have innovatively addressed.

Down payment

The down payment required by the surveyed lessors is significantly higher than those typically required by lessors in developed leasing markets. While the high down payments are likely to make leases less affordable to rural enterprises, this is likely to be a response to the higher risks lessors face in a rural context. The surveyed lessors provide two reasons for requiring down-payments. One, in the case of repossession, some of the costs of seizure and change in market value could be recovered from the down-payment, and second, it creates a strong incentive for the lessee to keep making payments to avoid losing

the down-payment. Down-payments among the firms surveyed ranged from 10 percent to 40 percent, with most being in the range of 15-25 percent. Down-payments demanded also vary by equipment type. For example, CECAM requires 20 percent down-payment for equipment, but requires 25 percent for farm animals because of the higher risk of losing this asset. John Deere, Mexico demands 30 percent down-payment for agricultural equipment, but only 15 percent for construction equipment.

Monitoring

Monitoring is concerned with ensuring on-time lease payments and the physical presence of the leased assets. In rural areas, monitoring costs can be large because of the higher distances to lessee locations and their dispersion. However, innovative means to reduce monitoring costs can be used, for example, contracting a local business support center to monitor the leases. CECAM uses its strong community linkages to monitor its leases (see box 4).

Equipment maintenance

Although maintenance is the lessee's responsibility in finance leases (the most common type in rural areas), ensuring that adequate maintenance service is available is important to reduce the risk of default due to equipment breakdown. In rural areas where maintenance services may not be easily available, this is a significant risk. Better equipment maintenance could also be enhanced by: 1) incentives that encourage suitable maintenance by lessees, and 2) requiring equipment maintenance capabilities or obligatory training as a qualification criteria for being considered for a lease. ANED negotiates contracts with equipment suppliers that include technical training for new lessees.

Insurance

Two types of insurance are relevant in leasing: 1) multiperil insurance against the risk of incidental loss, damage, and premature damage; and 2) liability insurance for the risk of losses that may occur to others (harm to life, health, and property) from the use of the assets. The first is usually not mandatory while the second is mandatory for certain assets such as vehicles. Liability insurance is especially important in the cases of vehicle leases to protect the lessor from liability claims arising out of accidents. Non-availability of insurance services in rural areas could be a significant constraint to providing leases in rural areas.

Used equipment leasing

Leasing used equipment is likely to be more affordable to a larger number of rural clients than leasing new equipment. It also allows lessors to offer shorter-term leases—entailing lower credit risk and asset-liability management problems. Over 60 percent of leases written by DFCU Leasing are for used equipment (Kisaame 2003). Used equipment however have a higher risk of break-downs. CECAM requires a higher down-payment to offset the higher risks associated with used equipment (40 percent instead of 20 percent demanded for new equipment) (Fraslin 2003). When leasing companies lease used-equipment, they also create markets for used-equipment and make leasing more affordable.

Repossession

Repossession can be costly in a rural context because of the geographical dispersion of enterprises. Defaults resulting from natural disasters such as natural calamities and price fluctuations of agricultural

Box 4. CECAM, Madagascar: Monitoring of leased assets through solidarity groups.

CECAM's equipment leases are guaranteed by verbal commitment of solidarity group members, based in the same locality as the lessee. These members monitor the physical status of the asset and its appropriate use, and ensure that the asset has not been sold. If the lessee defaults, the group is liable for repayment. Given CECAM's prominence in rural areas and throughout the country, this has proven an effective way to reduce the costs of monitoring and to increase the quality in monitoring remote clients.

Source: Fraslin 2003.

commodities may also require renegotiation of contracts rather than repossession. For example, during a crisis in the fishing industry that seriously affected NLCL clients, NLCL renegotiated leases that facilitated the recuperation of funds for the company (Khan 2003).

3. Enabling Environment for Leasing

As for any economic activity, an enabling environment is crucial for the development of leasing. Two critical elements are clear legal basis and minimal regulation. The use of internationally accepted accounting standards and a tax code that is not biased against leasing would further enhance leasing sector development. Additional factors such as a clear property rights regime, adequate creditor protection, and well-functioning asset registries and credit bureaus (that enable financial activity in general) also contribute to the development of a strong leasing market.

Legal Framework

In most countries, the civil code provides the legal basis for leasing. Some countries such as United States, France, Argentina, Brazil, Russia, Korea, Indonesia, Morocco, and Ghana have specific leasing laws. Tajikistan, Uzbekistan, and Kyrgyz Republic have recently enacted leasing laws with support from IFC. Whether provided by a specific leasing law or by the general civil code, the effectiveness of the legal framework will depend on the following key elements:

- ❑ *Clarity in defining a lease contract, leased assets, and responsibilities and rights of parties to a lease contract:* The legal framework should define what constitutes a lease transaction, a leased asset, and the responsibilities and rights of the lessor and lessee. For example, it clarifies whether or not the lessor can use a leased asset as collateral to leverage further funding for the financial institution or company.
- ❑ *Liability:* Clarifying responsibility for liability of third-party losses arising out of the operation of leased assets is especially important because ownership and use of an asset is separated in leasing. This is particularly relevant in the case of assets such as vehicles because the risk of causing third-party losses is significant.
- ❑ *Priority of lessor's claim over leased asset:* This provides the basis for the advantage of leasing over lending under conditions of lessee bankruptcy. As the equipment owner, the lessor's claim to the asset should be superior to any claim creditors may have on the lessee.
- ❑ *Repossession:* Easy and fast repossession of leased assets is one of the main advantages the lessor has compared with the lender. The legal framework should permit noncourt repossession, so that lessors can repossess leased assets without going to court as long as the lessee does not contest the repossession. When repossession is legally and judicially easy, lessors can lend to riskier businesses and price their leases with a lower risk premium, making leasing available more cheaply (Carter 1996).

Regulation

Two key issues are whether leasing warrants prudential regulation, and whether institutions subject to prudential regulation (particularly banks) should be permitted to provide leasing services. Carmichael and Pomerleano (2002) define prudential regulation as the form of regulation involved in counteracting asymmetric information problems in financial markets. Information asymmetry arises where products or

services are sufficiently complex that other forms of regulation are insufficient. The general practice is to subject institutions that obtain public deposits to prudential regulation because of the information asymmetry problems faced by the large number of depositors in monitoring the use of their deposits. By this rationale, lessors that do not obtain public deposits (leasing companies in most countries, equipment sellers, NGOs,) should not be subject to prudential regulation. In several countries—developed leasing markets such as U.S., U.K., and Germany and emerging markets such as South Korea and Thailand, leasing companies are not subject to any prudential regulation. However, in several countries, leasing companies are included under the category of nonbanking financial institutions (NBFIs) and are required to adhere to some prudential requirements, but are not supervised on an ongoing basis.⁵

Amembal (2000) identifies the advantages and disadvantages of having prudential regulation for the leasing sector. The advantages are: a) providing an element of credibility that can be useful during the initial stages of the development of the leasing industry; and b) preventing loss of public confidence on the industry that might result from large scale failure of leasing firms. The disadvantages include:

- ❑ Stifling growth of the industry, especially when prudential norms are too strict (for example, by preventing entry of firms because of high capital requirements or causing inefficient use of funds because of the high levels of reserves required and low leverage ratios).
- ❑ Hampering the evolution of the industry from just being a simple substitute for loans to a specialized service serving a natural market for such services.
- ❑ Inadequate knowledge and capacity of the supervisors in charge of regulation.
- ❑ Dissuading lessors from taking the risks needed to reach clients perceived as high-risk—SMEs and microenterprises. This is especially important because high risk clients do not have adequate access to bank finance.

