USAID FROM THE AMERICAN PEOPLE | **FS SHARE** FINANCIAL SECTOR KNOWLEDGE SHARING

FS SERIES #7: ENHANCING THE LEASING ENABLING ENVIRONMENT

PRIMER

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ACRONYMS

DCA	Development Credit Authority
DFID	U.K. Department for International Development
EGAT	Bureau for Economic Growth Agriculture and Trade
FS Share	Financial Sector Knowledge Sharing Project
IFC	International Finance Corporation
MFI	microfinance institution
MSE	micro and small enterprises
SME	small- and medium-sized enterprise
SOW	scope of work
VAT	value-added tax

INTRODUCTION

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

Through the FS Share task order, USAID EGAT and Chemonics proactively collaborate with missions to identify financial-sector 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, primers, diagnostic tools, best-practice case analyses, and other tools. These deliverables are disseminated to USAID missions for use in financial-sector programs. FS Share can also 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 FS Series

The objective of this FS Series, "Enhancing the Leasing Enabling Environment," is to provide U.S. government program designers with a basis of technical understanding of lease financing as a sustainable approach to increasing access to financial services and practical tools to integrate best practices and lessons learned into effective economic growth programming. The FS Series includes a primer, a diagnostic checklist, and a model scope of work. The primer introduces, defines, and provides an overview and case examples of introducing and implementing leasing in emerging economies. **This is the primer.**

This FS Series was developed by Roger Bird on behalf of the QED Group and reviewed by FS Share on behalf of Chemonics International.

FS Share Rapid Response Hotline

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EXECUTIVE SUMMARY

At the heart of economic development activity is the need for businesses to access financing, particularly long-term financing of equipment (three to five years). The availability of equipment financing within a developing economy can translate into additional economic activity through increased employment, productivity, product quality, and exports. This creates a multiplier effect through the additional demand of products and services such as accounting, advertising, transportation, mechanical repairs/parts and service, and consumer goods. Increasing access to equipment financing is a catalyst for economic growth.

By replacing outdated equipment, emerging economies can increase production, product quality, exports, and employment. Access to financing for equipment, however, continues to be a significant hurdle for small- and medium-sized enterprises (SMEs) and the agricultural sector in many countries. Traditional banking in emerging economies often has structural limitations due to insufficient liquidity, poor or nonexistent secured transactions laws and collateral registries, inadequate judicial processes, and limited or absent creditors' rights. Developing leasing can mitigate many of these constraints. Leasing companies are not secured parties; they are owners of equipment that have more control over their equipment than banks do over their collateral. Furthermore, because up-front costs for leasing are lower than traditional bank lending, leasing is a viable alternative to lending in many economies where unreasonable collateral requirements are prohibitive.

Leasing is a method of financing that provides for the use of an asset (e.g., equipment) rather than advancing money (in the form of a loan) to a business to purchase the asset. Leasing is based on the premise that profits are earned through the use of equipment, not ownership. It focuses on the lessee's ability to generate cash flow from the use of equipment and its business operations to service the lease payment, not the balance sheet or collateral, as with loans. This can be advantageous for new businesses or SMEs that do not have enough cash savings for large down payments or sufficient other assets that could be pledged as collateral for a loan. Leasing does not require additional collateral because the equipment is owned by the lessor (the leasing company).

Lending and leasing are similar in that both involve decisions regarding the creditworthiness of the borrower (i.e., the lessee) and an analysis of the risks. Leasing, however, has additional factors: The lender must be knowledgeable about both agricultural credit analysis and the equipment (its value, the dealers, parts providers, repairs, maintenance schedules, manufacturers' warranties, and how to calculate expected depreciation). This is why a leasing company might choose to specialize and build expertise in one equipment or industry.

There is a significant amount of confusion in lease terminology. For example, "finance lease" and "operating lease" are commonly referred to as types of leases, though they are accounting terms that define how companies account for a lease transaction in their financial reporting. Care must be taken when defining leasing under a lease law or tax code because accounting, commercial law, and tax codes have different objectives and each should be clearly defined. The confusion over these terms in developing countries and their improper use has seriously constrained the growth of leasing and the positive economic impact leasing could be having in developing countries.

Demand for agricultural equipment is high in many developing economies. Leasing is a well-suited form of financing for the agricultural sector because most farmers use the same or similar equipment, and this equipment has a long, useful life. Leasing offers more flexible terms than traditional bank loan products, particularly to the agricultural sector, whose income is seasonal and can benefit from this kind of flexibility.

Leasing, as a new source of financing, needs support in its development. The most effective ways to support a nascent leasing industry are 1) a proper legal definition of leasing (i.e., it is a three-party transaction); 2) laws that do not restrict the parties' freedom in contract negotiations; 3) zero-rating lease payments for value-added tax (VAT); and 4) allowing the lessor and lessee to choose who will be considered the owner of the equipment for tax purposes.

The availability of leasing in emerging economies becomes the difference between having access to long-term credit and not. One of the most compelling reasons for leasing in emerging economies is that the leased equipment is owned by the lessor. Financial leasing allows the lessee to use equipment owned by the lessor in exchange for specified periodic payments. The legal owner relies on the ability of the user to generate sufficient cash flows to make lease payments, rather than relying on its assets, capital base, or credit history. Knowledge of the equipment and business results from leased equipment generate indicators of prospective cash flows. This knowledge also provides substitute information for credit history that might not otherwise be available. Security for the transaction is provided by the asset itself.

Thus, leasing enables borrowers without well-developed balance sheets or credit histories — especially new or small businesses — to access the use of capital equipment when they would not otherwise be able to qualify for traditional commercial bank lending.

As with any successful project, a well-conceived work plan and strategy are the first place to begin. To realize leasing's potential, it is critical to complete a thorough assessment of local laws, tax codes, the financial sector, and the capacity of the government on relevant issues. A good assessment will provide understanding of the priorities needed to develop a solid foundation for leasing and increased access to financing by businesses.

Leasing is an innovative financial product that has been proven to increase access to credit and improve the lives of small business owners and the agricultural market chain in developing economies. Different models and approaches, each appropriate to a given country/environment, can be used when developing leasing interventions. Case studies and the author's practical field experience provide key lessons learned and tested technical approaches that will assist in designing practical intervention projects for leasing.

PRIMER

The objective of this primer is to provide U.S. government program designers with a basic technical understanding of lease financing as a sustainable approach to increasing access to financial services, as well as practical tools to integrate best practices and lessons learned into effective economic growth programming. This primer defines leasing and describes how lease financing can stimulate economic activity through increased access to credit for SMEs and the agricultural sector. The information presented is based on a review and analysis of existing literature and resources, lessons learned, and approaches used to implement USAID and non-USAID programs.

Section A provides an introduction to leasing and demystifies the complexity of the alternative types of lease products. It compares a loan product to a lease and considers programming application for the micro and agriculture market segments. It explores applications with Islamic banking practices, vendor leasing models, and gives an example of how USAID's Development Credit Authority (DCA) credit enhancements can support leasing initiatives and further develop sustainable private-sector financing models.

Section B discusses the legal and tax platform necessary for leasing to become an effective and sustainable financial product. It identifies important elements needed within leasing legislation and highlights how VAT and profit taxes affect the economic value of leasing. Section C describes the enabling environment and alternative lease products that offer program designers guiding principles for designing and developing leasing in emerging economies.

Section D presents three case studies of leasing interventions that are potentially replicable in other developing economies. These case studies have been supported by USAID and other donors in Africa, Asia, Russia, and the Caucasus, and include agricultural, SME, and microcredit program models. The cases present different approaches used to stimulate leasing and represent lessons learned from alternative interventions that program designers can build upon.

Section E summarizes how alternative approaches have been used and their lessons learned. Key programming considerations and prerequisites for replication provide further guidance in developing market interventions.

Annex A provides a diagnostic checklist and Annex B offers a model SOW to assist USG programmers with evaluating the preconditions and options available to integrate leasing as a viable financial product. Both are intended as practical tools for integrating lessons learned and best practices. Annex C provides a glossary of leasing and financial terminology.

A. Introduction to Leasing

Leasing is a type of financing that provides a business with the use of equipment, not necessarily ownership. The company (borrower/lessee) earns profits by using the equipment, giving them the ability (i.e., cash) to make the lease payments. A financial lease is a three-party transaction between the lessor, the lessee, and the supplier of the equipment. The lessee, which in

developing economies is frequently an SME or an agricultural enterprise, is empowered because it is able to choose the equipment, the equipment supplier, and the leasing company.

In emerging economies, depending on the stage of development of the financial sector, traditional bank financing methods are often unable to meet the high demands for equipment financing. Reasons for this inability include:

- *Banks often lack sufficient capital and long-term deposits to fund three- to five-year loans.* Banks must comply with the national/central bank's liquidity requirement and prevent a mismatch in maturities of loans versus deposits. In developing countries, the majority of a bank's deposits are in current accounts, meaning that customers can withdraw their deposited money at any time. Therefore, banks are unable to lend money on a long-term basis because they must ensure their liquidity in case customers want to withdraw their money.
- *The absence of an effective secured transactions law and collateral registry for movable assets is a significant barrier to lending and serves as a disincentive for banks to lend.* Without strong creditor rights established by laws and an effective system for establishing a creditor's priority, lenders are not confident that they will be able to recover their collateral and receive any value from its sale if there is a default.
- *Judicial systems for creditors in emerging economies are often clogged and bureaucratic, and sometimes corrupt.* Legal proceedings are costly and it is not uncommon for collection cases to take a year or more. This seriously affects the recovery of any value that the lender placed on the collateral, and further prevents banks from risking loans secured by equipment.
- *In an effort to compensate for such market imperfections, a bank will charge a much higher-than-normal interest rate and demand excessive collateral.* Acceptable forms of collateral are typically immovable property (e.g., real estate), which most SMEs do not have. Bank loan collateral requirements can be as much as 150-200 percent of the loan amount; this seriously restricts businesses' access to credit.

A lease is not affected by these structural deficiencies of traditional loans. For example, leasing companies obtain their source of funds (i.e., capital) from a combination of long-term debt and equity, not from depositors. Therefore, they are not restricted to extending loan terms based on the maturities of their deposits. In fact, they are eager to extend three- to five-year leases to more effectively employ (invest) their funds.

Nearly all SMEs cannot meet the collateral requirements of traditional bank loans. With a lease, no excessive security or collateral is needed because the leasing company owns the equipment.

