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FINANCIAL SECTOR KNOWLEDGE SHARING

ASSET-BASED FINANCE

WHITE PAPER #1

JANUARY 2010

This document was produced for review by the United States Agency for International Development. It was prepared by Chemonics International Inc. for the Financial Sector Knowledge Sharing Project, delivery order number EEM-E-03-05-00006-00.

ASSET-BASED FINANCE

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CONTENTS

ACRONYMS

A/R	accounts receivable
DCA	Development Credit Authority
EGAT	USAID Bureau for Economic Growth Agriculture and Trade
FS Share	Financial Sector Knowledge Sharing Project
IAS	International Accounting Standard
IFC	International Finance Corporation
MSOW	model scope of work
OECD	Organization for Economic Co-operation and Development
POF	purchase order finance
SME	small- and medium-sized enterprises
SOW	scope of work
SPV	special purpose vehicle
WHR	warehouse receipts

INTRODUCTION

The USAID Bureau for Economic Growth Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International Inc. the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a 3-year period of performance, July 2008 through July 2011.

Through the FS Share Task Order, USAID/EGAT and Chemonics proactively collaborate with missions to identify priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial-sector best practices and aggregates them through model scopes of work (MSOW), primers, diagnostic tools, best practice case analyses, white papers, and other tools. These deliverables are disseminated to USAID missions for use in financial-sector programs. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers presentations and other knowledge-sharing endeavors.

Objective of this White Paper

The objective of this white paper, *Asset-Based Finance*, is to provide U.S. government program designers with a basis of technical understanding on asset-based financing as an approach to meet the operation and expansion needs of small- and medium-sized enterprises (SMEs). The paper summarizes different instruments of asset-based financing, describes when and how the instruments may be used in technical assistance interventions, and lists the programmatic prerequisites necessary to develop a project that provides or reinforces access to asset-based financing by banks and non-bank financial institutions.

This FS Series was authored by Francois-Jude Pepin and reviewed by Roberto Toso and Melissa Scudo for Chemonics International.

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EXECUTIVE SUMMARY

This white paper provides U.S. government program designers with a basis of technical understanding on asset-based financing as an approach to meet the operation and expansion needs of SMEs. It summarizes seven types of asset-based financial products, when and how they may be used in technical assistance interventions, and the programmatic prerequisites necessary to develop a project that provides or reinforces access to asset-based finance as a financing practice for banks and non-bank financial institutions.

The products reviewed in this paper are accounts receivables (A/R) finance; warehouse receipts (WHR); purchase order finance (POF); factoring; leasing; asset-backed securities; and a few of their equivalents in Islamic finance.

A/R finance and WHR are available from banks and specialized commercial lenders; asset-backed securities are a capital market instrument. However, each requires well-developed secured lending infrastructure or investment securities law. Non-bank financial institutions and bank subsidiaries provide factoring and leasing; they separate this type of lending from their related deposit-taking activities. These instruments can reasonably exist within a country's normal legal framework.

WHITE PAPER

A. Asset-Based Finance

A1. Background

Banks often do not deliver the types of financial products SMEs need, especially in developing markets. Bank lending to SMEs is often for lines of credit, not transaction-based short-term working capital. For their own credit-rating requirement, banks separate riskier asset-based activities from regular banking activities. Furthermore, banks do not usually have the skill set required for SME financing or the resources to closely monitor the assets. They often do not know how to use or modify the product or deliver it profitably to SMEs.

To deal with more frequent and larger orders — two requirements for growth — SMEs need short-term working capital for inputs such as raw materials and packaging. Most SMEs cannot satisfy banks' lending criteria (e.g., financial transparency, audited statements, and real estate or other collateral), and most banks do not accept growth opportunities or trading assets as a basis for providing financing.

Therefore, SMEs need to be able to borrow against their assets, as in factoring, to speed up their collection rate and recycle their working capital faster, which allows them to extend credit terms to potential customers or lease revenue-generating equipment.

Asset-based finance allows SMEs to utilize commonly produced assets (e.g., purchase orders, A/R, inventory, equipment, and real estate) as a source of liquid funds. It is suited to SMEs because it does not require them to qualify for traditional bank loans or limit them to financial products short of meeting their borrowing needs. By contrast, manufacturers or equipment suppliers often readily provide leasing as a part of their sales/marketing activities.