IFC advises against prudential regulation of leasing companies that do not obtain public deposits. Carmichael and Pomerelano (2002) also do the same.

The relevant question relating to the second issue (permitting banks and other lenders to undertake leasing) is whether leasing is more risky than lending. Westley (2003) rightly argues that financial leasing (unlike operational leasing) is rarely riskier than lending because of the stronger security position of the lessor and hence recommends that all financial institutions that are permitted to lend should also be permitted to provide finance leases. In five out of eight countries in Latin America surveyed in Westley (2003), banks are permitted to provide leasing services directly. In the other countries, banks can provide leasing only through subsidiaries.

Accounting

The accounting framework defines how leased assets should be reflected in the accounts of the lessor and the lessee. The International Accounting Standards Schedule 17 (IAS-17) provides guidelines for categorization of leases into operating and finance leases (see box 5). All European Union countries are required to use IAS—17 by 2005. IAS-17 has the advantage that lessees can no longer hide financial commitments arising out of noncancelable lease agreements (which are comparable to debt).

⁵ Regulatory measures used in prudential regulation usually include entry requirements, capital requirements, balance sheet restrictions (maximum leverage ratios, single client exposure, insider transaction limitations, and provisioning requirements), associations among institutions, liquidity requirements, accountability requirements, and insurance / support schemes.

Box 5. The International Accounting Standard (IAS) for classification of a finance lease.

IAS-17 defines a finance lease as one that transfers substantially the risks and rewards associated with ownership to the lessee during the lease period. Operating leases are all leases other than finance leases. A lease having one or more of the following features is classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price, which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.
- The lease term is for the major part of the economic life of the asset.
- The *present value* of the minimum lease payments expected at the inception of the lease is a substantial portion of the fair value of the leased asset.
- The leased asset is of a specialized nature such that only the lessee can use it without major modification after the lease period is over.

Source: World Leasing Yearbook 2003.

Taxation

Income or profit tax and value-added taxes (VAT) are two major taxes that have significant implications for leasing. Actual impact of taxes on leasing is however much more complicated. Deelen and others (2003) discuss some additional taxes (capital gains tax, property tax, stamp duty, etc.) which impact leasing in some countries.

Income or profit tax

Two factors of particular relevance are: a) whether lessors are allowed to deduct depreciation (and lessees deduct lease payments) from their taxable income; and b) whether accelerated depreciation is permitted. The first factor depends on whether a country follows a “form” approach or “substance” approach to lease taxation. In *form* countries, lessors can deduct depreciation for all contracts that are labeled leases. In *substance* countries, lessors can deduct depreciation only if a lease satisfies criteria specified in the tax regulations that qualify it as a ‘true lease.’ As for (b), some countries permit lessors to depreciate the leased asset over the lease period (typically shorter than the economic life period over which normal depreciation is allowed). This further increases the tax-gains because taxes are deferred (and thereby have lower present value).

As indicated in chapter 1, one of the advantages of leasing is that it allows the lessor to use depreciation as a tax-shield. Additionally, the lessee gains from the larger-tax shields arising out of deducting lease rentals rather than interest on a loan and depreciation on equipment. Operating leases automatically benefit from the typical tax treatment of leasing. *Form* approach to lease taxation encourages leasing since it allows even full-payout leases to obtain tax savings usually associated with leasing. This is especially relevant to developing economies where simple finance leases form the major proportion of leasing, and particularly for microenterprises and SMEs that are more likely to use finance leases rather than operating leases.

Although, using *form* approach results in governments foregoing tax revenue, the gains to the economy from higher investments resulting because of the favorable treatment could be larger. It is also worth noting that adoption of IAS-17 for accounting purposes (which requires lessees to capitalize all finance leases) does not restrict the use of the *form* approach for taxation purposes. This would only require lessors and lessees to maintain an additional set of accounts for taxation purposes and reconcile it with their primary accounts.

Value-added taxes

The most common arrangement is for lessor to pay VAT during equipment purchase, and for lessee to pay VAT on lease payments and on value of the asset if ownership is transferred at the end of the lease period. Amembal (2000) recommends waiving VAT on lease payments in emerging markets since in these markets most leases are simple finance leases that are close substitutes for term-loans; VAT is typically not charged on loan payments. Westley's argument that loans and finance leases need to be treated similarly for tax purposes (since they are close substitutes) also appears to support this recommendation (Westley 2003). VAT should also not discriminate between domestic and cross-border leasing as this may harm the development of domestic leasing, and thereby deepening of the domestic financial markets.⁶

4. Review of World Bank and IFC Experience in Leasing

This section analyzes World Bank and IFC experience in supporting the development of leasing markets, and discusses project features and lessons that have relevance for rural leasing. Some instances of support for leasing market development by other donors are also mentioned. Table gives an overview of the major projects and investments discussed in this section. Appendix 5 gives detailed profiles of these projects.

IFC has significant experience in leasing through investments in leasing companies, through debt and equity finance, and in projects with an exclusive focus on technical assistance for improving the legal and financial environment for leasing activities. The Russia Leasing Development Group (RLDG) project and the Central Asia Leasing Project (CALP) are projects funded under the Private Enterprise Partnership (PEP), IFC's facility to provide technical assistance in the post-USSR republics and Mongolia. Between 1977 and 2002, IFC approved US\$1.04 billion in 179 projects in 56 countries (IFC 2003). In many of these countries, IFC was the first foreign investor in the leasing sector. An overall internal review of IFC's leasing experience finds that leasing projects have had strongly positive impacts on private sector development particularly in the SME sector, where they have pioneered financing for a previously under-served market. Box 6 lists three key lessons identified by the review. A more detailed listing of lessons from the review is given in appendix 6.

Relative to IFC, World Bank's experience in leasing is limited. The Microenterprise Development Project in Pakistan (1991-98) provided financing and technical assistance exclusively to leasing companies to expand their clientele to microenterprises (World Bank 1999). The Micro, Small and Medium Enterprise Project in Nigeria (2003-2009), inter alia, envisages technical assistance support, and performance-based grants to lessors (World Bank 2003). The ongoing Rural Finance Project (RFP) (2001-2006) in Romania provides financing and technical assistance to banks and leasing companies to extend their outreach into rural areas (World Bank 2001).

⁶ A lease is considered a cross-border lease if the lessor and the lessee are located in different countries.

Table 5. World Bank and IFC projects reviewed

Projects / Investments	Country	Status	Interventions to create an enabling environment			Firm-level interventions		
			Legal	Taxation	Accounting	Set up	TA	Financing
World Bank								
Rural Finance Project (RFP)	Romania	Ongoing	x	x			x	x
Micro, Small, and Medium Enterprise Project (MSME)	Nigeria	Ongoing	x	x	x	x	x	
Micro-enterprises Development Project	Pakistan	Completed					x	x
IFC								
Central Asia Leasing Project (CALP)	Tajikistan, Uzbekistan, Kyrgyz Republic, Kazakhstan	Ongoing	x	x	x		x	
Russia Leasing Development Group (RLDG)	Russia	Completed	x	x	x		x	
IFC Investments								
DFCU Leasing	Uganda						x	x*
Uzbek Leasing International	Uzbekistan						x	x
Network Leasing Corporation Limited (NLCL)	Pakistan							x

Source: Authors.

Note: Technical assistance (TA) funding was provided by DFID. An “x” indicates that the particular intervention was addressed by a project.