The absence of collateral requirements with leasing offers an important advantage in countries with weak legal environments, particularly those with weak creditors' rights, collateral laws, or collateral registries. Though an effective, properly written secured transactions law can also benefit leasing, leasing companies can often operate without such a law because they own the equipment; they are not a secured party.

A transparent judicial credit recovery system is critical for all forms of credit, including lending. Leasing often fares better than bank loans in the judicial system because equipment recovery falls under contract law (or a separate law on leasing) more often and the leasing company is clearly the owner of the equipment.

In addition to the advantages leasing has for a country's economy, businesses find significant advantages in leasing over traditional bank lending. For example, initial upfront cash requirements to obtain the equipment are low, and in many cases the leasing company asks for only one or two payments in advance. This means lower up-front costs, enabling businesses to better manage their cash and working capital.

Leasing is the most flexible form of equipment financing. However, as in all lending, it requires a sound knowledge of its principles, the equipment that is being leased, the related legal and tax implications, and the credit analysis skills to adequately assess and monitor investment risks. Leasing institutions can be banks or bank subsidiaries, leasing companies, subsidiaries of insurance companies, equipment producers or suppliers, or other nonbank financial institutions. The lessor provides the equipment to the lessee for its use over a specified period in return for periodic payments for an agreed amount. The lessee usually selects the equipment it will lease.

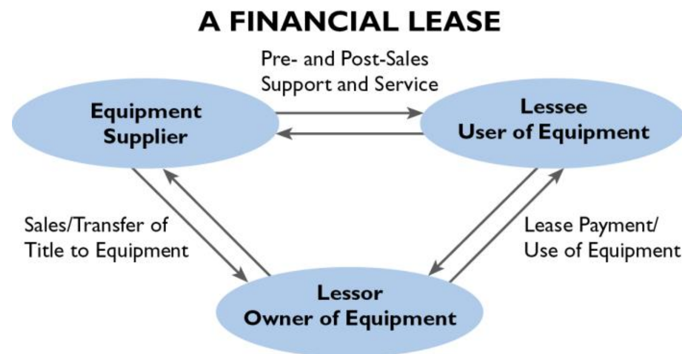
Leasing is an expanded financial product, not a substitute or replacement for traditional bank lending. Many banks start leasing companies because they want to provide their customers with a greater choice of financing services and greater depth in serving their markets. Leasing is important for developing economies because it creates an additional source of financing, increases competition, and overcomes many of the obstacles that traditional bank financing encounters. As a result, equipment leasing has become a popular financing alternative, particularly for SMEs.

A1. Types and Structures of Leases

A lease is different from traditional financing because it separates the legal ownership of the equipment from its economic use. Legal ownership of the equipment remains with the leasing company, while its economic use lies with the lessee throughout the term of the lease agreement. This does not mean that a business cannot one day opt to own (i.e., purchase) the leased equipment; however, the lessee has no vested ownership interest or equity during the lease term.

As stated above, a financial lease is a three-party transaction. First, the user chooses the equipment and the dealer after comparing factors such as models, prices, and maintenance. After getting a quote from a supplier, the user chooses a lessor based on lease terms (e.g., payments, lease term, and purchase options). The lessor then purchases and delivers the equipment to the user, who is now the lessee and uses the equipment for the term of the lease in exchange for fixed regular payments (Rozner, 2006, p. 2).

There are two types of financial leases: finance and operating. Understanding these two types of leases can be difficult because the industry has not been consistent in its terminology. The confusion comes from mixing accounting principles with contractual leasing structures. The terms "finance lease" and "operating lease" are accounting terms that classify *how* a lease will be



Source: Rozner, 2006, p.2

reported on a company's financial statements (i.e., balance sheet and income statement). The purpose of these definitions or classifications is to accurately report a company's financial condition .

To further complicate things, many tax codes in emerging economies also use these terms in their application of depreciation and/or tax benefits, which may differ from accounting standards. (See Section B for a discussion/clarification of the accounting and tax issues.) It is important to note that it is a common misunderstanding, particularly in emerging economies, that a finance lease is strictly an alternative form of a loan for purchasing equipment; "a finance lease is about financing the *use* of an asset, not necessarily financing its *acquisition*" (Gilyeart, 2004, p. 11).

A **finance lease** is also referred to as a full-payout lease or a lease purchase (Rozner, 2006). It is also called a capital lease. It is a fixed-term, non-cancellable contract in which the lessee is responsible for maintenance, taxes, and insurance. The lessee chooses a piece of equipment from a third-party vendor (i.e., a supplier) and the lessor purchases the equipment for the specific purpose of leasing the equipment to the lessee.

The period of a finance lease typically extends for most or all of the equipment's useful life. The lessee usually has the option to purchase the asset for a nominal price at the end of the lease. The lessor will recover the equipment costs plus a profit (i.e., interest) over the term of the lease through regular lease payments. Although the mechanics are somewhat different, finance leases are similar to term loans, akin to acquisition financing.

Clients who choose to use a finance lease are usually planning to acquire the equipment at the end of the lease agreement (or at least considering it). With an agreement to purchase the equipment at the end of the lease, the lessee assumes the risk of equipment obsolescence, maintenance, and insurance. (Innovations in Microfinance, 2000, p. 3)

An **operating lease** is a fixed-term contract in which the lessor is responsible for maintenance, taxes, and insurance. The lessee chooses the equipment from a third-party vendor or sometimes from the lessor's inventory. Unlike a finance lease, operating leases can usually be canceled and the full cost of the equipment is not always fully amortized over the term of the lease. Because of the additional risks that operating leases pose to lessors — not least of which is the uncertainty of finding a market for used equipment — finance leases are the first stage for leasing in emerging

economies. As leasing companies mature, they will begin to offer operating leases on limited types of equipment or serve an industry that the lessor has specific knowledge about.

Clients who choose to use operating leases typically need equipment that rapidly depreciates or becomes obsolete. The lessor retains ownership of the equipment during the lease and recovers its capital costs through multiple rentals and the equipment's final sale (Innovations in Microfinance, 2000, p. 3).

It is important that lessors and lessees agree on the type of lease contract and the conditions of any purchase agreement at the outset of the agreement. The terms and conditions of this lease contract will clearly state the responsibilities of each party. Next is a summary of the primary differences between a finance lease and an operating lease.

Two other financial products are sometimes referred to as leases: rental and higher-purchase. A rental is short-term contract for the use of equipment. Rental terms can range from one day to one year. With rentals, the lessor owns an inventory of equipment from which the lessee chooses. Because this is a two-party transaction, it is not considered a financial lease. Commonly rented equipment includes cars, trucks, tools, and machinery. The terms "lease" and "rent" are often considered synonymous, and many commercial laws (i.e., civil codes) treat them that way. However, "lease" is more applicable to a contract that is longer than one year and "rent" usually means a term of one year or less.

Higher-purchase is also sometimes referred to as a lease, though it is also a two-party transaction. A higher-purchase resembles a vendor's or dealer's conditional sale contract. It requires a down payment, sometimes up to 30 percent of the purchase price, and with each payment the purchaser obtains a higher percentage of equipment ownership, thus building equity. This is unlike a financial lease, where the lessee does not gain any equity or ownership rights until it purchases the equipment from the lessee at the end of the lease.

Leasing is a very flexible form of financing; it has many structures. This allows leases to be tailored to the specific needs of the lessee's business. For example, the lease payment amount and due dates can be structured to accommodate a business's cash flow and cash collection cycle. Payments can be higher when cash flow is plentiful and lower or skipped in certain months during the off season. Such flexibility allows lease payments to match the productivity of the leased equipment and is particularly advantageous to the agricultural sector.

The lessee may have the option to purchase the equipment at the end of the lease term. Purchase options are determined before the lease is signed. Common purchase options include a nominal payment (e.g., $1.00) and an automatic transfer of title (i.e., ownership) upon the final lease payment, or payment of a predetermined amount, usually a percentage of the original cost of the equipment or the fair-market-value, which is determined at the end of the lease by considering the value of similar equipment in comparable condition. A purchase option allows the lessee to decide if it is more advantageous to purchase the equipment or lease a new model with a warranty.

Leasing can help businesses avoid equipment obsolescence. When a company owns a piece of equipment, they bear all the risk of devaluation due to technological advances and wear. With

leasing, the transaction can be structured so that this risk is transferred to the leasing company. This becomes especially important for assets that have a relatively short economic life (e.g., computers). A planned replacement cycle ensures access to reliable, low-maintenance equipment, and state-of-the-art technology for quality and efficiency. Rapid technological advances in production equipment can also make purchasing impractical.

A lease can be structured to amortize only that portion of the equipment's value that will be depleted during the term of the lease. For example, a new truck, valued at $40,000 today may still be worth 25 percent of its original value, or $10,000, three years from now. Therefore, lease payments can be based on amortization of 75 percent of the capital cost, compared with 100 percent with a loan. This structure will lower lease payments and, depending on the value of any tax benefits that are passed to the lessor, can further lower payments.

In addition to typical contract terms (e.g., the lease amount, and the number and frequency of payments), an end-of-lease-option lease can be customized with advance or arrear payments, capital cost reductions, security deposits, and allocation of tax benefits to the lessee or lessor. Annex E provides a summary of factors considered within lease structures.

Many different kinds of equipment can be leased. Annex G has a list of commonly leased equipment, divided by sector. This list was compiled by the Equipment Leasing Association, the largest leasing association in the United States.

A2. Lease vs. Loan

Lending and leasing are similar in that both involve decisions regarding the creditworthiness of the borrower (i.e., the lessee) and an analysis of the risks. Leasing, however, has additional factors: The lender must be knowledgeable about both agricultural credit analysis and the equipment (its value, the dealers, parts providers, repairs, maintenance schedules, manufacturers' warranties, and how to calculate expected depreciation). This is why a leasing company might choose to specialize and build expertise in one equipment or industry.

Leasing is anchored on the business philosophy that profits are earned through the use rather than the "ownership" of equipment and assets. A basic principle in long-term lending is that cash generated by the investment that has been partly financed should be the primary source of repayment. The collateral that is provided as security for the loan serves as a secondary source of repayment, in the event that the borrower is unable to repay the loan from cash generated by business operations. Conventional asset-based loans offered by banks focus on a primary source (i.e., cash flow from business operations) and a secondary source (i.e., excess collateral) of loan repayment by the borrower.