With conventional lending, the asset or collateral is viewed as a secondary source of repayment. With asset-based lending, the asset or collateral is viewed as the primary source (Bakker, Klapper and Udell, 2004, p.10). This is advantageous for undercapitalized companies with well-performing receivables or those that are growing or expanding faster than their cash flow intake. It works well with producers, manufacturers, distributors, and service companies with a leveraged balance sheet, and whose seasonal needs and industry cycles often disrupt their cash flow.

A2. Instruments and Applications

A2a. Accounts Receivables Finance

A/R financing is based on an asset constituted of final sales of goods or services on credit terms (i.e. payment in 30 days), that can be pledged as collateral to a bank or commercial finance corporation to secure a loan, a line of credit facility, or a cash advance.

> **A/R Financing**
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> **A/R financing** is also referred to as receivable factoring, invoice factoring, or cash flow factoring.

This conversion of sales on credit terms to immediate cash flow provides the SME with flexible working capital when previous earnings do not qualify the SME for a loan or an increase in a line of credit from a financial institution. The A/R line of credit facility or cash advance is determined by the credit strength of the SME's customers, not the SME itself. The maximum amount of credit an SME can receive is determined by a formula linked to the liquidation value of the A/R pledged as collateral. The lender monitors the value of A/R so it does not exceed the amount of the line of credit (USAID, 2009a, p. 11).

A2b. Warehouse Receipts

Also known as inventory credits, a WHR finance system is based on receipts or "warrants" that prove ownership of a specific non-perishable commodity of a stated quality and condition stored in a specified location. When the commodity is pledged or sold by mere delivery of the receipt, the buyer or pledgee bank has the assurance, without physical inspection, that the specific commodity will be available when it is required.

Development donors have promoted WHRs to facilitate the financing of agricultural production, trade, and processing as instruments that can be pledged as collateral for credit against the inventory of the stored commodity. WHRs enable smallholder farmers to participate more actively in the broader market of agricultural products. Before the loan matures, a farmer and its pledgee bank will likely agree to sell the stored commodity to a processor at the most opportune time (i.e., at the best price). Upon repayment of the loan with the sales proceeds, the WHR is released by the lender and delivered to the buying processor.

> **WHRs**
>
> A coherent institutional and regulatory framework is necessary for WHRs to become a convincing instrument to secure loans to agricultural enterprises. Banks need to be able to trust warehouses and must be certain that the receipts can be used as effective deeds to exercise their rights in case of loan default.
>
> \- Source: FAO and ERDB, 2002

A WHR system will work well where government and industry have established a legal foundation for collateral. This includes foreclosure and sound management of licensed and bonded warehouses. Furthermore, warehouses must be adequately supervised by a regulatory agency, with a system that guarantees performance and minimizes transaction costs. These conditions make warehouses convincing instruments and will drive demand (FAO and ERDB, 2002, p.1). Accurate, transparent market commodity prices must also be disseminated. This will allow a depositor agricultural SME to determine the best time to sell its stored commodity (USAID, 2009a, p.12).

WHRs are also an integral part of agricultural and non-agricultural commodities futures exchanges because they allow commodity trading via the delivery of receipts rather than the actual commodity (Emerging Markets Group, Ltd., 2007). An exchange's rules can specify the grade of a commodity and warehouse standards. To leverage the high capital investment and operating costs required for WHR systems, the development of WHRs for financing and a commodity futures exchange could be linked in the design of a comprehensive agricultural commodity infrastructure program (Lacroix and Varangis, 1996, p. 38). This will foster a market economy by removing government subsidy intervention. It will also provide better price information for farmers, which can improve their livelihoods.

A2c. Purchase Order Finance

POF is not a general loan or line of credit; it is a transaction-specific form of short-term working-capital finance. POF allows an SME to obtain the capital necessary to fill a particularly large customer order — larger than it could fill without assistance —that may present a growth opportunity. The capital finances the purchase of the raw material, packaging, production, and shipment of the goods ordered by the client.

POF is provided by specialized commercial financiers, usually managed by trade finance and merchant banking professionals, and professionals from manufacturing and trading. Banks and non-bank financial institutions do not provide POFs.