Creating an Enabling Environment

As discussed in Chapter 3, an enabling environment for leasing includes appropriate legal and regulatory frameworks, tax treatments, and accounting standards. Creating such an environment entails working with the governments to either remove adverse features or introduce additional features in the legal and regulatory frameworks, and in some countries supporting the development of specific laws on leasing (Central Asia Leasing Project 2003). While most work in this area was addressed during RFP preparation in Romania, this has been the core activity of the RLDG and CALP.

The impact of an enabling environment can be dramatic. In Russia, leasing volumes increased from a few hundred millions to US\$2.4 billion between 1997 and 2002—the years that coincided with the implementation of the RLDG

Box 6. IFC’s evaluation of leasing investments: three key lessons.

- To be sustainable, leasing companies need access to local currency funding at a competitive cost;
- Stand-alone leasing companies are vulnerable to competition especially from banks entering the leasing market, as banks have major funding, pricing power and operational advantages;
- As leasing project sponsors, banks have strong advantages over other sponsor types, and are more likely to assist or even absorb an affiliated leasing company should competition become fierce.

Source: IFC 2003.

project (IFC 2002). In Panama, after the legal framework for leasing was changed, leasing volumes increased from US\$11 to 15 million before 1990 to US\$200 million in 2001 (Westley 2003). In Pakistan, which has a good environment for leasing, leasing contributes to 7 percent of investment financing compared to 1 to 3 percent in most developing countries (see box 7).

Box 7. Pakistan: A supportive environment for leasing.

Overall, the legal environment is favorable and supportive. There are no restrictions on leasing terms, leasing rates, and geographic area of operation. Current banking regulations for leasing are favorable and the taxation framework is supportive for the leasing sector. Lessors claim capital allowances and accelerated first year depreciation is allowed. Lessees can deduct full lease rentals from their taxable income. The accounting framework follows the IAS-17.

Source: Siddiqi 2003.

RLDG drafted and advocated amendments to the Tax Code (passed in August 2001) and the 1998 Law on Leasing (passed in January 2002) in Russia. The amendments eliminated contradictions between the Civil Code and the Tax Code, and the Law on Leasing significantly reduced investment risk by clarifying the legal framework for leasing. The RFP gave an incentive for the Romanian government to create a legal framework for supporting and making pledges on movable assets (see box 8). The 1999 law in preparation of the RFP, introduced a “real-rights framework” which aided the creation, publication, and enforcement of security interests.⁷ CALP has supported the development of legislation enabling leasing in Uzbekistan, Kazakhstan, Kyrgyz Republic, and Tajikistan (see box 9).

The new leasing laws in Kyrgyz Republic and Tajikistan, and the amendments in the civil codes in Uzbekistan and Kazakhstan improve the legal framework for leasing. The laws and the amendments define leasing activity, leased asset, and parties to a leasing transaction, and clarify the responsibilities of parties to a leasing contract. They prohibit the use of the leased asset as collateral by the lessee and require the lessor to obtain the lessee’s written permission if the lessor intends to use the leased asset as collateral. In Uzbekistan and the Kyrgyz Republic, while insurance is not mandatory, the law requires that leasing contracts state whether insurance is required, which party is responsible for paying the premium, and who would be the recipient of a claim.

CALP and RFP have also helped simplify repossession. Previously, the law in Uzbekistan permitted repossession only through lengthy court proceedings. The new law only requires the lessor to obtain a court-issued repossession notice. If the lessee does not contest the repossession notice, the repossession can take place in under 30 days. Kazakhstan has also adopted this system. The Romanian law goes further and permits noncourt repossession. In both cases, a normal court litigation procedure is initiated if a lessee contests a lessor’s repossession notice, thereby protecting the lessee’s rights. In Tajikistan and Kyrgyz Republic, CALP is also supporting the development of third party arbitration systems to decide commercial disputes.

In Uzbekistan, tax barriers to leasing were removed in 2002. Leasing was recognized as a mechanism for capital investment and taxation of leasing operations was equated with taxation of lending. The decree established the following: a) VAT is not levied on lease payments; b) VAT on import and customs fees are not levied on equipment imported for leasing; c) lessees are not levied property tax on leased assets; and d) lessors can deduct interest payments (on loans received to purchase assets for lease) from their

⁷ Romania currently has 45 registered banks but 75 banks sign security contracts within its laws. This is an indicative factor of the quality of the law on security interests because it attracts neighboring banks to the Romanian banking system

taxable income. In Romania, during RFP preparation, the government rectified deficiencies in the accounting framework that were adversely affecting the leasing sector (see box 10).

Financial Assistance to Firms

Firm-level financial assistance helps to establish leasing firms, expand their products and client base, and become commercially viable. Within the World Bank Group, most work in this area has been done by IFC as part of its investment in leasing companies across the world. IFC involvement in the start-up phase of leasing companies has usually been in the form of a small equity investment and a small loan. All three World Bank projects reviewed here provide(d) financial assistance to leasing firms. Bilateral agencies such as United Kingdom's Department for International Development (DFID) and United States Agency for International Development (USAID), and development investors such as CDC Capital Partners, the Netherlands Development Finance Company (FMO), and the German Development and Investment Company (DEG) have also provided financial assistance to leasing firms.⁸ The major forms of financial support are discussed below in further detail.

Grants

Grants are usually provided to subsidize initial establishment costs and as seed-capital to start operations. They have been used in the development of microfinance organizations worldwide. Nigeria MSME project envisages providing performance-based grants to leasing firms to accessing technical assistance and meeting operational costs for an initial and limited period. DFID provided DFCU Leasing a grant facility of £ 2 million (to be matched by DFCU) for an initiative on small unit leasing. Similarly, USAID provided US\$300,000 (on a matching basis) to DFCU Leasing to establish three Rural Leasing Centers in Uganda (Kisaame 2003). Start-up funds can also be extremely small. The European Commission provided Euros 15,000 each to three business incubators in three towns in Kyrgyz Republic to set up leasing funds. Two of these incubators together provided 33 leases worth over US\$34,000 in their first year of operation. CALP provided the technical assistance (Choibekova 2003).

Equity

The share of equity investments in total IFC investments in the leasing sector (between 1977 and 2002) is around 15 percent. IFC holds 21.5 percent stake in DFCU group, 15 percent stake in Uzbek Leasing, and 5.6 percent stake in Orix Leasing. IFC's equity investments in leasing companies usually precede the loan investment. IFCs investments in African leasing companies have mostly been in equity since neither the leasing companies nor the lessees could afford the foreign exchange risk associated with dollar-denominated loans. Other donors that have made equity investments in leasing companies include DFID (through CDC Capital Partners) and the German Development and Investment Company (DEG). CDC presently holds 60 percent stake in the DFCU group, after having purchased DEG's 25 stake in 2003 (CDC Web site).

Loans and credit lines

Approximately 80 percent of IFC's investment in leasing has been through loans. It provided a loan of US\$2.5 million to Uzbek Leasing in 2002. The Microenterprise Development Project in Pakistan had a credit line that was used by three leasing companies, including Orix Leasing; RFP has a credit line component that can be accessed by banks and leasing companies. However, loans denominated in a

⁸ For more information, refer to the following organizations' Web sites: www.cdcgroup.com, www.fmo.nl, and www.deginvest.de

foreign currency have the associated foreign exchange risk. World Bank credit lines have the advantage that the foreign exchange risk is often borne by the government (the primary borrower of World Bank loans are governments), while this is not the case for IFC loans.