In contrast, leasing is more intensely focused on the lessee's ability to generate cash flow from business operations to service lease payments, because the lessor retains ownership of the asset during the term of the lease. This makes leasing well-suited to SMEs and the agricultural sector, both of which seldom have historical credit information or formal financial statements.

The intended impact of leasing is to increase a business' total availability of capital from an external source, leaving its own sources of capital available for other productive uses. The

additional revenue generated by the use of the leased asset should be sufficient to meet the monthly lease rental payments.

Conventional asset-based financing from a bank generally requires a borrower to provide as much as 40 percent of the cost of the asset to be acquired as a cash down payment or additional collateral valued at 150-200 percent of the loan amount (e.g., real estate in an urban center). The bank may require additional security in the form of assignment of bank deposits, marketable securities, trade receivables, or third-party guarantees. Collateral provided as direct or additional security for loan purposes will often be assessed at a discounted value. Additional collateral requirements increase the effective cost of a loan and further restrict borrowers' access to credit. Furthermore, three- to five-year term financing for equipment acquisition is frequently not available in developing countries, because conventional bank loans are usually structured on a well-secured short-term basis, such as one year. With ineffective collateral laws and judicial processes for loan collections, banks have little incentive to grant loans because they have no assurances or confidence that they will get the collateral back or receive it in a condition of any value if a borrower defaults.

In contrast, a lease arrangement typically requires the owner/lessee to provide much less cash up front. The asset itself serves as collateral for the transaction because the lessor retains ownership of the asset during the term of the lease. Therefore, leasing involves better, simpler security arrangements and can reduce collection problems.

A finance lease is the first product (or stage of leasing) that develops in emerging economies. This type of leasing offers several advantages over conventional bank financing for the lessee:

- *Availability*. In most developing economies, leasing may be the only form of long-term financing available for purchasing equipment that can expand production levels or increase workers' productivity.
- *Simplicity*. Simpler security arrangements, combined with less stringent requirements for historical balance sheets, mean that new and small businesses can access lease finance more easily than bank loans.
- *Lower up-front costs*. Small businesses have greater access to financing with leasing because the up-front costs are lower than conventional bank financing. Leasing can finance a higher percentage of the equipment's cost, allowing the business to preserve its working capital. Also, leasing contracts are easier to structure to match the lessee's generation of cash flow. In some cases, the initial cash required is less than 10 percent of the equipment cost.
- *Faster credit approval*. Leasing can be arranged more quickly than conventional bank loans because it does not often require establishing additional security. The costs of assigning additional collateral, documentation, and processing times for bank loans can be significant.
- *Tax incentives*. Depending on the tax code, lease financing can offer tax incentives. Lessees can offset their full lease payments against income before tax (compared with the depreciation allowance or the interest charges on bank loans). Though this may not be a big attraction for small businesses and micro enterprises because they may not keep records for

income tax purposes, lessors may be able to pass along some tax benefits related to the depreciation charges they can book as owners of the asset.

- *Lower costs*. The main advantage leasing offers the lessee is a significantly lower discounted present value of cash disbursements over the term of the lease (compared with the discounted present value of payments associated with bank-financed acquisition of an asset). The reason is that the lessee can book the aggregate periodic lease rental payments, which are a combination of interest-related financing costs and payments against principal, as a business expense to shield against tax liability on income realized. The asset being financed is depreciated over the life of the lease, a period shorter than its economic life (Gallardo, 1999, pp. 4-5, 7).

Leasing provides lessors opportunities to reach new borrowers and deepen their market share. Leasing as a financial product can address an unsatisfied demand for financing and, at the same time, attract borrowers away from more traditional financial products such as bank loans. Other advantages for the lessor include:

- *Transparency*. The lessor purchases the equipment directly from the supplier after the lessee has chosen, eliminating the opportunity for the lessee to use the borrowed funds for other purposes. In some cases, this allows the lessor to take advantage of lower priced equipment based on fleet or volume sales.
- *Simplicity*. Simpler documentation and speedy processing can keep transaction costs down, permitting leasing companies to achieve high volumes with lower costs.
- *Product pricing/yield*. The lessor uses the expected investment yield in calculating periodic payments to be paid by the lessee. The expected investment yield will include the lessor's tax advantage from depreciation expense and, in some cases, the lessor may pass this advantage on to the lessee through a lower lease payment.
- *Long-term source of capital*. Because leasing companies are usually not deposit-taking institutions, they are subject to less stringent regulations than banks, permitting them higher leverage than other financial institutions.
- *Owner of the equipment*. As legal owner of the asset being financed, the lessor has a stronger security position; enforcement of security rights upon non-payment is potentially simpler and less costly because no court action is required.
- *Tax advantage*. The tax advantage of lease financing compared with conventional financing, depending on the tax code, is that the lessor, as legal owner of the asset, may be able to take the benefit of depreciation expense as a shield against taxes on revenue realized from the lease. (Gallardo, 1999, pp. 9-10).

Differences between an Equipment Loan and Financial Leasing of Equipment

Loan	Financial Lease
A loan requires the end user to make a cash investment (i.e., a down payment) in the equipment; as much as 30-40% of the total cost.	A lease requires a modest initial cash investment (e.g., 10%) and finances the value of the equipment expected to be depleted during the lease term. The lessee can have an option to purchase the equipment at the end of the lease.
A loan typically requires the borrower to pledge other assets for collateral — as much as 200–300% of the loan amount in the form of urban real estate.	The leased equipment is already owned by the lessor. No additional or supportive collateral is needed.
The end user bears all the risk of equipment devaluation or obsolescence.	The end user can transfer all risk of obsolescence to the lessor because there is no obligation to own equipment at the end of the lease.
Equipment owners may claim the interest portion of the loan payment and depreciation as an expense (according to tax code depreciation schedules), which results in a lower amount of profit tax.	Depending on the tax code, the lessee may claim the entire lease payment as an expense. The equipment write-off is tied to the lease term, which can be shorter than allowable depreciation schedules, resulting in a larger expense than provided by depreciation, further lowering profit tax. The deduction is also the same every year, which simplifies budgeting.
Financial accounting standards require owned equipment to appear as an asset with a corresponding liability on the balance sheet.	When a lease is classified by the accounting rules as an operating lease, the leased payment is deducted as an expense and the leased assets do not appear on the balance sheet. This can improve financial ratios.
A larger portion of the financial obligation is paid in today's more expensive dollars.	More of the cash flow, especially the option to purchase the equipment, occurs later in the lease term when inflation makes dollars cheaper.

A3. Micro-Leasing

As microfinance has evolved, the range of products offered has expanded. Micro-leasing is an alternative for microfinance institutions (MFIs) to expand into longer-term equipment financing and for borrowers who did not previously have access to equipment (i.e., financing). Most MFIs and banks in emerging countries limit themselves to providing working capital loans in short loan cycles. However, many micro and small enterprises (MSEs), especially in the production and service sectors, need long-term investment finance to increase productivity. This is where micro-leasing can help.

Small enterprises (those above subsistence levels) often need loans that are slightly larger and have longer terms than what MFIs can offer. These enterprises sometimes find that they are too big for MFIs and too small for traditional bank loans. They often have difficulty providing the collateral necessary for a bank loan. The simple security arrangements of leasing allow borrowers who do not have well-developed balance sheets or credit histories to access equipment financing for which they might not have otherwise been eligible. Meeting the needs of small enterprises is one way that leasing can have an important impact on local economic development (Deelen, Dupleich, and Othieno, 2003, p. 8).

MFIs that make numerous loans or leases for the same type of equipment (e.g., sewing machines) may have sufficient bargaining power to negotiate discounted prices, extended warranties, additional service, and other benefits with one or more dealers/suppliers for volume purchases. Such MFIs should select reputable equipment dealers with good products, service,

and availability of spare parts, and then try to negotiate discounts and other benefits. The MFI should then make the dealer discount programs known to their loan and lease clients. In a typical financial lease, the lessee chooses the supplier and equipment. With micro-leasing, it is important that MFIs direct the borrowers to reputable dealers with whom they have established relationships. This benefits the MFI and the borrower in the long run by reducing the costs of equipment and repairs. Also, dealer discount programs give an MFI a competitive advantage over other financial institutions by establishing a solid vendor/supplier relationship and enabling them to select equipment that is in high demand (Westley, 2003, p. 50).

Tax advantages in traditional leasing do not provide the same advantages in the context of micro-leasing because most of the micro-enterprises are too small to be registered VAT users and they do not incur profit tax. This minimizes one advantage of leasing where VAT and/or profit tax is a factor within the lease structure or pricing. Consequently, a finance lease that recovers all of the equipment's cost, plus interest, from the lessee's periodic installment payments lowers the financial risk to MFIs. The final leasing payment or guaranteed purchase amount should be set at a nominal value (e.g., $1.00) so it does not serve as a barrier to the client taking ownership and does not create marketability, residual value, or second-hand market risks.

Although group lending is common with MFIs, micro-leases should be made on an individual basis and not to solidarity groups. This is because group members are reluctant to bear the increased risk of exposure to the longer terms and/or larger lease sizes generally associated with equipment financing. MFIs that lend only through solidarity groups or village banks need to acquire skills in making individual loans (based on cash flow analysis and other considerations) before launching an equipment loan or lease product. A variant of the group lending model, in which all group members share use of a single piece of equipment financed with a single lease that all group members agree to repay, creates additional difficulties beyond those of a typical group loan. Such shared-equipment operations are subject to the "tragedy-of-the-commons" problem. Group members may become careless about damage, overuse, misuse, or maintenance because they bear only a part of the responsibility for the equipment and its repair or replacement cost. In contrast, borrowers with individual ownership and lessees with individual leases bear the full cost and consequences (Westley, 2003, p. 49).

One of the major challenges for MFI lessors is equipment maintenance. The availability of efficient workshops and access to spare parts is essential. Analysis is very important to choose the appropriate technology, suitable equipment, and a suitable dealer/supplier. Because most financial institutions do not have this knowledge, it is important for the lessor to establish links with suppliers/dealers that can provide technical assistance and recommendations (Deelen, Dupleich, and Othieno, 2003, p. 10).