POF requires close monitoring of an SME's operations and production (i.e., track record of production and timely delivery). It presents higher risks and requires higher interest rates and fees than other asset-based products (USAID, 2009a, p. 16). The financier must verify the purchase order from the SME's commercial or government buyer and obtain estimates based on actual quotes of direct costs to determine the exact amount. The financier must also continually review and monitor the SME's labor and production costs breakdown, operating records, and customer creditworthiness.

To further mitigate its risks and profitably finance growth, the financier may rely on an SME's projected cash flows, take collateral in inventory, real estate or documentary credit, and advance a percentage of the order value smaller than the usual maximum of 75 percent. It may also pay the SME's suppliers directly, using a letter of credit to prevent the use of funds for other activities. Once the order is filled and invoiced, with receivables assigned to the financier, the financier pays the SME after deducting its fees and interest.

Tangible Benefits of POF

When done properly, POF generates rapid SME growth in sales, profitability, employment and exports, and makes the difference between success and failure for many SMEs"

- Source: USAID, 2009a, p. 15

A2d. Factoring

Factoring and POF can work in tandem. Whereas POF funds the production phase, factoring finances the collection phase, after the order has been completed and delivered. Like A/R finance (and unlike POF), factoring eliminates the risk that the supplier will not produce and ship the goods.

Customers issue purchase orders for an SME's goods or services. The SME delivers them and issues its invoice to its customers with terms of payment (30 or 60 days). During this period, the SME has an asset in the form of A/Rs, but must wait until payment to recover its production cost and profit.

Factoring provides a source of finance based on an SME's asset. It converts the payments the SME will receive in 30 or 120 days into immediate funds. The SME sells its A/Rs to a factor, which pays the SME a discounted price (50-80 percent of the A/R's face value), free of any lien. The factor will pay the SME the balance, less interest and service fees, when it receives payment from the SME's customers.

The sale of the A/R is an essential element of the factoring transaction. The factor owns the A/R and is protected from an adverse change in the SME's financial situation, unless it has retained the right to claim against the SME if its customers do not fully pay receivables. Such "recourse factoring" is more frequent in emerging markets where default risk assessment is problematic (Klapper, 2005, p.7).

Factoring differs depending on the functions a factor performs. Finance and collection without maintenance of accounts is **invoice discounting**. Traditional factoring is usually limited to commercial receivables, excluding consumer receivables, and is more popular with SMEs that cannot or do not want to employ full-time staff to manage credit. When an SME resorts to factoring, it in effect outsources its credit and collection functions to the factor. The factor assesses the creditworthiness of the SME's customers (whose accounts it will purchase) using its own proprietary data and publicly available data on account payment performance. The factor also manages A/Rs (a process called ledgering), collects delinquent accounts by giving past-due notice to the SME's debtor and ultimately initiating judicial proceedings, and bears the debtor's payment risk (known as non-recourse factoring).

Future receivables are a potentially important source of factoring and should be included in any definition of factoring. A stable commercial relationship usually means future cash flow from product delivery will be reliable, so an SME may wish to factor the receivables and the factor may wish to purchase them. This is a common practice that increases the flexibility of factoring as a financing instrument.

Factoring is one type of **receivables financing**. There are other types that should not be included in the definition of factoring:

1. *Forfeiting* is the purchase or discounting of documentary receivables (e.g., promissory notes) without recourse, involving financial rather than commercial transactions with different collection characteristics
2. *Refinancing* is the assignment of receivables against some form of bank or other credit granted to the assignor
3. *Securitization* can involve issuance of securities backed by commercial receivables of various types purchased by the issuing securitization company from the commercial entity that originated the receivables
4. *Project finance*, or loans to project contractors secured by future revenues generated by the project

If the SME and its factor are in the same country, it is called **domestic factoring**. The domestic factor is solely responsible for the collection and quality of service. **International factoring** is when the SME is in one country and its factor is in the country where the SME's customer is located. A single factor can conduct the activity (known as **direct factoring**) in international factoring. However, there are advantages to the so-called two-factor system, in which a factor in the SME's country (the **export factor**) and a factor in the SME's customer country (the **import factor**), responsible for collections and the quality of service) cooperate. An SME exporting to several countries signs one factoring agreement with the export factor in its own language, and the SME customers deal with a local import factor in their own language. This is useful to facilitate the SME's sales to foreign markets.