Guarantees

IFC is providing a guarantee worth US\$2 million to NLCL in Pakistan to help it access loans from local commercial banks. In IFC's investments in Russia, the exchange rate risk was managed by the Swiss government by setting up a guarantee fund. In Africa, IFC developed a local currency guarantee scheme that allowed West African leasing companies in the Ivory Coast to access local funds. It used a new regulation in 1997 in the West African countries using the CFA franc (the common currency guaranteed by France) that required insurance companies to invest 15-50 percent of their reserves into specified institutions—IFC was among the institutions that qualified. Using these investments, IFC offered local currency guarantees to two leasing companies in the Ivory Coast to enable them to borrow from local insurance companies (Carter 1996). However, guarantee arrangements do have the risk of creating moral hazard problems resulting from inadequate internal control by the lenders because of the guarantee.

Technical Assistance to Lessors

Technical assistance usually addresses three major stake-holders: potential and current lessors, potential lessees, and government officials. Support provided by the reviewed projects include seminars, workshops, specific consultancies, publications, market surveys, and mass education campaigns through the media. Both RLDG and CALP have offered several seminars on leasing targeted at all the stakeholders. RLDG conducted over 25 similar seminars during the project period; CALP provided over 100 seminars, using modules on lessees, lessors, and microleasing. The main seminar targeted lawyers and accountants of local banks and potential leasing companies that plan to start leasing activity.

RLDG carried out four annual market surveys on leasing between 1998 and 2002; CALP conducted two annual surveys in 2002 and 2003 covering Kyrgyz Republic, Uzbekistan, and Tajikistan. RLDG published over 20 issues of a bi-monthly newsletter "Leasing Courier" which shared information through email and the internet on a wide range of leasing issues.⁹ CALP has launched a similar publication, "Leasing Info," as a monthly column in leading publications in all the project countries. Leasing Info was initiated with the goal to raise awareness of leasing among entrepreneurs as well as to advocate for legislative changes crucial to the development of leasing in Central Asia. Both RLDG and CALP Web sites also maintain a "Frequently Asked Questions" section on accounting, tax, and legal issues related to leasing.

The technical assistance component under RFP includes activities to promote public awareness in rural areas of the project's Rural Credit and Leasing Facility, and technical assistance to final beneficiaries of the project. Although, technical assistance provided by RLDG and CALP has been for both creating an enabling environment (legal, regulatory, tax, and accounting) and for leasing firms, most of IFC's technical assistance has focused on creating an enabling environment (55 percent). Technical assistance focusing on specific companies was 29 percent and those having a mix of several components were 16 percent (IFC 2003).

⁹ Available at <http://www2.ifc.org/russianleasing/eng/lc/index.htm>.

5. Conclusions and Recommendations

Leasing has significant potential as a rural finance tool. Increasing mechanization of agriculture in many countries and the increasing significance and needs of the agroindustry, industrial and service sectors in rural areas offer a natural market for leasing. The survey conducted for this paper finds several entities that are providing leasing services to farm and nonfarm rural enterprises. These include leasing companies, equipment suppliers, farmer cooperatives, and MFOs. However, leasing sector in most developing countries is underdeveloped and availability of leasing services in rural areas is very limited. Lack of a clear legal framework, restrictive regulations, flawed accounting policies, and a tax-code that is biased against leasing often constrain the development of the leasing sector. Furthermore, very few lessors have the experience of operating in rural areas.

Given the potential of leasing as an alternative financing tool for rural enterprises and the constraints in increasing its access in rural areas, there is a case to support access to leasing through World Bank's rural development projects. Presently, this is typically not the case. Most rural finance and other rural development projects with rural finance components do not include leasing among the financial services supported. The Romania Rural Finance Project presents a good model of mainstreaming leasing in a rural finance project. Recommendations are made on four fronts: a) better documentation of the current outreach of leasing services in rural areas and their development impact; b) operational support for developing rural leasing services; c) creation of regional leasing development facilities; and d) enhanced collaboration with IFC and other donors.

Better Documentation and Research

Information on both demand and supply of leasing services in rural areas is sparse. Better information on the demand for equipment in rural enterprises can give more reliable estimates of the potential for leasing in rural areas. Areas with significant potential for equipment leasing but little information include leasing by local governments (as lessees) and leasing for rural infrastructure (roads, transport services, water-supply and sanitation, etc.). Regional analysis, such as that done by Westley (2003), and IFC (Central Asia Leasing Project 2003) can contribute to better understanding of the policy and regulatory environments for leasing in specific countries. Economic and Sector Works (ESWs) on rural finance should incorporate assessments of leasing.

Operational Support

Operational support could cover legal and policy reforms, grants and loans, and technical assistance. Such support needs to be incorporated primarily into rural finance projects, but some elements could also be included in other sectors' projects. Rural finance projects should assess demand for equipment finance and support the development of equipment leasing if adequate demand exists. Attention should be paid to ensure that the facilities available under a project do not discriminate between loans and finance leases. Projects in other sectors could encourage equipment leasing as a means to acquiring equipment. The potential components of support are:

- *Legal and Policy reforms:* Policy reforms such as reducing entry barriers to new firms, removing interest rate controls, and devising appropriate regulatory regimes required for the development of financial services have positive implications for the development of leasing. Rural finance projects with policy reform components should ensure that reforms specific to leasing are addressed in addition to the broader rural finance reforms. The Romania Rural Finance project provides a good model.

- ❑ *Grants and Loans:* Grants reduce risks associated with expanding outreach to rural areas or introducing a leasing product. Recipients could either be primarily urban organizations interested in expanding into rural markets or organizations or companies already having a significant rural presence interested in introducing leasing products. Setting up a new leasing company or developing new products within an existing entity requires staff to be trained, new systems to be created, and promotional materials to be generated. The Nigeria MSME project envisages performance-based grants to leasing firms. The extremely small seed grants to set up leasing funds in Krygzstan is an example of decentralized start-up support that was provided as part of projects in other sectors. Rural Finance projects that provide credit lines to financial institutions should include leasing providers in their potential clientele.
- ❑ *Technical assistance:* Technical assistance may take the form of training or advisory services. Such assistance could be to existing or start-up leasing institutions and aimed at developing new products, or for increasing the general service-delivery capacity of leasing firms. By transferring knowledge of technology and products used in developed leasing markets, such facilities could help upgrade the technology used in emerging markets. Technical assistance could also be provided to expand awareness of leasing among potential lessees and government officials. Apart from traditional modes of technical assistance such as advisory services, innovative mechanisms such as management contracts could also be supported.

Regional Leasing Development Facilities

Apart from operational support through its lending and nonlending operations, the World Bank could also consider creating regional leasing development facilities along the lines of RLDG and CALP. The facilities are unique models of localized support as 98 percent of the staff is field-based and 90 percent are local professionals. This enables the facilities to develop first-rate local specialists who work with local stakeholders in influencing the policymaking and policy implementation process. The localized and time-bound nature of the facility also makes it cost-effective. Exclusive focus on technical assistance and training is another critical feature of the facility.¹⁰

Collaboration with IFC and Other Development Agencies

IFC's significant experience in leasing and SME development makes it a prime candidate for collaboration. Such collaboration would be especially useful for World Bank projects that do not have a rural finance component, but require project clients or other stakeholders to acquire equipment. IFC could examine project partners, provide technical assistance, make equity investments, and provide loans and guarantees. World Bank could also collaborate with IFC in setting up Regional leasing development facilities. Possibilities of collaboration should also be explored with development agencies such as the USAID and DFID, and development investors such as CDC and DEG.