A4. Agricultural Leasing

The analytical techniques and lending practices used to assess loan risks differ by industry. Agricultural lending, for example, requires an understanding of needed farm inputs, costs, cropping cycles, cultivation practices, yields, post-harvest handling, and market information for the sale of the final product. However, in addition to understanding the analytical credit techniques, agricultural leasing requires an understanding of the mitigation measures for risks such as weather (e.g., droughts and crop damage due to freezing). There are always risks in

lending; but without knowledge about the industry, farmers and lenders will be unsure how to mitigate those risks.

Leasing is a well-suited form of financing for the agricultural sector because most farmers use the same or similar equipment, and this equipment has a long, useful life. Leasing offers more flexible terms than traditional bank loan products, particularly to the agricultural sector, whose income is seasonal and can benefit from this kind of flexibility. In addition to proper credit analysis, leasing requires the lender to be knowledgeable about agricultural equipment, its value, the dealers, and who provides parts, repairs, and maintenance. Many developing economies have a large demand for agricultural equipment. This gives leasing companies a ready market to sell or re-lease the equipment if a lessee is unable to meet its obligation or when the equipment is returned at the end of the lease, thereby lowering risks.

Traditionally, ownership is sacrosanct in the agricultural sector and is considered the only method for obtaining equipment. Persuading those who have only borrowed in the past that ownership is not always the best alternative can be very challenging. Therefore, the first type of lease that the agricultural sector will find acceptable is one with a guaranteed purchase option. Though this is a good place to start, over time the leasing companies must take responsibility for educating their borrowers. Other forms of leasing can be more profitable for the leasing company and less costly for borrowers.

To facilitate the whole agricultural value chain — from input suppliers to producers, processors, and distributors — leasing companies must be knowledgeable of what agricultural equipment is available. Leasing companies also need to learn how to accurately assess the creditworthiness of the farmer and/or food producer. Farms in the same area of the same country can range from less than one hectare to tens of thousands of hectares. Their productivity also varies widely, determined by diverse factors such as location, quality of inputs, and equipment quality.

Lessors must therefore understand food growing and farm operations before they enter this sector. Many leasing companies have employed agricultural experts rather than rely on general sales and credit-risk analysis personnel. However, regardless of whether experts are employed, leasing companies must assess the creditworthiness of an agricultural sector lease by understanding the income generated from crops and animals. Critically, they must also understand the seasonality of cash flow. Not all farmers enjoy regular monthly incomes. Some do, such as dairy farmers and egg producers, but many, particularly cereal farmers, have a harvest (and income) only once a year. Leasing companies need to structure their leasing repayments accordingly.

To address the financing needs of the agricultural sector, leasing companies can be creative and consider negotiating and/or linking with others that would also benefit from more mechanization in the agricultural sector. These parties include equipment vendors, grain traders, fertilizer sellers, and processers; because they will benefit if farmers lease equipment, there may be opportunities for the leasing company to mitigate some of the risks associated with the agricultural sector (Rabah, Sugheyer, Kotei, Naïm, Pirni, and Sultanov, 2009).

A5. Vendor Leasing Model

To be sustainable, leasing companies must lower transactional costs and reduce lenders' credit risks. To stimulate sales, a retail vendor can align with a leasing company and provide **vendor leasing**, also known as lease asset servicing or vendor programs. To do so, the vendor establishes a formal or informal relationship with a financing source so it can offer leases to its customers on behalf of the financer.

Vendor leasing models allow vendors to offer customers an option other than cash-on-delivery or 30-day terms. This can be a major benefit on high-ticket items because some customers may not be able to meet such immediate cash payment terms.

Vendor leasing helps build vendor-customer relationships while improving vendor sales volume. Customers can view the vendor as a one-stop shop where they can fulfill their orders *and* get financing, rather than having to seek financing beforehand from a bank or other lending institution.

By offering a financing program, the vendor is making a cash sale to the leasing company. Depending on the structure of the relationship with the vendor, the customer may make its lease payments to the vendor, who then turns it over to the finance company. Or, as is often the case, the customer pays directly to the leasing company.

Some vendors also perform credit checks and other operational or administrative credit screening. This helps pre-screen borrowers for the leasing company, which lowers transaction costs. It also helps the vendor to evaluate a customer's creditworthiness for possible trade credit for parts and service (What Is Vendor Leasing?, n.d.).

A6. Islamic Leasing

Leasing can be an acceptable form of financing under Islamic laws (*Shariah*), though it is subject to certain conditions. There must be substantial differences between leasing and an interest-bearing loan; it is not sufficient to substitute the word "interest" with the word "rent" and replace the word "mortgage" with the word "leased asset." Therefore, it is important to be aware of Islamic rules for leasing.

According to Rabah et al. (2009): Islamic leasing, or *Ijarah* — referring to *Ijarah Muntahia Bittamleek* (lease to own) — is the most rapidly growing Islamic financial product. Because debt instruments usually cannot be resold in Islamic countries, but must be held to maturity by the originator, the ability of *Ijarah* leases to be sold on secondary markets makes them an increasingly desirable product.

Ijarah literally means to give something on rent. In the context of Islamic banking, *Ijarah* can be defined as a process by which the right of possession of a particular property is transferred to another person in exchange for a rent. In the past, *Ijarah* contracts have typically not involved the transfer of ownership. Over time, however, *Ijarah* contracts have developed into transactions with more complex features. Today, *Ijarah* is very similar in principle to conventional finance leasing. Both leasing and *Ijarah* are based on the proposition that the title to an asset comprises

three components: the right of ownership, which remains with the lessor; the right of use; and the right of possession. These last two rights are transferred to a lessee for a specific period in exchange for payment of specific amounts (Johnson, 2005, p. 31).

Ijarah versus Conventional Leasing

- Ownership responsibilities: A finance lease aims to move the lessor as far away as possible from any ownership responsibilities. In contrast, the *Ijarah* requires the lessor to maintain the basic responsibilities of ownership, such as repairs and maintenance.
- Interest-related characteristics: As with other Islamic financial products, *Ijarah* does not allow interest-related characteristics as part of its contractual terms and conditions.
- Allowable asset: An asset subject to an *Ijarah* contract must not be *haram* (unacceptable under Islamic standards). Therefore, *Ijarah* contracts cannot involve assets of any kind that are connected with an activity or product considered harmful to humans or society as defined by Islamic practice. Examples would include assets used in the production or distribution of alcoholic beverages or pork products.
- Late fees: *Ijarah* does not allow late fees and penalties to be imposed on lessees when lease payments are delayed, although some alternative forms of compensation may be allowable.

A7. Supporting Leasing with DCA

When leasing is introduced in emerging economies, lease products are usually little more than a loan with a "lease" label. With a small amount of DCA support (e.g., a 15-percent guarantee), leasing companies can further develop and enter into more modern leasing products, ones that use residual values within the lease terms.

As a leasing industry matures, it graduates from the basic finance leases into more flexible and innovative leases, such as the operating lease. However, leasing companies may resist the introduction of new products because they have not been proven in the market. With a structured DCA guarantee to support a residual value of 15 percent of the original equipment cost, for example, lessors will be more likely to introduce this product.

Other than increasing access to credit and introducing more innovative financing products, operating leases with a residual balance are attractive because they reduce the lease payments to the lessee. Because leasing is usually the only source of long-term (i.e., three to five years) financing available for equipment, it is important that new leasing products are supported, particularly those that can reduce monthly payments for the lessee (i.e., the SME). Annex G has a sample DCA Concept Document that was prepared to support SME and agricultural leasing for USAID's AgVantage program in Georgia.

B. Enabling Environment

Leasing requires a stable macroeconomic environment with a clear legal and regulatory framework. A supportive leasing environment begins with sound financial leasing laws, prudential supervision, and clear tax regulations that govern leasing transactions. This structured environment is needed to foster the leasing industry's continued growth and encourage leasing companies to enter the market.

According to Gilyeart (2004), it is important to understand the terminology of the infrastructure in which leasing operates when considering the enabling environment for leasing. These terms can be misunderstood and used incorrectly. Like any business, leasing is affected by laws and other rules that constrain or promote its business practices.

Each of the four areas in the Leasing Infrastructure Matrix relates to different policy agendas and helps separate their individual purposes. The rules and the definitions used in emerging countries can be confusing. For example, the definition of what constitutes a lease under a commercial law can and should be different than what constitutes a lease under tax law and accounting rules. This is not often the case in emerging economies. The table below outlines the purpose or goal of each area and the issues that they attempt to govern.

Leasing Infrastructure Matrix		
Area	**Purpose/Goals**	**Issues**
Legal (Commercial Law, Civil Code, etc.)	Resolve private disputes	Rights, remedies, enforcement
Tax: • Direct • Indirect	Raise revenue and direct social policy	Fair burden-sharing, tax incentives and disincentives, administrative efficiency
Accounting	Accurately reflect financial conditions	Balance sheet/income statement treatments
Licensing/Supervision	Maintain public confidence in financial sector	Appropriate licensing requirements and prudential norms

Source: Gilyeart, 2004

Legal and tax definitions and standards for international accounting can differ considerably from one country to another. Therefore, this primer should be used as a basis of technical understanding of leasing finance and not relied upon as legal opinion.

B1. Important Elements for Leasing Laws

In recent decades, financial leasing laws have been enacted in countries with diverse levels of economic maturity. Often, leasing laws are poorly drafted because of the limited understanding of leasing products, how they are used, and the differing principle between leasing laws, tax codes, and accounting rules. These poorly drafted laws end up hurting the leasing industry and become missed opportunities to helping a country's economic growth.

There is not a universal model for a lease law. Because legal traditions, economic situations, business practices, and the stage of leasing's development differ, the details of a law should vary from country to country. There are, however, fundamental drafting principles for essential items, as well as unacceptable provisions and proper boundaries for a leasing law's application and coverage. While accommodation and adjustment for local circumstance should be made, there are universal "fundamentals" that must not be ignored.

According to Gilyeart (2004, p. 1), a good commercial leasing law, as with many other types of legislation, adheres to five guiding principles:

1. *Simplicity.* The law should be simple and straightforward. A law that is hard to understand is difficult to follow and is honored more in breach than in observance. Though a simply constructed law may not cover some more complex and sophisticated situations, it achieves a clearer and more disciplined set of principles for the majority of circumstances. A

commercial law best serves society when it focuses on regular and normal circumstances rather than obscure and rare situations.