With **reverse factoring**, a factor purchases A/Rs from only select, high-quality customers. This allows the factor to determine the credit risk of only high-quality customers, assume the risk of default by and factor in emerging markets on a "without recourse" basis, allowing SMEs to sell A/Rs in greater amounts at lower costs.

A2e. Leasing

Money is lent out in a loan; an asset is lent out in a lease (Fletcher, Sultanov, and Umarov, 2005, p. 15). Leasing finances the medium- to long-term acquisition or use of an asset. It assumes value comes from using the asset rather than owning it. As a **lessee**, an SME leases the asset from the **lessor**, who owns it. The SME generates extra income from the use of the asset and the lessor receives income and has the security of owning the asset.

Benefits of Leasing

Leasing promotes investment in capital equipment, increases competition in the financial sector, and facilitates the transfer of technology.

Non-consumable assets range from equipment (e.g., heavy road machinery or a dentist's chair) and real estate (e.g., a manufacturing plant or improvements to it) to vehicles (e.g., aircraft and cars).

For SMEs, leasing has several advantages over a loan:

- It does not require additional collateral.
- It provides 100-percent financing with no down payment, except to reduce the lease payments.
- The lease allows for accelerated depreciation.
- It can provide enhanced financial ratios.
- It offers flexibility and hedges against technology obsolescence: Early termination can be negotiated and, at the end of term, the lease can be extended or the asset returned.

The lease is a contract describing the asset. It sets forth the duration of the lease, the payment schedule and amounts, insurance requirements, and purchasing options at end of term. Payments by the SME lessee can be tailored to its cash flow: seasonal payments adapted to higher payments in peak season; varying monthly payments based on predictable income variations; and deferred lease payments that allow time for equipment installation, staff training, and a period until the equipment can generate income.

In longer-term leases (i.e., more than 1 year), the lessee often selects the supplier from which the lessor purchases the asset to be leased. The supplier is then responsible to the lessee for warranty, and an after-sales service package may be added.

Excluding a simple **rental**, which is a type of short-term operating lease for a fully maintained asset that is returned at the end of the contract (e.g., a car rental for a day trip), there are several types of leases available to SMEs:

1. A *financial or capital lease*, for a term longer than one year, closely matches the expected economic life of the asset. At the end of the lease, the lessee usually becomes the owner or purchases the equipment for the amount of the residual value, because the secondary market or resale possibility is usually limited due to its nature (e.g., specialized factory machinery).
2. An *operating lease*, also for a term longer than a year, is on a net basis or without services. The lessee is responsible for maintenance and has the option to become the owner at the end of lease period. The lessor usually bears the risk of the asset's residual value, but the secondary market is usually developed (e.g., office furniture).
3. A *sale and leaseback* is a type of financial lease. The client is the initial owner of the equipment and sells it to the lessor. Both enter into a lease agreement to lease back the equipment, freeing up funds the SME will use as working capital. The lessee is committed to buying back the asset through payment of lease obligations, including the residual value (e.g., the sale and lease of a manufacturing plant).

A2f. Asset-Backed Securities

An asset-backed security, or **securitization**, is an asset-based finance product available on the capital market. It is, therefore, non-bank finance. Consider an SME that leases cars and has accumulated a substantial leasing business. It has reached the point where it needs to replenish funds tied up in contracts so it can enter into more leasing contracts to meet consumer demand and generate more business and profit. It has several choices: borrow additional money from a bank, raise funds on the capital market by issuing shares or even bonds, or obtain financing from its own asset (i.e., its portfolio of outstanding leasing contracts that generate payments now and in the future, and the cars leased in that portfolio).

As **originator** of the leasing contracts, the SME sells that portfolio for cash to a securitization company, or **special purpose vehicle** (SPV), which pays the SME a discounted price for the value of the portfolio. The SME (i.e., the originator) uses the funds to continue underwriting more leasing business.