¹⁰ The IFC is considering establishing a Central Asia Leasing Facility that will provide both TA and financing beyond CALP (Freeman 2003).

Appendix 1. Global Leasing Market and Development Impact

The global leasing market was worth US\$476.6 billion in 2001 (World Leasing Yearbook 2003). Europe and North America account for 82.7 percent of this market volume. Modern leasing emerged in the 1950s as a specialized financial service industry in the United States. The industry expanded to Europe and Japan in the 1960s and to the developing countries in the 1970s. Leasing is used in all economic sectors and for all asset types. In the United States, 10.2 percent of the leasing volume (by equipment type) is in agriculture (World Leasing Yearbook 2003).

The significance of leasing in a country is usually estimated by market penetration. The most direct measure of market penetration is the proportion of leasing volumes to all fixed investment in plant and equipment. This indicates how leasing fares compared to other sources of financing. Table 6 gives the leasing volumes in selected countries. Figure 2 compares the market penetration of leasing in the same set of countries.

Several beneficial impacts of leasing have been identified in the literature (Amembal 2000; Carter 1996). The most significant include:

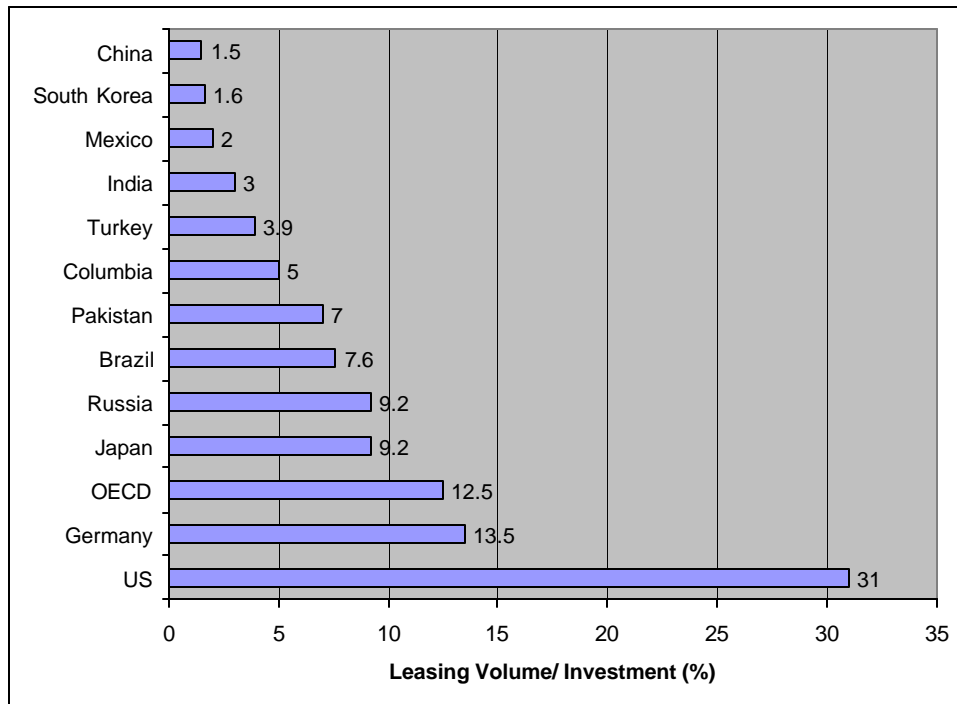
- *Access to finance and increase in capital investment:* This is perhaps the most significant development impact. Lessors are often willing to lease to entities that cannot access bank credit. Legal ownership of leased assets allows the lessor to require lesser equity than demanded by lenders and less or no additional collateral. SMEs benefit most from leasing. Finance for SMEs has been called the ‘missing middle’ of finance since banks mostly address the needs of large enterprises and microfinance organizations (MFOs) are increasingly addressing the needs of microenterprises (World Bank Group and IFC 2003). Since leasing supports acquisition of equipment it enhances capital investment in an economy.
- *Increase in capital base and capital market development:* Growth of leasing sector requires that leasing companies have access to capital. This leads to increased borrowing from banks as well as from the capital market, thereby increasing the gross capital base of a country. Leasing companies raise capital from pension funds and insurance companies, innovative bond offerings, securitizing of their lease receivables, and listing in the equity market. These activities contribute to capital market development.

Table 6. Annual leasing volumes in selected countries, 2001

<i>Country</i>	<i>Annual Leasing Volume</i> <i>(US\$ billion)</i>
U.S.	242.00
Japan	58.95
Germany	34.45
Brazil	3.52
China	2.10
Russia	1.90
South Korea	1.17
India	1.05
Mexico	0.90
Columbia	0.76
Turkey	0.72
Pakistan	0.37

Source: World Leasing Yearbook 2003

Figure 2. Significance of leasing: Market Penetration



Source: World Leasing Yearbook 2003

*OECD figure is the average for 26 member countries. No data was available for Iceland, Luxembourg, Poland and New Zealand.

- *Competition in the financial market:* As an additional source of investment financing, leasing competes with bank financing. This provides incentive for both banks and lessors to become more efficient and innovative, leading to better products, and lower spreads in interest rates.

Well-developed leasing markets in the United States and Western Europe suggest that leasing can play an important role in overall economic growth. Leasing is also an effective mechanism to help businesses without credit history and collateral needs to finance investments in equipment. In several developing and transition economies, the leasing sector has contributed significantly to deepening financial markets and overcoming legal and regulatory problems—particularly relating to property rights and secured interest in collateral. IFC considers leasing as a high impact development activity in deepening financial markets and supporting SMEs (IFC Corporate Strategy, cited in IFC 2003).

Appendix 2: Leasing vs. Borrowing: Using NPV Analysis for Decisionmaking

When both leasing and borrowing are feasible options, the recommended method to make a decision is to use the net present value analysis. To determine whether leasing or borrowing is the cheaper option, both cash-flows should be discounted using appropriate discount rates. Table 8 demonstrates this analysis for an enterprise that needs to acquire an equipment that costs US\$10,000. It is assumed that both the lessor

and the lender charge the same interest rate (15 percent), and for simplicity, the same rate is used as a discount rate. Three situations can be envisaged:

1. *Tax-shields not available to both lessee and lessor*: A lessee may not use the tax-shield if it is a nontax-paying entity—either because it is exempted from paying taxes (a nonprofit entity or the sector—agriculture sector in many countries—is not taxed) or because its income is less than the minimum taxable income. The tax-shield may not be available to the lessor if the tax regulations do not permit the lessor to use capital allowances on finance leases. In this situation, NPV of both cash flows are the same, and the lessee would decide to lease if it prefers the lower down payment or other nonfinancial factors.
2. *Only lessor uses tax-shield*: The client is indifferent between leasing and borrowing, unless the lessor transfers a part of the tax-benefits available to it (US\$1,965) to the lessee in the form of lower lease payments. This is likely to happen in a competitive market.
3. *Both lessee and lessor can use the tax-shields*: The client clearly prefers the lease option since it has higher NPV (when NPV of the lease/loan cash flows and tax-shields are combined). The lease option has an NPV of US\$1,738 compared to the NPV of US\$1,518 in the loan option.