2. *Compatibility.* To the extent appropriate, a new law should be drafted with a view to existing law and practices. Proposals for change in such law and practices are not meant to imply in any way that existing approaches are wrong. Instead, such proposals are made with a desire to further economic development of the economy through increased availability, flexibility, and suitability of new financial products.
3. *Practicality*. The law must be practical. Whenever possible, it ought to accommodate existing business practices and understanding. Generally, the law ought to reflect business realities rather than to artificially direct it.
4. *Effectiveness.* Effectiveness means that the law gives parties engaging in commercial transactions greater confidence in the legal treatment and consequences of their contracts. A law cannot address every commercial structure — especially a law that espouses simplicity as one of its guiding principles. An effective law will enhance the predictability of how transactions are treated and provide a stronger base for determining the treatment of unique situations.
5. *Longevity.* The law should have a reasonable life so it does not have to be rewritten over and over. Its basic structure and concepts should be useful for the foreseeable future and beyond.

The basic structure of a modern financially oriented lease is different from a traditional rental; it needs legal provisions that are often the opposite of what is appropriate in a rental. For example, under a traditional rental, the lessor is responsible for equipment defects. Under a finance lease, the lessor is not responsible because the lessee chooses the equipment and the supplier and will usually know much more about the equipment than the lessor. The supplier is a critical third party in a modern finance lease. It is important to recognize these facts.

The duties assigned by the law must be consistent with each party's role in the transaction. The law should also be a fall-back framework for parties who fail to cover a topic in their lease agreement or when the provision that they have does not work in the circumstances that occurred. The law should not mandate provisions that cannot be changed by contract; if it does, it should state clearly that those provisions cannot be changed by the parties' agreement. Freedom of contract must be paramount if leasing is to contribute its hallmark characteristic: flexibility. See Annex F for additional leasing legislation guidelines.

Further provisions may be suitable, depending on local commerce issues, existing legal confusion, or a country's commercial law traditions. Properly conceived and drafted, provisions covering a few of the following topics can be included in a quality leasing law:

- Security deposits
- Indemnification
- Insurance
- Maintenance and repairs
- Duties, fees, and taxes
- Pledges, liens, and encumbrances

Of course, other provisions might be acceptable/needed to deal with special situations, such as currency controls, barter economics, special notary rules, and banking controls.

B2. Application of VAT

VAT is a common form of taxation on goods and services. It can range from 15- 20 percent of the cost of a good or service in emerging economies. It is important to understand how VAT affects businesses and the leasing industry.

According to Rabah et al. (2009), VAT is a tax on consumer spending collected by VAT-registered businesses on their supplies of goods and services to their customers. Each business in the supply chain (from manufacturer to retailer) charges the VAT on its sales and is entitled to deduct from this amount the VAT paid on its purchases. The effect of offsetting purchases against sales is to impose the tax on the added value at each stage of production (hence "value-added" tax). The end consumer absorbs the VAT as part of the purchase price. Therefore, the VAT is not a charge on business — it is a consumption tax borne ultimately by the final consumer. VAT is levied as a percentage of the price, meaning that the actual tax burden is visible at each stage in the production and distribution chain. Though the seller of goods pays VAT to the tax authorities, the buyer pays it to the seller as part of the purchase price. It is an indirect tax. All businesses registered to charge and reclaim the VAT must account for two types of VAT:

How VAT Works

Consider a snack packaging machine that cost $10,000. VAT is 10 percent, lease payments are $350, and the lease requires three payments in advance, or $1,050. When the lessor purchases the equipment, it pays the supplier the cost of the equipment plus the amount of VAT, or $11,000. If the lease is taxed as a supply of goods, then lessee must pay the value of the at the time it takes delivery of the equipment. The lessor is then "whole," having paid $1,000 to the supplier and receiving $1,000 from the lessee.

However, the lessee paid an additional $1,000 at the same time his initial lease payments are due — a total out of pocket cost of $2,050. If the lease is taxed as a supply of service, the lessee pays $35 VAT on each lease payment: $350 + 35 = $385 x 3 lease payments = $1,155 (a savings of $895). In this example, the lessor has paid the $1,000 VAT to the equipment supplier, but now only receives an output credit of $35 per month to offset the VAT it paid.

- **Output VAT** is the tax a business charges on the items or services that it sells.
- **Input VAT** is the tax a business is charged on the items or services that it purchases.

One characteristic of the VAT is the offset mechanism. The VAT is collected fractionally via a system of partial payments whereby taxable entities (i.e., VAT-registered businesses) deduct the amount of VAT tax they have paid to other taxable entities on purchases for their business activities from the VAT they have collected. This mechanism ensures that the tax is neutral regardless of how many transactions are involved (Rabah et al., 2009, p. 46).

With leasing, the treatment of VAT can have serious economic consequences for the lessee and the lessor in the economic viability of a lease transaction. For example, does the tax code apply VAT to a lease transaction as a supply of a good or as a supply of a service? If it is a supply of a good, the full amount of VAT is due at the time the equipment is delivered. If leases are classified as a supply of a service, then VAT is collected on each lease payment.

Small businesses or farmers in emerging countries are often non-registered VAT, meaning they are exempt from paying any VAT. This is problematic for leasing because the leasing company will pay VAT to the supplier but not collect any VAT from the lessee, which would offset this cash expenditure. Therefore, leasing companies have no incentive to lease to small businesses, allowing more traditional loan products to maintain an unfair competitive advantage.

Another concern is that some equipment is VAT-exempt or VAT-zero rated. This means that the leasing company does not have to pay tax on the equipment when it is purchased. Instead, VAT applies to the lease. The lessee, therefore, is required to pay VAT to the leasing company. (Agricultural equipment is a good example of this.) This gives a loan product another unfair competitive advantage. It is important to know how leases are treated in the tax code regarding VAT.

Some emerging countries recognize the value of stimulating private-sector investment in production equipment and will zero-rate VAT on leases for a period of time (e.g. leases entered into during a period of 5 or 7 years). The application of VAT to leasing transactions can be detrimental or beneficial to the development of leasing. At minimum, leasing must be on a level playing field with other financial services, especially traditional bank loans, to effectively compete. One key component of this is to make VAT on leases and loans the same (e.g., a zero rating).

Leasing issues are a sensitive subject for governments and businesses. The tax code and lease law require assistance from experienced leasing and tax professionals. If they are not directed properly, these areas can significantly damage the future of leasing.

B3. Accounting and the Effects of Profit Tax

The Leasing Infrastructure Matrix on page 14 noted that what constitutes a lease under a commercial law can and should be different from what constitutes a lease under tax law and accounting rules. The purpose of commercial law is consumer protection and resolving private disputes; the purpose of direct-profit taxes and VAT is to raise revenues and direct social policy. Accounting is for accurate reporting of a company's financial position. It is perfectly normal that a tax code differs from the rules of accounting for depreciation and tax ownership.

The tax code in many emerging countries defines the lessee as the tax owner of the leased assets, meaning that the lessee takes the depreciation/amortization deduction and interest deduction, not an expense deduction, for the lease payments during the tax year. The lessor will have no asset deduction and will report interest income during the tax year. Note that this is not advisable for developing economies that want to stimulate investment (Gilyeart, 2004, p. 14).

For purposes of direct taxation (profit tax), countries differ on whether the lessor or the lessee owns the leased objects. In a country in need of substantial economic development, the lessor should be the tax owner. International accounting has adopted an "economic substance" (a financial calculation) to determine who claims the depreciation of the equipment. Though many emerging countries have adopted this method within their tax codes, the real issue is who can best utilize the tax benefits.

In an emerging economy, lessors are much more likely to be in a full tax-paying position than lessees. Lessors can make use of the tax benefit better than lessees, who are often SMEs with little or no taxable income. With depreciation expense, leasing companies can improve their sustainability and/or lower the cost of financing. The best approach is to allow the parties to negotiate who will be considered the tax owner. Of course, there can be only one and the decision must be in writing. If the lessee pays little or no taxes because its operating profit is low, any additional depreciation it claims will be wasted because the additional expenses do not result in lower taxes. However, if the leasing company claims the depreciation, its taxes will decrease and it can pass cost savings to the lessee in the form of lower lease payments.

One reason why tax writers often use an approach that will give deductions to parties who cannot use them (e.g., lessees via an economic analysis approach) is that it causes more unused and wasted deductions, resulting in higher government tax revenues. This is not good fiscal policy design. For example, if the deductions from accelerated depreciation are created to help businesses replace capital equipment, the businesses should receive the full benefit.

Some countries' laws state that tax rules must follow the country's accounting rules. This is not advisable. Tax rules and accounting rules have very different purposes; they cannot and should not be the same, even for the sake of simplicity or efficiency. If tax rules simply follow accounting rules, a government's fiscal policy is, in effect, handed over to accountants and made static. This destroys the flexibility that is critical to fiscal policy and monetary policy. Fiscal policy changes and adjustments are an essential government tool for macroeconomic management of a country's economy — and that policy must always be free to move dynamically as the economy evolves.

C. Guiding Principles for Developing Leasing in Emerging Economies

Because leasing is often misunderstood, experienced personnel must assess its viability. Regardless of whether or not leasing is being practiced, an assessment is essential to understand the environment, prioritize issues and constraints, and develop a strategy that will gain crucial support from the government, the financial sector, and the market.

Like all development work, motivated stakeholders are essential to successful implementation, particularly at the government level, but also in the financial sector and at the national/central bank. A leasing assessment should include the following:

- *Current market understanding of leasing, its principles, and potential.* It is important to know to what extent the following understand modern leasing practices: the financial sector; the national/central bank; the legislative branch of government (and the ministry of economy); the tax department; local accounting firms; the business community.
- *Viability of leasing in the current legal and regulatory environment.* Leasing is often provided for within the civil code or incorporated within commercial law. However, this may not allow modern leasing practices to be established or flourish. If a stand-alone law on leasing does exist, care must be taken to ensure that it does not conflict with the relevant civil code provisions. Existing laws on leasing can be ambiguous and inadequate to provide for modern leasing. Care must be taken to ensure that the legal environment does not limit

leasing to a specific type of lease product (e.g., a finance lease as defined by accounting criteria), which will constrain growth and innovations in the leasing sector.

It is also important to know how borrower-defaulted lease transactions are handled in the courts. Leased equipment is owned by the lessor, who should have immediate rights to repossess their equipment if the lessee defaults. The judicial process and its timing are important elements in developing a productive leasing environment.