To obtain repayment, the SPV sells on the capital market through a private or a public placement, a bond (a debt investment **security**) guaranteed or **backed** by the income stream of the lease portfolio.

Investors (**bondholders**) are repaid their principal amount plus interest over the period of the bond from the incoming cash flow from leasing payments. They also have the security of the cars as collateral for any payment default by lessees. Because the bond is guaranteed by an asset, its rate of interest should be less than what the originator SME would pay on an unsecured bond or a bank loan.

Portfolio valuation and bond rating must apply under securities laws, but a crucial element is to ensure the asset belongs entirely and exclusively to the bondholders. For this reason, the sale of the asset by the originator to the SPV must be a **true sale**, because the SPV acts as the trustee for bondholders. There must also be **bankruptcy remoteness** for the SPV, precluding the originator from claiming any right over the cash flow and cars that belong to the bondholders.

Securitization can be structured on a **true sale** of the underlying asset to the SVP so the asset will be **off balance sheet** and the originator has no liability to bondholders. It can also be structured without a true sale: The originator retains the portfolio on its balance sheet and assumes liability to bondholders for any default in payment of the principal and interest of the asset-backed bond.

A2g. Islamic Finance

Islamic finance is included in this white paper because it is asset-based. It offers a solution when/where conventional finance may not be tolerated; it also provides an alternate product or supports an alternate finance provider.

Islamic finance is a financial system consistent with principles of Islamic law (*Shariah*), which prohibits usury, the collection and payment of interest (*riba),* business activities contrary to Islamic values (e.g., selling alcohol or pork, or operating a casino), and requires finance structured on an underlying asset or the profit it generates.

Here are three Islamic financing products matching conventional asset-based financing products (USAID, 2008a):

- *Ijara* is a *manfaah* (usufruct) contract whereby a lessor (owner) leases an asset or equipment to its client at an agreed rental fee and pre-determined lease period upon the *`aqad* (contract). The ownership of the leased equipment remains in the hands of the lessor. It is equivalent to leasing.
- *Ijarah thumma bai`* is a contract that begins with an *ijara* contract for the purpose of leasing the lessor's asset to a lessee. At the end of the lease period, the lessee will purchase the asset from the lessor at an agreed price by executing a purchase (*bai`*) contract. It is equivalent to sale and leaseback.
- A *sukuk* backed by any Shariah-compliant asset-based products is equivalent to an asset-backed bond or securitization.

B. Access to Asset-Based Finance

A financial institution's ability to extend asset-based financing — and an SME's ability to obtain it — depends on factors that determine or can further its accessibility and viability.

B1. Legal, Regulatory, and Judicial Environments

The bedrock of asset-based finance is a combination of:

- the general law governing commercial contracts and assignment of book debts or receivables
- laws and regulations directly affecting a specific product (e.g., factoring or leasing) or more general laws (e.g., bankruptcy law) that implicitly affect products
- the regulatory body, if any, that supervises non-bank financial services
- the tax code and accounting rules, as applied to asset-based transactions, providers, and users
- the knowledge of courts of law or arbitrators in such transactions

It is possible to design or adjust these to develop an asset-based finance industry — but only after these environments are thoroughly understood.

Key legal issues include whether these environments properly address factoring as a sale and purchase; efficient debt collection; bankruptcy procedures for leases; and the ability to freely assign receivables and transfer assets to an SPV. A law that recognizes factoring or leasing law as "financial services" and clarifies the nature of the transaction will legitimize the industry, as will electronic security laws that allow electronic sales and transfers of goods in support of viable technology infrastructure for warehouse receipts (Klapper, 2005, pp. 9-11; Giovannucci, Varangis, and Larson, n.d.).

Adequate regulation is a balancing act for finance providers that do not take deposits (Fletcher, Sultanov, and Umarov, 2005, pp. 14, 25) because it can limit competition or hinder industry development with burdensome and costly regulations (Bakker, Klapper, and Udell, 2004, p. 9). Non-bank lessors and factors use their own funds or borrow on commercial markets, and have the expertise to judge and assume credit risks without outside intervention (Fletcher, Sultanov, and Umarov, p. 26). A best practice in developed economies is to leave leasing and factoring unregulated, except perhaps for consumer protection or stipulating moderate minimum capital requirement for deposit-taking financiers (USAID EFS on factoring and leasing). Securities laws and the regulator must look after the interest of the investing public in asset-backed securities, with adequate disclosure and bondholder protection mechanisms. Furthermore, raising judges' and arbitrators' awareness to the fundamentals of asset-based finance, collateral, repossession, and foreclosure are advisable programmatic activities (Fletcher, Sultanov, and Umarov, p.22).