Table 3. Lease vs. borrow: net present value (NPV) analysis

Year	Cash Flows		Tax-shields for client		Tax-shield for lessor/lender	
	Lease	Loan	Lease	Loan	Lessor	Lender
0	7500	6000	500	250	438	394
1	-2627	-2102	525	475	438	315
2	-2627	-2102	525	430	438	224
3	-2627	-2102	525	378	438	120
4	-2627	-2102	525	319	438	
5				250	438	
6				250	438	
7				250	438	
NPV @15%			US\$1,738	US\$1,518	US\$1,965	US\$797

Notes:

Equipment Cost	10000	Loan equity	4000
Interest rate on loan / lessee	15%	Lease Down Payment	2500
Lessee/borrower tax rate	20%	Lessor/Lender tax rate	35%
Depreciation method	Straight line depreciation		

Tax-shield under the loan option includes shields on interest paid and depreciation.

Source: Authors

Appendix 3. Rural Lessors: A Comparison Matrix

Country	Bangladesh	Bolivia	Madagascar	Pakistan	Pakistan	Uganda	Kazakhstan	Uzbekistan	Uzbekistan	Mexico
Organization	Grameen Bank	ANED	CECAM	Network Leasing Company Limited	Orix Leasing Pakistan Limited	DFCU Leasing Company	AgroMash Leasing	UzbekLeasing	Uzelmalhosh-leasing	John Deere
Organizational Type	Micro Credit Bank	MFO-NGO	MFO-Cooperative	Private Company	Private Company	Private Company	Private Company	Private Company	State-owned Company	Equipment Supplier
Primary Client group	Micro-entrepreneurs and Microenterprises	Micro-enterprises	Micro-enterprises and family farmers	Micro-enterprises	SMEs	SMEs	Farm enterprises	SMEs	Farm enterprises	Farm enterprises
Year	2003	2002	2003	2002	2002	2002	2003	2002	2002	2002
Lease Volume (US\$)	25.3 million		2.8 million	5.2 million	64.9 million			5.1 million	40.3 million	30.2 million
Lease Portfolio (US\$)	22 million	400,000	2.6 million		121.1 million	16 million	1.47 million			57.8 million
Average lease size (US\$)	364	1,200	945	3,000	21,000	27,375	48,921	200,000	16300	28000
Country's Per Capita GDP (US\$)	380	900	240	420	420	240	1510	460	460	4,410
Lowest and highest individual lease (US\$)	170; 16975	550;29,970	50; 20,000	61; 63,000	170; 522,310	1200; 290,000 (in 2000)	40,620; 640,264	53,000; 1.1 million	900; 1.3 million	9300; 725,000
Percentage of Rural Portfolio	100%	90%	90%	20-30%	Small towns 10%	47% (26% agricultural)	100%	6% of leases	100%	85 % of leases

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Portfolio quality	Nif	AR 8.4 %	AR 2.7 %	3%	9.1% (PAR30)	PAR (30): 15% on Agrl leases.	PAR(30): 0%	PAR (60): 4.3%	PAR (30): 3.9%	
Type of lease:	Finance and Retro lease	Finance and Retroleases	Finance lease only	Finance lease only	Finance, Operational, Hire-purchase and Retro leasing	Finance lease	Finance lease and Hire-purchase	98% Finance leases 2% Retro leasing	Finance lease	Finance Leases
Down payment	Not required. Lessees some times supplement from own resources according to their capacity.	15-25%	20% New equipment 40% (animals and used equipment)	20%	10-25%	10-15% cash down payment	23-35%	Down payment equal to 3 lease payments	15%	30% for agrl. equipment, 15% for construction equipment
Interest	20%	16%	24 % to 30%	15-22%	General 10-14% Micro 12-13% (Dec 2003)	16-26%, average is 18%	12-25%	16-25% flat	Subsidized rate for 95% of leases	Variable and Fixed rates; 11 to18% in Pesos; 7-9% in US\$
Term/Duration	3 month to 3 years	max 5 years (max 2/3 of economic life of assets)	10-36 months		3-5 Years	2-5 years, average 3	Typically 3 years Rarely 5 years	1-5 years, mostly 2-3 years		Up to 5 years
Lease payments	Weekly and according to the contract	Monthly/Quarterly/ Half-yearly	Monthly or three to four times a year depending on crop cycle	Monthly	Monthly / Quarterly		Annual for agrl equipment; Monthly for non-agrl. equipment			Mostly annual for agrl equipment; Mostly monthly for construction equipment
Additional Collateral	None	Only for 20% of leases	Collateral needed for animal leasing	None	None	Occasionally requested	Not yet; deposit demanded in some cases of higher risk.	Additional collateral covering 50% of the cost of leased assets	Additional collateral covering 60-80% of the cost of leased assets	Sometimes

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Repossession	None. Some times lessee transfers to other lessee if situation demands.	None	Less than 2%	Approximately 1% of leases	calls, follow up visits and notices then to mobile rent collectors	Once areas exceed three months	None	1 out of 47 leases written so far	6 out of 5860 leases written so far	Around 1%; mostly on friendly terms
Equipment (new/used)	New	Only new	New and used	New and used	New and used	New and used (60% used)				New and used

Notes:

When reported in local currency, volumes converted to U.S. dollars using EIU exchange rates.

Arrear Rate (AR) is defined as percentage of loan amount in arrears (amount in arrear as a percentage of total amounts outstanding). This is a relatively weak measure of loan performance since it does not give indication of how long the amounts have been in arrear. PAR gives the percentage of loan portfolio that is in arrears (balance outstanding in a loan that is in arrear as a percentage of total loan portfolio). PAR is usually calculated for arrears of different ages and indicated by PAR (30), PAR (90), etc..

Grameen uses a unique methodology to estimate portfolio quality. If a lessee misses ten consecutive installments, the entire outstanding loan is treated as overdue. Additionally, in case of one year loan, if the borrower fails to repay half the loan amount with interest, within 26 weeks, entire amount not paid is treated as overdue, and in case of loans with longer duration, if principal amount and interest scheduled to be paid within each segment of 26 weeks is not paid, entire amount not paid is treated as overdue. One hundred per cent provision is made against all overdue loans and entire outstanding amount of overdue loans are written off one year after they become overdue.

Appendix 4. Profiles of Rural Lessors

Microfinance Organizations

Grameen Bank, Bangladesh: Grameen Bank is one of the largest MFOs in the world. It has an outreach in over 43,600 villages and has 3.12 million borrowers. It disbursed over US\$369 million in loans in 2003 and had a portfolio of US\$274 million. The leasing product was introduced in 1992, and presently accounts for US\$22 million of the portfolio. Most of the leases are extended to the service industries and small rural manufacturing. Lessees are selected among existing clients and tend to be those better off, with additional income sources. No down-payment is demanded (Barua 2003; Dowla 1998; Grameen Bank Web site).

Caisses d'Epargne et de Credit Agricole Mutuels Madagascar (CECAM), Madagascar: This Agricultural Savings and Credit Union was created in 1991 by the farmer organization FIFATA with the financial and technical assistance of a French NGO, FERT. It includes a network of 170 local banks and eight regional credit unions located mostly in less favored rural regions. Presently, CECAM is the largest financial institution in rural Madagascar. It provides working capital loans, grain storage loans, term loans, and microleases for agricultural equipment. Leases accounts for 27 percent of its portfolio. Leased equipment includes capital equipment for agriculture (plough, harrow) and animals, equipment for rural artisan implements (welding units, vans) and domestic equipment (bicycles, sewing machines, solar lights, televisions). To qualify for a lease, the lessee needs to be a network member. Secondary income sources are not required. The lease application is appraised by local credit committees. Leases are secured through the equipment and by the verbal promise of solidarity group members who monitor that the equipment is well maintained and not sold or destroyed (Fraslin 2003).