- *Current tax considerations under leasing.* It is critically important to have clear direct and indirect tax regulation regarding leasing. The more favorable tax considerations are for leasing, the greater economic impact it can have. More important, a lessor will incorporate effects of tax into the pricing of each lease transition. An unclear or misinterpreted tax rule can make the difference between a profit and a loss on a lease transaction. Also, the amount of VAT due can vary depending on whether the transaction is considered a "delivery" of a good or the "supply" of a service. This can significantly change the cost of financing for the borrower and/or the leasing company's lease yield.
- *Operational capabilities.* Leasing is not an easily transferable skill from lending. It requires a different approach in accounting, documentation, credit underwriting, monitoring, knowledge of equipment, and its valuation and marketability. Leasing is one of the most flexible forms of equipment financing and requires personnel who understand leasing and an operational system that can properly monitor the risks of a lease portfolio.

The biggest advantage that leasing companies have over banks is that they raise capital through debt and equity instruments, not deposits. Banks are regulated to ensure that there is a match of maturities between its loans and deposits; leasing does not have this constraint.

The commercial or company law (i.e., civil code) should be reviewed to determine capitalization requirements, if any, for a leasing company. Banks like to have leasing as an additional financial service to its customers; however, caution must be taken to understand the national bank rules on subsidiary investments by banks. There are often limits on the percentage of a bank's capital that can be invested in a subsidiary, such as a leasing company. Capital investment in a subsidiary includes debt, equity, and guarantees. In the beginning, the limitation may not be significant, but it can quickly curtail leasing activity if the demand outstrips the parent company's (i.e., bank's) ability to raise additional capital.

Increasing the capital of leasing companies in emerging economies can be challenging. There are two ways to do this: through debt or equity. Equity can be the most challenging because the leasing company is usually not willing to give up any percentage of its ownership. Sources such as the International Finance Corporation (IFC), investment funds, and, in some cases, donor agencies such as USAID are possible candidates to provide loans. However, these lenders usually require some percentage of equity as added security for the loan. Other financing alternatives include other local banks or correspondence banks of the parent company. The leasing company should be evaluated like any other borrower; the lender usually requires sufficient collateral and guarantees from the parent bank.

Leasing companies generate leases that have value in their payment streams (i.e., the monthly collection of all lease payments). One alternative for a leasing company to raise capital is to package a portfolio of leases and pledge them as collateral to another lender. There are

disadvantages of borrowing locally. First, pledging lease receivables to another bank discloses a list of customers to a competitor. Second, local interest rates are usually high in emerging economies. Local competing banks will not likely offer favorable rates to a competing financial institution. Third, leasing companies need term loans of five years or more, and local lenders are usually constrained by the matching of maturities issue discussed above. Other alternatives to consider for lease capital include:

- *Loans from insurance companies.* Insurance companies often have excess funds that could be loaned. This avoids the issue of providing a competing bank with names of customers and may overcome the longer-term borrower requirements. Interest rates from local lenders may remain an issue, however.

- *Loans from wealthy individuals.* The way to find these individuals is through the banks' senior management, who know who their wealthy customers are and know a leasing company can be a very good investment.

- *Securitization.* Depending on how well the capital market is functioning, a portfolio of leases could be pooled, securitized, and offered as collateral for a bond sale. A 50-percent DCA guarantee could strengthen the value of the pledged security, which would result in a lower interest rate and increase the probability of a full subscription rate.

- *Leverage leasing.* Leverage leasing is when the leasing company borrows money to fund a lease or a series of lease transactions from its parent bank on a non-recourse basis. The leasing company pledges the payment stream of the lease to the bank. If the leasing company fails to repay the bank, the bank has the lease receivable and the asset under lease as security for its loan. As a non-recourse transaction, the bank has no recourse against the leasing company, but they do have the full rights (as if they were the lessor) to collect from the lessee.

In the first stages of leasing, the most commonly understood lease is a finance lease with guaranteed purchase options. This is mainly because the companies' personnel came from the banking industry and understand a loan-type product best. Borrowers also understand this type of product. This is not true leasing, but a lease label on a loan product; this stage is necessary to get things started. But as leasing develops, the leasing companies and the borrowers learn the advantages of true leasing and demand additional products. The leasing companies will learn how they can increase their yields with other non-loan lease products. Furthermore, once the borrowers learn about the cost savings of true leasing, the industry will graduate to using more modern leasing products.

D. Case Studies

The cases include one example supported by USAID and two supported by other donor agencies. Each provides field results for analysis and offers information for a comparison of lessons learned. Cases were drawn from Russia, Kenya, and Georgia; each had different implementing partners. The data is a compilation of publicly available documents, primarily project inception, interim, and completion reports. FS Share Senior Finance/Management Specialist III Roger Bird,

author of this primer, managed the implementation of leasing in Georgia and has added his personal experience to that case.

D1. IFC: Russia Leasing Development Group Project (1997-2002)

This case study is summarized from Sposeep, S., & Sedova, I., (2006). *Leasing: A Potential Solution for SME Expansion and Rural Financial Sector Deepening: A Study of Russia*, USAID MicroReport #46.

> **Project Objective**
>
> Reform the leasing environment, provide public understanding of the benefits of leasing, and stimulate industry growth through debt or equity investments in leasing companies.

At the start of the Leasing Development Group Project in Russia, about 75 percent of machinery and equipment in use was old and outdated, generating a high demand for capital asset replacement among SMEs. After the 1998 economic crisis, many large enterprises were broken apart and divided into SMEs. Many of these became inefficient because of old non-productive assets, which stifle enterprise growth.

At the time, 27 percent of Russia's population lived in rural areas where agricultural SMEs were an important source of employment, and two-thirds of the country's rural population generated income from agricultural activities. Agricultural SMEs are, however, vulnerable to idiosyncratic, weather-related risks, which constrains their access to finance. In addition, weak regulation and enforcement of the land code discourages creditors from accepting land as collateral, inhibiting the ability of agribusinesses to take out bank loans.

While some SMEs were able to obtain working capital bank loans, many struggled with inadequate access to long-term financing to invest in newer technologies and improved equipment, and to finance agricultural production. This prevented them from undertaking investments that could have enhanced the scale and/or productivity of their operations.

The IFC's approach was to work with government agencies to instigate reform from the top down by changing the laws that govern the leasing environment. To help develop the market, they also provided in-depth advisory services to leasing companies and end users by strengthening credit risk management and financial controls related to leasing.

D1a. Results

The Russia Leasing Development Group project began with educational campaigns explaining the concepts of leasing and its benefits to national and regional governments, entrepreneurs, bankers, and the business community across Russia. Information campaigns were conducted through mass media and public events to increase awareness about leasing, generate more demand for leasing, and create public support for legal reform.

Local expertise was developed by organizing specialized seminars for leasing institutions, providing individual consultations, and creating model documents (e.g., lease agreements and financial forms). The project trained thousands of people across 35 of Russia's 89 regions and provided more than 1,400 consultations to Russian and foreign companies on the legal, accounting, and taxation aspects of leasing in Russia.

The project conducted a survey of the leasing market's potential and educated potential suppliers and domestic and foreign investors about the opportunities in leasing. The IFC also trained SMEs to evaluate alternative financing options and work with leasing companies.

Amendments to the tax code and the Law on Leasing were drafted and advocated in collaboration with multiple stakeholders (e.g., the private sector, government, and donors). These changes eliminated remaining contradictions among the civil code, the tax code, and the Law on Leasing, and significantly reduced investment risk stemming from previous legislative uncertainty. The tax advantages for leasing in Russia today include the flexibility to record an asset on either the lessor's and lessee's balance sheet; accelerated depreciation of the asset up to a factor of three; lowering profit and property taxes; and the ability of lessees to fully expense leasing payments, thus lowering the taxable profit.

To further support the project's technical assistance, the IFC provided capital investments of $19 million of its own resources and mobilized another $45 million from Western co-investors in four Russian leasing companies (Deutsche Leasing Vostok, Delta Leasing, Baltiskii Leasing, and the Agro-industrial Finance Company). Today, the leasing market is approaching $2.3 billion, six times its size at the time of the 1998 financial crisis.

D1b. Key Findings and Lessons Learned

- *Encourage an appropriate legal and regulatory environment conducive to potential leasing players to enter and exit the leasing market.* A licensing regime is a bureaucratic barrier that may actually prevent or delay the entry of leasing companies rather than prevent corrupt or weak companies from entering the market. A level playing field for leasing companies to profitably operate and compete fairly is necessary, particularly with regard to receiving the same VAT and customs duty treatment as other financial institutions. Sound, transparent, and consistent legislation on leasing can reduce investment risks and uncertainties that impede leasing industry development.

- *Support a clear tax policy with advantages to the leasing industry to stimulate the demand and supply sides of the leasing market.* Though the leasing industry in some developed countries has expanded without advantageous tax treatment, such treatment is often necessary to spur growth. Identify and coordinate with a policy champion to push through a policy reform agenda. This champion can contribute political insight and an effective approach to tackling institutional change. Champion(s) who are responsive and open to working with key stakeholders are also crucial to generating a participatory process that includes opportunities for discussing, drafting, and finalizing policy reform. Once tax policy is reformed, engage local governments, especially tax authorities, to explain how leasing operates and the benefits it can create for the local economy by reducing scrutiny of leasing activities and creating a more transparent environment.

- *Socially responsible investors and financial institutions demonstrate the viability of leasing as a financing option by investing in leasing companies.* In Russia, the IFC has been instrumental in developing and promoting the leasing industry through equity and debt investment. The IFC provided equity financing of $3 million to establish the Agricultural Finance Corporation to enhance leasing to the agricultural sector, along with two other

shareholders — Rabobank and Netherlands Development Finance Company. The Agricultural Finance Corporation has $1.5 million in equity shared among three shareholders and $15 million in loan capital from its three shareholders. IFC assumes the syndicated risk.

- *Use market-oriented guarantees such as DCA in conjunction with technical assistance to generate greater access to finance among leasing companies.* "Money is the raw material of the finance industry," as one leasing company president in Russia said. A guarantee facility can support a commercial bank's extension of long-term loans to viable leasing company partners. USAID missions can consider use of DCA to leverage domestic long-term bank financing to leasing companies to achieve strategic objectives, such as expanded services to rural areas, SMEs, and agribusinesses.