B2. Secured Lending and Collateral Registry

Factoring and leasing do not depend on secured lending laws, a collateral registry, or the judicial foreclosure of collateral because they are the property of factors and lessors who can freely dispose of them to recover value. But A/R, POF, and WHR finance entirely depends on them. Nevertheless, a collateral registry for moveable property, essentially targeted at secured lending (e.g., A/R and POF), will facilitate access to all asset-based finance products and prevent fraud because it determines ownership of the asset underlying the financing (Fletcher, Sultanov, and Umarov, 2005, p. 22). In addition, for the benefit of third parties, civil law regimes generally require publication of a transfer of book debts (A/R finance, factoring) through an entry in a registry. A collateral registry is an important element of finance infrastructure in the World Bank Doing Business project methodology, which grants 10 points for the strength of secured lending with collateral registry.[1]

B3. Credit Information Bureau

Asset-based finance is greatly assisted by dependable credit information about local businesses from sources such as credit information bureaus and business registries. Promoting the development of credit information bureaus and accurate business registries, therefore, is vital to developing a stable asset-based finance system. In fact, it is the other essential component of "access to credit" in the Doing Business project, which grants six points for depth of credit information.

B4. USAID Development Credit Authority Guarantee program

To reconcile conservative bank lending practices with the need to support access to finance, USAID missions use the Development Credit Authority (DCA) guarantee program to stimulate lending through partial credit guarantees in support of sustainable broad-based development. The facility can be considered when designing programs contemplated by the Foreign Assistance Act. DCA covers up to 50 percent of the default risk sustained by financial institutions.[2]

B5. Industry Associations

It is difficult to envision the development of an industry without an association representing its unified interest. A leasing, factoring, or a combined asset-based finance trade association would serve the finance industry to develop business standards, ethics, and operational guidelines; gather and disseminate information; train professionals; promote industry; participate in formulating government policy and reforms; and even organize sharing member clients' data with a credit information bureau.

Where sectors are not developed or underdeveloped, finance providers could join an international association such as the U.S. Equipment Leasing Association.

[1] see http://www.doingbusiness.org/MethodologySurveys
[2] see http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit

B6. International Standards

International standards foster good business and attract international players.

It is important to understand what fiscal regime applies to asset-based finance, particularly factoring and leasing, and what accounting practices are applied by the fiscal authorities, regulators, and the accounting and auditing profession.

It is also important to clarify the application and rates of value-added tax or sales tax to factoring, leasing, and commissions and interest on advances. It is common practice in developed countries to exempt financial services such as factoring and leasing from a value-added tax. Customs and excise taxes should be adapted to leasing when imported equipment must be returned to its country of origin. Other obstacles to the development of asset-based finance are transactions taxes and stamp duty taxes on factoring, accounts collection, leasing, and lease-back.

Accounting rules must also be clarified for the benefit of proper tax and the reporting of factoring and leasing financial statements. The accounting treatment of provisions and losses should be clearly understood and applied, particularly for factors who purchase receivables and make contingent commitments involving degrees of risk. International Accounting Standard (IAS) 17 applies to leasing: The IFC Leasing Manual illustrates the impact of several approaches to accounting and taxation of leasing, and proposes best practices (Fletcher, Freeman, Sultanov, and Umarov, 2005, pp. 30-54) consistent with those stated here.

Standards for securitization are IAS 39 for accounting purposes and the December 2005 U.S. Securities and Exchange Commission "Asset Backed Rule," the first codification of a comprehensive set of securitization rules.[3] Best practices are set forth in IFC's "Securitization in Russia-Ways to Expand Markets and Reduce Borrowing Costs" (IFC, 2005).