Asociación Nacional Ecuemenica de Desarrollo (ANED), Bolivia: ANED is supported by Ecumenical Church Loan Fund, Switzerland and others. ANED provides finance leases and retro-leasing operations as well as term loans both to individuals and groups. While 90 percent of ANED's overall portfolio is in rural areas, only 7 percent is in leasing. The leasing portfolio had a lower delinquency rate (8.4 percent) than ANED's other financial products (10.55 percent). Eligibility requirements include experience in operating the equipment to be leased and the ability to make 15 to 25 percent in down payment. No more than 30 percent of total net household income can be allocated to lease payments. Risk management techniques include the exclusive financing of new equipment. There is close monitoring by ANED loan officers. The purchase or buy-back option works as a strong incentive for timely repayment. ANED established close links with at least two suppliers for tractors and pumps which often leads to discounts for bulk purchases. The contract with equipment suppliers includes guarantees against breakdown, some minimal technical training, and other after-sales services (CGAO 2002a; Dupleich 2003).

Independent Leasing Companies¹¹

DFCU Leasing Company, Uganda: Established in 1994, DFCU Leasing is the first leasing company in Uganda. The DFCU group is jointly owned by IFC, Government of Uganda, and CDC Capital Partners, a company fully owned by DFID. The company currently has 80 percent of the leasing market share in Uganda. However, its larger clients have increasingly moved from DFCU, attracted lower interest rates charged by banks. DFCU leasing company is therefore looking further to smaller companies for new

¹¹ Profile for Agromash Lending, Kazakhstan was not available at the time of publication.

customers. DFCU leasing operates three special projects with particular relevance for rural leasing. The Small Unit Leasing initiative supported by the DFID Challenge Fund Grant was launched in January 2002. The initiative provides GBP 4 million (GBP 2 million from DFID and GBP 2 million equivalent from DFCU) for providing leases to small and rural-based businesses. As of March 2003, GBP 2.4 million was used in leases to 560 beneficiaries. The project also supports some capacity building activities. USAID's SPEED (Support for Private Enterprise Expansion & Development) Project supports the second initiative, Rural Leasing Centers. The funding of US\$300,000 covers capital expenditures and two-year operational costs of three Rural Leasing Centers on a matching basis with DFCU Leasing. Shell Foundation supports the third initiative, the Uganda Energy Fund. The fund has US\$4 million equally matched by Shell Foundation and DFCU Leasing. The initiative aims to promote modern energy services and targets SMEs in rural areas (CGAP 2002b; DFCU Web site; Kisaame 2003).

Network Leasing Corporation Limited (NLCL) Pakistan: NLCL is a public limited liability company registered as a nonbank finance company. NLCL started operations in Karachi in 1995 in order to serve microenterprises and its business is predominantly in urban and suburban areas. To qualify for a finance lease by NLCL, lessees have to be in business for at least three years. NLCL has a guarantee from IFC to borrow in local currency equivalent of up to US\$2 million from a local bank for 5 years. The company intends to use the proceeds from the guaranteed loan to fund the expansion of its business to meet existing demand in its current areas of operation as well as in targeted new areas in Pakistan. (Khan 2003; NLCL Web site).

Orix Leasing Pakistan Limited, Pakistan: A subsidiary of Orix Corporation, Japan, Orix Leasing Pakistan was initially established as a private limited company. It was converted to a public limited company in 1988. IFC holds 5.6 percent stake in the company. It provides all four forms of leases (finance and operating leases, retro-leasing and hire-purchase leases). SMEs are its primary client group, forming over 90 percent of its leases and 50 percent of its lease volume. Microleases are a much smaller proportion at approximately 8 percent. Orix Leasing defines Microleases as those written for businesses with less than 10 employees. Examples of microleases include three-wheel motor vehicles, lathe machines, tire-puncture repair machines, injection molding machines, etc. Orix Leasing recently obtained a Rs.2 billion loan from the National Bank of Pakistan to be used for further expanding its rural outreach (Iqbal 2003; OLP Web site).

Uzbek Leasing Company, Uzbekistan: Uzbek Leasing was established in 1995 by the IFC, European Bank for Reconstruction and Development (EBRD) and a local bank. As the first leasing company it served as a model for companies entering the industry. Uzbek Leasing finances equipment for SMEs in consumer goods, construction material production, and services. The company obtains local currency financing from the local bank (NBU) and US dollar financing from EBRD and IFC and obtained lines of credit for the IFC and EBRD in December 2002. IFC provided US\$2.5 million of which US\$0.5 million was earmarked for the medical sector. Additionally, in cooperation with IFC, Uzbek Leasing has been involved in promoting legislative changes that favor the growth of the industry. Currently, IFC and EBRD each have a 15 percent share, while a Malayan Bank (Maybank) and the local bank (NBU) each have a 35 percent share in ownership (IFC Web site; Umarov 2003).

State-Owned Leasing Companies

Uzselkozmashleasing, Uzbekistan: This company is Uzbekistan's largest leasing company, specializing in domestic agricultural equipment leasing and with a network of branches throughout Uzbekistan. Interest rates vary greatly depending on whether the lease is financed from a fund dedicated to the provision of agricultural machinery. These subsidized rates are calculated at 50 percent of the central bank's refinancing rate (which results in a 6 percent annual interest rate). By contrast, unsubsidized leases bear an annual interest rate of 34 percent (Umarov 2003).

Equipment Suppliers

John Deere, United States and Mexico: Head-quartered in the United States and with operations in several countries, John Deere is one of the world's biggest manufacturer of agricultural equipment. John Deere, United States provides cross-border leases to lessees in several countries in Latin America, Asia and Eastern Europe with the average size ranging from US\$500,000 to US\$4 million. Most leases are finance leases (95 percent). All cross-border lessees need to qualify for credit insurance which redeems most of the approximately 5 percent of lessee default (only 1 percent of the assets are physically repossessed). John Deere, Mexico gets 70 percent of its funds for leasing operations from FIRA, the Mexican development fund that refinances rural lending. These funds are the lowest cost funds available in the market and this significantly lowers the rate at which John Deere is able to offer its leases (FIRA does not impose an interest cap) (Olalde 2003; Sabroske 2003).

Appendix 5. Profiles of World Bank Group Projects Reviewed

World Bank Projects

Rural Finance Project, Romania (2001-2006): The first phase of an Adaptable Program Loan, RFP seeks to promote economic growth and reduce poverty in rural Romania. Project costs US\$147.6 million, of which US\$80 million is financed by the World Bank. The project has three components: (1) *a rural credit and leasing facility* that can be accessed by participating financial intermediaries to finance loans, microloans, and leases to target beneficiaries; (2) *a rural retail banking and microfinance component*; and (3) *project management and technical assistance for rural financial market development*. While the leasing terms are determined by each leasing company, the project requires that (1) interest rates be based on market terms and (2) down-payments be sufficiently large to reduce the asset value to below market costs and (3) companies may choose to use additional collateral instead of sizable down-payments. While approved in 2001, a delay in procurement resulted in project implementation starting in 2003 only (Chaves 2003; World Bank 2001).