- *Donor interventions in the leasing industry should entail a combination of investment and technical assistance.* A leasing initiative that involves investment in select leasing companies and wide-reaching technical assistance is a best-practice strategy learned by IFC management. Donor technical assistance to multiple leasing companies rather than to one leasing company may also be a more effective approach to stimulate SME development.

- *Leasing support services that serve rural and agricultural SMEs are more effective when located where rural and agricultural SMEs operate.* Donor interventions that promote leasing industry development may be based in urban areas during the early phase of a project to concentrate on enabling environment issues. However, the second phase of donor activities should be implemented in rural areas. This allows donors to coordinate more closely with regional and local players that are serving rural and agricultural SMEs.

- *Facilitate public education initiatives about leasing benefits and risks to increase supply and demand.* A lack of understanding about leasing persists in the rural areas of Russia. Use information distribution channels such as workshops, seminars, and trade shows to disseminate information about leasing as a viable financing option and how leasing deals are structured. Facilitating links among potential lessees, leasing companies, and equipment suppliers through such channels is integral to promoting leasing industry development.

- *Share and leverage best practices by nurturing closer donor and stakeholder collaboration and coordination and increased research on leasing models.* Proactive donor and stakeholder coordination is needed on legal and policy reform initiatives to promote consistency across sectors. There is little information about the supply and demand of leasing in rural areas and to agribusinesses. Further research and analysis on successful leasing models will help USAID missions and other donors understand how leasing can be integrated into rural finance and development projects and how best to reach rural and agricultural SMEs. Existing studies should be made more widely available through better dissemination.

- *Advocate portfolio diversification as an effective tool for leasing companies to safeguard against defaults.* Rather than exclusively targeting agricultural SMEs or rural areas, successful leasing institutions can better manage risk and portfolio quality by diversifying their client base geographically and by sector and size of leases. Several IFC-assisted leasing companies reported that default rates accounted for less than 1 percent of the leasing portfolio. The low arrears and write-offs among SMEs may be attributed to the fact that

productive equipment is too important to client operations to risk losing it by defaulting on lease payments.

- *Assist in developing a strong leasing association.* Supporting a national or regional leasing association that provides legislative advocacy and capacity-building to leasing companies is an effective exit strategy for donors if the industry is large enough to sustain it through membership dues or other fee-based services. An association can evolve from a leasing advocacy working group (e.g., the North-West Leasing Association, which now advocates on leasing policy and legislation and provides training services to industry players in northwestern Russia). Donor assistance in association building is a longer-term commitment because it may take more than five years to reach sustainability.

D2. USAID: Georgia AgVantage Project (Leasing Component)

> **Project Objective**
>
> Establish leasing as a viable long-term financing alternative and increase access to credit for the agricultural sector.

The AgVantage project (also known as Support Added Value Enterprises, or SAVE) was a five-year, multifaceted agricultural project that strengthened the capacity of Georgia's agricultural sector to increase export opportunities and compete in global markets. The project included a leasing component designed to increase access to long-term (three to five years) credit for the agricultural sector. Leasing was identified as an effective product for agricultural equipment financing.

The leasing component of the AgVantage project operated for the first three years of the project; it was designed to mitigate the lack of long-term financing available in Georgia, specifically to the agricultural sector. Outdated equipment was one of the main constraints faced by Georgian farmers.

Prior to the start of the AgVantage project, USAID provided technical assistance and drafted a leasing law that was passed by Georgia's Parliament. It was the country's first law on leasing. The banking system at the time was very underdeveloped, and loans to the agricultural sector were virtually nonexistent. Leasing was seen as a way to ease some of the constraints that banks were encountering, including:

- The term of a bank loan was tied to the term of its deposit (a liquidity and mismatch of maturities issue for banks) and nearly all bank deposits were in current accounts.
- Banks required security of 150-200 percent of the loan value (with more than 50 percent of the collateral's value in the form of real estate located in Tbilisi).
- Banks' collections rates were low and credit recovery/litigation/summary judgment was a lengthy and costly process.

The original strategy for the leasing component was to capitalize and launch a new leasing company that would ultimately be sold to the private sector, not unlike the American Bank of Kosovo. However, there were substantial delays in obtaining approval of the component's work plan. Ultimately, the leasing component's strategy was redesigned to provide technical assistance to develop leasing as a viable financial sub-sector and $500,000 was made available to co-

finance lease transactions with private leasing companies. (Co-financing was guaranteed by the leasing company, in the event of a lessee's default.)

Before the project started, the leasing industry in Georgia consisted of one company with only four transactions totaling $150,000 — and those leases were to the parent bank shareholders (i.e., insider transactions).

D2a. Results

Project activities focused first on building allies in the financial sector and offering workshops and training on basic leasing techniques. This led to the start-up of another leasing company and the formation of a leasing association by proponents of leasing for Georgia. The association's objectives were to promote leasing as a viable financing alternative; to advocate legal reforms to assist in the development of a leasing industry and provide a stimulus for greater economic growth in Georgia; to promote high standards of business practices, ethics, and transparency in the industry; and to promote training and development programs to benefit the growth and modernization of leasing.

A legal and tax attorney leasing expert provided technical assistance to study Georgia's legal structure for leasing. The expert concluded that the new law made leasing the equivalent of a loan product, with the added disadvantage of VAT.

The expert prepared two reports: "Recommendation to the Lease Law" and "Recommendations to the Tax Code Regarding Leasing." These reports were distributed throughout the financial sector, and to business associations, the Chamber of Commerce, the Ministry of Finance, and members of Parliament. Stakeholders attended meetings and workshops; special emphasis was placed on government officials (e.g., the Ministry of Finance, the Ministry of Economic Development, and the Financial Budgetary Parliamentary Committee). This led to the formation of a local legal and tax-drafting committee, supported by the legal expert's technical assistance, and included members from the Ministry of Economic Development. The final revised Law on Leasing and recommended tax amendments were the product of a local team, supported by the project's technical assistance. The previous law was repealed and the new law was passed, along with key amendments to the tax code.

Two additional leasing companies were created and technical assistance, in the form of teaming or shadow management, was provided to help them establish policies and procedures, strategic business and capital financing plans, lease administration, lease product development, and lease pricing models. The companies also received technical assistance on evaluating agricultural credit.

By the completion of the leasing component's term, the leasing portfolio of the three companies totaled more than $10 million. Leases included the agriculture, construction, services, international freight, communications, trade, and food-processing industries. The agricultural sector received 11 percent of all the leases. Today, there are six leasing companies and the sector continues healthy growth. Annual lease volume now exceeds $20 million.

The project used less than 10 percent of the funds it designated to co-finance leases. To access these funds, the leasing companies assumed full responsibility for the repayment of project funds. Fortunately, the leasing companies were well-capitalized, so they found little advantage in utilizing these funds.

Economic Impact from the Leasing Component's Activities	
Increased total lease portfolio	$17.5 million (up from $150,000)
Number of new leasing companies	5
New investments/capital	$11 million
New jobs created	1,150
John Deer distributor	Commenced operations

D2b. Key Findings and Lessons Learned

- *Timely progression of project implementation is a key to building stakeholder trust.* The mission should establish internal agreement on a project's SOW prior to requesting an implementing partner's work plan. Work plan approval was delayed for one year and the project suffered credibility issues with the stakeholders. Delays and confusion on the technical approach caused a $500,000 lease-support fund to go unused. The newly formed leasing companies had sufficient capital to fund leases; they did not need the financial support offered.

- *Technical assistance for lenders on how to evaluate agricultural credit should be given a high priority early in the project.* The financial sector had suffered losses in lending to the agricultural sector prior to the AgVantatge project. These losses resulted from lenders' poor understanding of borrower capabilities in business planning and financial management.

- *Lenders should be supported to establish educational outreach programs to teach borrowers basic recordkeeping and explain what documents are needed for a loan application.* It was surprising to learn that the agricultural sector managed its financial records like a household. There was no financial data available to perform basic credit analyses. Leasing companies (i.e., banks) would have benefitted from a training of trainers program to teach the agricultural sector how to manage its records and apply for loans.

- *Understanding the natural progression of leasing development in emerging economies helps target the appropriate level of technical assistance.* Leasing has stages of development. Georgia was at the first stage, in which loans were simply labeled as leases (i.e., the structures were the same). This significantly limited the real potential of leasing and access to credit for SMEs. Additional technical assistance in product development was needed to move the industry into the next stage; this would have required a longer term for the project's leasing component.

- *A public awareness campaign directed to the business community about leasing helps businesses understand the advantages of leasing and broaden its utilization.* The SOW and approved work plan focused technical assistance on the supply side (i.e., the leasing companies).

- *Building local consensus is important for legislative changes or amendments.* A local drafting team supported by project experts and including key stakeholders (e.g., government and business associations) was important for developing a new financial product and supportive legislation. The formation of a leasing association substantially helped a new and more effective law on leasing and tax code amendments get passed.

- *"Teaming" type of technical assistance was instrumental in the growth of the leasing companies.* Because the leasing companies were new and had no prior experience in leasing, the teaming assistance provided an international leasing expert to be on site at the leasing company full time for two three-week periods. Significant operational improvements were noted at the time, however the real impact of such technical assistance would be recognized several months later.

- *A thorough assessment of the legal and tax environment should be a first priority of any leasing project.* Leasing is a complex issue. The assessment should be performed by a well-qualified leasing legal and tax expert. In the case of AgVantage, the leasing component manager was an experienced leasing expert; however one person cannot possess all of the technical skills to institute leasing. In Georgia, it required a team of short-term technical assistants in areas of legal and tax, credit operations, credit analysis, product development and marketing, to name a few.

D3. U.K. Department for International Development (DFID): Kenya Micro-Leasing for Poor People's Enterprises

Data in this case study was compiled from Othieno, L., (n.d.), *Exploring Micro-Leasing for the Poor People's Enterprises Project: Key Lessons Learnt*, and ITC & Development Outcomes (n.d.), *Micro-Leasing for Poor People's Enterprises: Project Completion Report*. Both were retrieved from www.itcltd.com/microleasing/reports.htm.

Project Objective

Provide immediate and practical value for 200 microenterprises to increase their investment in capital equipment to increase employment and income for the poor.

At the start of the DFID-funded Kenya Micro-Leasing for Poor People's Enterprises, a significant gap existed in the financial services market in Kenya for medium-term finance for MSEs looking to invest modest amounts (e.g., $500-$5,000) in capital equipment. Such enterprises rarely qualify for tradition bank loans; they require smaller amounts than are accommodated by commercial leasing companies. Therefore, MSEs usually have to purchase capital equipment with cash up front, which significantly increases business risks, discourages enterprise start-ups, and stifles the graduation of MSEs to established businesses.