International factoring will benefit from an industry-formulated framework governing SMEs, their customers, and the export and import factors. Factors Chain International is the most prominent factors network. To join the network, export and import factors sign an interfactor agreement whereby they become governed by the General Rules for International Factoring, which details standard operating procedures, the rules for secure e-mail communications, and the arbitration rules of a voluntary dispute resolution process. A country does not have to incorporate any of these in a regulatory framework. International conventions also define international leasing and factoring, and relationships between parties, but the compatibility of Factors Chain International practices with International Institute for the Unification of Private Law convention of 1988 renders it unnecessary for a country to ratify. For factoring, the more recent United Nations Commission on International Trade Law convention on contracts for the international sale of goods has even fewer signatories.

[3] see http://www.sec.gov/rules/final/33-8518.htm

For public warehouses, local standards may exist or be set forth in rules of a commodity or futures exchange. A source of generally accepted auditing standards comes from the Public Company Accounting Oversight Board in its interim auditing standard, AU Section 900, "Public Warehouses—Controls and Auditing Procedure for Goods Held."[4]

B7. Shariah compliance

If a financial institution wants to offer Islamic finance products, it must appoint a Shariah board or a Shariah counselor to ensure products are Shariah-compliant. It must also segregate funds derived from Islamic finance activities from non-Islamic activities.

There are institutions that help governments and supervisory agencies understand Islamic finance, and issue standards and best practices (e.g., accounting standards). Prominent ones include the International Monetary Fund, the Islamic Financial Services Board, the Accounting and Auditing Organization for Islamic Financial Institutions, and the Islamic Development Bank.

C. Experiences with Asset-Based Finance

It is the government's role to create awareness of the benefits of access to financial services. Furthermore, these benefits deserve consideration in the design of development assistance programs to all types of financial products (Nenova, Niang, and Ahmed, 2009, p. iv). Intense marketing efforts and outreach programs to targeted borrowers foster the success of introducing such asset-based products (USAID, 2009a, p. 33).

C1. Warehouse Receipts

> **The Importance of Law**
>
> "The most important thing in establishing [a WHR] system is the creation of a proper foundation in the law."
>
> Source: FAO/EBRD, 2002, p. 34

The experience of several developing countries that have tried to establish WHR systems indicates that, in order to work well, WHRs need a recognized basis in law, so the ownership established by the receipt is not challenged. Equally important are provisions for performance guarantees and the establishment of systems for warehouse inspection and crop-quality determination (Lacroix and Varangis, 996, p. 39).

The World Bank concludes the general experience of transition and developing countries with WHR is limited but provides important lessons on the impact of government intervention and conflicting signals.[5]

The FAO and EBRD report (2002) comments on the positive experiences in Bulgaria and Hungary with WHR and with the observational tour which was conducted in these countries. FAO and EBRD propose a replication in Lithuania in order to improve the

[4] see http://www.pcaob.com/Standards/Interim_Standards
[5] See http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTARD/0,,contentMDK:20440946~pagePK:210058~piPK:210062~theSitePK:336682,00.html

existing WHR system; the text of the proposed draft amendments is provided (p. 34). The FAO recently released a publication describing and assessing the use of WHRs and other asset-based finance products in agriculture in the Eastern European and Central Asian regions; it offers insights into how WHRs improve productivity in agriculture, making a distinction between asset-based finance and traditional credit, which has had mixed results in these regions.

A WHR system offers potential but may not be the best means to increase SME finance and program designers should exercise caution. (USAID, 2009a, p. 12)

C2. Purchase Order Finance in Bolivia

The "Purchase Order Finance in Bolivia: Innovations in Financing Value Chains" case study, discussed in *FS Series #4: Enabling Small- and Medium-Sized Enterprise Access to Finance*, details the methodology and experience of Chemonics and Crimson Capital in implementing the USAID-funded Rural Competitiveness Activity (ARCo) in Bolivia (pp. 21-24). ARCo developed POF to address barriers and increase access to financial services for small-scale producers. POF considers all the actors in the value chain, leveraging existing relationships among them to guarantee loans without physical collateral requirements. Several important lessons emerged from the ARCo model with respect to reducing risk and building trust and sustainable incentives in the coffee industry:

- Creating an A/R mechanism reduces risks for financial institutions.
- Targeted subsidies lower costs of entering the market and encourage long-term sustainable interventions by financial institutions.
- Increased information-sharing, collaboration, and understanding of each party's constraints improves trust among buyers, sellers, and financial intermediaries.
- Training the financial institution's staff in marketing skills plays an important role in project success, because POFs are driven by supply.
- It is important to design an exit strategy to avoid creating dependency.