Micro-, Small-, and Medium-Sized Enterprise Project, Nigeria (2004-2009): The project objective is to increase the performance and employment levels of micro, small, and medium enterprises in the non-oil industry sub-sectors. The project cost is US\$60 million, of which World Bank financing is US\$33.5 million (US\$32 million IDA and US\$1.5 million IFC). The project comprises four components: (i) access to finance; (ii) business development services; (iii) investment climate; (iv) monitoring and evaluation. Leasing is supported under the first and third components. The access to finance component would provide performance-based grants to qualifying lessors to be used for accessing technical assistance and meeting operational costs for an initial period. The investment climate component would support the development of an enabling legal, regulatory, and accounting framework for leasing (World Bank 2003).

Microenterprise Development Project, Pakistan (1991-1998): The project objective was to provide credit through the formal financial sector to micro and small-scale entrepreneurs for capital investment. The leasing component aimed to broaden financial instruments available for micro entrepreneurs. Total project cost was US\$28.8 million of which US\$26 million was financed by the World Bank. The government provided a guarantee for exchange rate risks, and funds were on-lend by an apex bank (Bankers Equity Limited). Two leasing firms reviewed for this study, Orix Leasing and NLCL, received funding from the project. The project targeted small-scale industry and micro enterprises (with 75 percent and 25 percent of leases disbursed respectively). The recovery rate of the leasing portfolio was 95 percent at closing. Leases were provided at market rates, around 22 to 24 percent per annum, which allowed for a

7 to 8 percent spread. Lease terms were usually three years that allowed the leasing companies to turn around funds three times on the 10 year Bank credit line. Factors that constrained the project included non-inclusion of used-equipment leasing. The project also did not succeed in ensuring alternative sources funding at project completion. Original project design assumed that commercial banks or other institutions would be persuaded to enter the market and provide private funding to SMEs because of project success, but this did not happen (World Bank 1999).

IFC Projects

Central Asian Leasing Project (CALP, 2001-), Kazakhstan, Kyrgyz Republic, Uzbekistan, and Tajikistan: The project is supported by SECO (Swiss Secretariat for Economic Affairs) for its operations in Kyrgyz Republic, Uzbekistan, and Tajikistan, and by USAID for Kazakhstan. CALP aims to create favorable conditions for the growth of the leasing industry in Central Asia. It is designed in three stages: 1) forming partnerships with governments to create and improve legislation on leasing; 2) increasing the knowledge and awareness of leasing; and 3) expanding the financial resources available for leasing in Central Asia. The program works with leasing companies, banks, potential leasing clients, and policymakers on the fundamentals of leasing operations and on conducting financial and risk analysis when making investment decisions. It also advises local and foreign companies on legal issues, taxation, and accounting aspects of leasing transactions and works with the private sector, government officials, and legislators to improve the legal framework for leasing operations. CALP also conducts sector studies to monitor the industry's development throughout the project's duration. CALP differs from traditional IFC leasing interventions in that it uses a methodology that empowers local lawyers and financiers to lead the reform process. CALP has played a lead role in the lobbying process for the leasing legislation in all the four countries (CALP Web site; Central Asia Leasing Project 2003; Freeman 2003).

Russia Leasing Development Group Project (1997-2002): RLDG was set up in 1997 with financial support from the governments of United Kingdom and Canada, to cooperate with the Russian government to create favorable legal and economic conditions for the development of leasing. The project drafted and advocated amendments to the Tax Code (passed in August 2001) and the 1998 Law on Leasing (passed in January 2002). The project began with public education campaigns explaining leasing and its benefits to national and regional governments, entrepreneurs, bankers, and mass media across Russia. To build local technical expertise on leasing, the project trained thousands of people across 35 of the 89 regions of Russia. In addition, the project provided more than 1,400 consultations to Russian and foreign companies on the legal, accounting, and taxation aspects of leasing operations in Russia. Some of the companies which IFC advised on starting leasing operations in Russia include KMB Bank, Citibank, Raiffeisen, MMB, ING, Rabobank, ABN-Amro, and Daimler Chrysler (RLDG Web site).

Appendix 6. Lessons from IFC's Leasing Review

An internal evaluation by IFC of its 25 years experience in leasing (IFC 2003) identified the following lessons:

Structuring

- ❑ Stand-alone leasing companies are more vulnerable to adversity than banks due to limited funding availability and higher cost of funds (borrowings vs. deposits), and also are capital-challenged since their leverage is normally lower than banks.
- ❑ Committed term funding (especially local currency) is essential for a leasing company.

- ❑ Project structuring should address all sector-specific risks (e.g. equipment valuation, maturity mis-match, currency and interest rate exposures, term lending risk, single lease and sector exposures, lease arrears management), and mitigate them in covenants or operating policies from the outset.
- ❑ At appraisal or structuring, the company's MIS system needs to track performance against key targets, operating policies and IFC's development objectives and monitors financial risks. MIS should be automated as much as possible to formalize risk management. Reporting requirements need to be addressed before disbursement to ensure IFC receives relevant information for needed close supervision.
- ❑ Denominating/indexing leases to dollars usually increases portfolio risk unless lessees have foreign currency earnings (which is unlikely with SMEs).
- ❑ Leasing companies own the equipment, theoretically giving them power to repossess—but this maybe hindered by local practices and cannot substitute for sound credit analysis on lessees and close follow-up.

Sponsors and technical partners (S/TP)

- ❑ Banks are generally strong sponsors and have operational synergy (local currency funds, distribution through branch network, customer/market knowledge, operational expertise, cross-product pricing flexibility, leverage on lessees).
- ❑ If banks are allowed to enter the leasing market thereby threatening stand-alone leasing companies, bank sponsors often have a stronger incentive than other sponsor types to absorb the leasing company (relationship banking, product completeness, operating advantages).
- ❑ Critical selection criteria for the S/TP are synergy, expertise, reliability, and senior management & shareholder commitment.
- ❑ Due to the small size and limited staff of many leasing companies, risk management may be difficult. The company's board should commit to conservative policies and procedures prior to IFC disbursement, closely monitor risks, insist on separation of functional duties and decision-making, and validate key decisions.
- ❑ It is important to ensure that the S/TP second high quality personnel but builds the leasing company's independent management team quickly.
- ❑ If the technical partner is also a shareholder of the company, the distinct roles and responsibilities and accountabilities of manager and shareholder should be reflected in contracts.
- ❑ Market, regulatory environment and competition.
- ❑ First-mover companies may initially have a benefit in pricing and ability to set terms, and have a strong development role, but the advantage may be eroded quickly if banks enter the market.
- ❑ The time needed to develop the market, nor the speed with which low-cost competitors can capture market share should not be underestimated.
- ❑ Regulations (tax changes, special rules, interest rate caps, currency restrictions or nonmarket pricing, equipment import restrictions) can impact leasing companies more than banks. IFC

should identify and work with governments to address any un-level playing field regulations or changes.

- Regulatory or economic changes affecting the SME sector that could impact the leasing company's portfolio quality and/or profitability should be anticipated.
- The use of TA to strengthen leasing companies and SMEs as well as the enabling environment should always be considered.

Glossary

- ❑ **Leasing:** A rental agreement that extends for a year or more and involves a series of fixed payments. In this paper, refers only to equipment leasing.
- ❑ **Financial leasing / Financial leases:** Leasing / leases where the primary objective is to acquire equipment at the end of the lease period.
- ❑ **Operational leasing / Operational leases:** Leasing / leases where the primary objective is to use the equipment for a significant period, but not to acquire the equipment at the end of the lease period.
- ❑ **Rural Leasing:** Equipment-leasing activities in rural areas for agriculture (farming, livestock, agro-industry), fisheries, infrastructure (transport, water and sanitation, telecommunication, nongrid electricity), etc.

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