Furthermore, the USAID Macedonia Business Resource Center project provided financial resources to create the market-driven SME Commercial Finance Fund, which developed and marketed POF, and closely monitored SME production. This resulted in increased finance, SME growth, exports, and job creation. The fund was replicated in Kosovo in 2008 (USAID, 2009a, pp. 31-33).

C3. Factoring

According to Klapper (2005), factoring, frequently done in developed countries on a "non-recourse" basis, has not proven profitable in emerging markets because factors assume large credit risks where credit information is unavailable and fraud is a serious drawback (bogus receivables, non-existing customers). This is compounded by a weak legal environment and the absence of electronic business registries and credit bureaus. In emerging markets, factor could buy receivables "with recourse" (p.7) to the SME if its buyer does not pay, provided the SME has the capital reserves to pay (p. 9). Klapper proposes “reverse factoring” as a more viable and effective solution, because it allows factoring “without recourse” and provides low risk finance to high-risk SMEs since the default risk is that of the high-quality customer (p.9). However, she recognizes that legal, tax, and accounting challenges of conventional factoring do remain. The author concludes at length on the Mexican experience of Nafin/DBP programs where “chains” of small SME suppliers and large buyers were created, and the use of electronic channels cut costs and provided greater SME services. Its success is proposed as model for other developing countries (Klapper, 2005, p.25).

A detailed analysis is provided in *FS Series #5: Value Chain Finance*. (USAID, 2009b, pp. 18-23).

C4. Leasing

Fletcher, Sultanov, and Umarov (2005) share experiences on developing equipment financial leasing, address policy issues and appropriate courses of action, and discuss how to maximize leasing’s contribution to development. Developing leasing adds a new product; deepens the financial sector; provides access for SMEs without a significant asset base; makes SMEs more economically active; improves their access to income-producing assets; and promotes domestic production, economic growth, and job creation in economies with weak business environments (p.6). They identify key stakeholders and their objectives in developing leasing (p.9), set forth guidelines for the legal framework (p.13) and approaches to tax and accounting treatment and their impact (pp.30-54). One recommendation is not to directly subsidize leasing companies (p.29).

FS Series #4: Enabling Small- and Medium-Sized Enterprise Access to Finance details how the successful introduction of leasing in Armenia, with ACBA Leasing Company (through the USAID Agribusiness SME Market Development program) has had a demonstration effect on other financial institutions and why it is a replicable model (USAID, 2009a , pp. 27-31).

C5. DCA Guarantees

This section presents a brief overview of select applications of the guarantee to four types of asset-based finance.

WHRs. To encourage lending to the agricultural sector in Zambia by using warehouse receipts as collateral, USAID provided 50 percent credit guarantees to local commercial banks for lending against WHRs. USAID also supported warehouse management, certification, and grades and standards testing to ensure warehouses were properly managed and collateralized commodities securely stored. Wealth shifted to smaller farmers and traders because local banks entered new rural markets. Prices stabilized because grain was stored instead of being sold at harvest time.

Leasing. USAID/Sri Lanka structured a lease portfolio guarantee with Lanka Orix Leasing Company, mobilizing enough financing for 150 equipment financial leases, including tractors and transportation vehicles. The innovative use of DCA enabled leasing to those not able to afford standard down payment requirements.

Asset-backed securities. To support mortgage lending development and the secondary mortgage market in Kazakhstan, USAID provided a 50 percent principal guarantee on a U.S. dollar-indexed mortgage-backed bond issued by Lariba Bank. This was designed to demonstrate that banks can finance mortgages and sell off their portfolios.

For a detailed analysis of how DCA assisted the development of access to SME finance in Kenya with K-Rep Bank, Kenya Commercial Bank, and Fina Bank, see *FS Series #4: Enabling Small- and Medium-Sized Enterprise Access to Finance* (USAID, 2009a, pp. 24-27).

ANNEX A. BIBLIOGRAPHY

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