Under the Enterprise Development Innovation Fund, DFID piloted a two-year (2002-2003) technical assistance program to extend micro-leasing to at least 200 microenterprises in Western Kenya. The project explored the obstacles of the legal and institutional frameworks, the market demand by MSEs for micro-leasing, and the perceptions of other stakeholders, including equipment suppliers and other financial institutions. The project also assessed the value of key variables such as administrative overhead and risk premiums required to sustain micro-leasing. With this knowledge, capacity-building was directed toward MFIs and financial institutions with

experience serving low-income client groups. Direct technical assistance for MFIs included leasing products development; documentation; market assessment for small-scale capital equipment; technical characteristics of equipment and its uses; and capacity-building to better appraise micro-entrepreneurs.

The expected results were increased employment and income for poor people in the micro-enterprise sector.

D3a. Results

The completed research and assessment provided an understanding of the context and constraints on micro-leasing in Kenya, including the legal and institutional frameworks, the market demand for micro-leasing from MSEs, and the perceptions of other stakeholders, including equipment suppliers and other financial institutions.

The project completed a "Leasing Equipment Handbook" and "Master Lease Agreement," and held workshops to disseminate information. These materials helped legislative policymakers understand the value of leasing. The project also developed a standard lease agreement to assist MFIs with leasing documentation at a considerably lower legal cost. The standard agreement contributed to a system change in the leasing environment. Change in the leasing legislation and further policy lobbying increased awareness and knowledge of leasing for MFIs and stakeholders.

Unfortunately, the project was unable to engage any MFI to issue or book a micro-lease because each was unwilling to take a risk on a new product. As a result, employment and income for the poor did not increase.

D3b. Key Findings and Lessons Learned

- *An initial assessment of the leasing environment and local knowledge of leasing would have been helpful early in the project.* The project underestimated how challenging it would be to educate the MFIs on the value of leasing; it was more difficult to introduce leasing — a more complex form of credit — than had been anticipated. Do not underestimate the rigor of research into business sectors and the identification of relevant equipment for leasing.

- *A leasing legal and tax expert is critical to an initial assessment.* Consider the legal and tax regulations for leasing first. Before taking any action, know the changes to regulations that will require lobbying and how much time will be needed to educate stakeholders. Effective dissemination of proposed changes/amendments early on will lead to a better understanding of the issues and help assess the likelihood of introducing leasing.

- *MFIs must be willing to learn and make the financial investment to create a new product and educate the market.* MFIs must also have a good understanding of the value of the equipment being leased and a thorough understanding of the related laws and tax consequences. The MFIs in Kenya were not willing to make such investments and risk capital on an unproven product (i.e., leasing). They placed a higher priority on improving the quality of their

borrowers, improving their qualifying approval process, and reducing administrative transaction costs.

- *Prior to beginning a leasing project, there must be capable and committed stakeholders.* Experience dealing with low-income borrowers was expected to be an advantage in selecting institutions to offer micro-leasing. However, MFIs must also understand the complexity of leasing, incorporate it in their operations, and understand the equipment to be leased and its value throughout the term of the lease. Furthermore, it is necessary to educate the market (i.e., prospective borrowers/lessees) about leasing. MFIs in Kenya were not willing to make this investment.

- *MFIs are unlikely to be the principal drivers in developing micro-leasing services***.** Most of the MFIs and micro-enterprises were so small that they were not registered VAT users. Because their profit margins were low, loan products had a greater competitive advantage. After legal and tax changes were passed, MFIs remained unsure about the exact tax treatment of leasing. They took a wait-and-see approach to the new legislation, waiting for another party to test the legislation.

- *Micro-leasing is not a passive lending process that reacts to the demands of existing small businesses.* Micro-leasing is an active discipline that depends on seeking opportunities where the use of equipment will “self-fund” a lease and the customer fully understands the lease terms.

- *Donors and the private sector have conflicting objectives.* The private sector is focused on minimizing risks and maximizing profitability. Donors are willing to introduce techniques that have risks for the purpose of market development (i.e., increasing access to credit). MFIs resisted investing time or money in new concepts without assurances of success. A technical assistance project to introduce a new financial product for which the private sector is expected to make the needed financial investment should be approached cautiously. Financial support by donors to mitigate the risks for MFIs may provide an opportunity to introduce or demonstrate the value of a new financing product such as leasing.

E. Summary of Lessons Learned and Approaches Used

Leasing is an innovative financial product that has demonstrated its ability to increase access to credit and improve the lives of small business owners and the agricultural market chain in developing economies worldwide. However, it is clear that there is not just one model or approach to interventions. Below are 10 key lessons learned and approaches from the case studies and the author’s practical field experience.

1. *Use credentialed experts.* There are two sides to the development equation for leasing interventions: the enabling environment and lease operations. Both are needed when first considering market opportunities for interventions, preparing a market assessment, completing a review of the legal and tax codes, and project implementation. A comprehensive assessment of the enabling environment is a prerequisite to building an appropriate project intervention.

2. *Build consensus early among all stakeholders.* Little will be accomplished without the momentum of the government and the financial sector. The desire for leasing and the local understanding of leasing can be determined in the initial market assessment.
3. *Create a local leasing development team.* "Local" is the critical word. To further support consensus and build momentum, it is important to create a team that includes a local attorney who is respected for legal draftsmanship; members of the local financial sector who strongly desire the development of leasing; and government officials, preferably from the tax department, the Ministry of Finance, and/or the central bank. The donor project should be the facilitator of this team and provide technical assistance from key experts to guide the essential elements of legal and tax codes. Leasing technical assistance is best suited to give support to the local advocates and is more effective when outside experts are not in lead positions. Building a local leasing team is a prerequisite to the introduction of a lease law (or amendments) and a tax code. Stakeholders must feel there has been an adequate vetting period; budget time accordingly.
4. *Do not underestimate the challenge of passing lease legislation, especially amendments to the tax code.* Changing or passing new lease legislation is a difficult task that requires patience and persistence. Legislators and the financial sector must have time to thoroughly understand the value of a new law and the legal implications. Tax codes are especially difficult because they touch the issues of tax revenues.
5. *Direct technical assistance must be provided at the operational level of leasing.* Technical assistance has many dimensions for leasing. In addition to the enabling environment issues, technical assistance is needed in the leasing companies themselves, at the management and operative levels.
6. *Train the trainers.* Leasing companies need guidance and, possibly, some financial assistance to create workshops on leasing. The leasing companies should take responsibility for their own market development and educate their borrowers on leasing products and how to apply for credit. These workshops should be ongoing events and include the rural sector.
7. *Include capital funds in projects to support product development.* Where leasing is new to the market, project capital funds will be needed to seed product start-up. Ideally, leasing companies will step into the first stage without assistance. Once there is some experience with the first stage, it is critical to provide financial support to help the leasing companies issue operating leases. Once operating leases are introduced to the market, leasing companies will begin to be more innovative in servicing the market demand.
8. *Offer financial support for training.* Support the leasing industry with financial assistance to attend leasing conferences, trade shows, and lease training programs in the United States and/or Europe. Find a reputable U.S.- or U.K.-based leasing company that will allow managers and key personnel from local leasing companies to spend a week observing their operations. This is a prerequisite for providing technical assistance to existing leasing companies. Leasing companies' management and staff are eager to learn modern techniques from developed countries; they learn well through effective training programs, meeting with leasing companies from other countries, and watching how successful leasing companies perform operational and management tasks.

9. *Manage expectations.* Do not expect leasing companies to enter into new markets or test new products without financial support (or guarantees). Leasing companies are profit-seeking entities; they are not interested in taking the kinds of risks that donor organizations take (e.g., economic reforms or development).
10. *Use DCA as support to introduce residual-based leasing.* The DCA guarantee program can provide the additional support leasing companies need to graduate from leases that closely resemble a loan into more modern leases.

ANNEX A. GLOSSARY

Advance Payments. One or more lease payments required to be paid to the lessor at the beginning of the lease term as part of the execution of the lease. Lease structures commonly require one payment to be made in advance. This term also refers to leasing arrangements in which the lease payment is due at the beginning of each period.

Advance Rental. Any payment in the form of rent made before the start of the lease term. The term also describes a rental payment arrangement in which the lessee pays each rental, on a per-period basis, at the start of each rental payment period. For example, a quarterly, in-advance rental program requires the lessee to pay one-fourth of the annual rental at the start of each consecutive three-month period during the lease term.

Balloon Payment. A large payment at the end of the loan that allows smaller payments to be made during the term.

Bankruptcy. An action taken by a party to legally protect its remaining assets by declaring that it cannot pay its bills. Typically, liabilities exceed assets. A common definition in the United States for bankruptcy is interest coverage less than one. A firm is generally forced into bankruptcy not when its liabilities are greater than its assets, but when it cannot make its interest payments with current earnings before interest and taxes.

Bargain Purchase Option. A lease provision allowing the lessee, at its option, to purchase the leased property at the end of the lease term for a price sufficiently lower than its expected fair market value, such that exercise of the option appears at the inception of the lease to be reasonably assured.

Capital Lease. A lease in the United States is classified as a capital lease if it satisfies any of the following: (a) it transfers ownership to the lessee at the end of the lease term; (b) it contains an option to purchase the property at a bargain price; (c) its term is equal to 75 percent or more of the economic life of the property; (d) the present value of minimum lease rental payments is equal to 90 percent or more of the fair market value of the leased property, less related investment tax credit retained by the lessor. A capital lease must be shown on the lessee's balance sheet as an asset with a related obligation.

Capitalize. To record an expenditure that may benefit future periods as an asset, not an expense to be charged off in the period it occurs.

Captive Lessor. A leasing company that has been set up by a manufacturer or equipment dealer to finance the sale or lease of its own products to end users or lessees.

Civil Law. The civil law system is the most common foundation of legal systems around the world. It is an alternative to the common law system. Like common law, civil law is rooted in Roman law.

In most — but not all — jurisdictions, civil law is codified (in civil codes). Most codes follow the tradition of the *Code Napoléon* in some fashion, though a country may adapt its civil code to local legal tradition, as is done in Germany.

Civil law is employed by almost every country/area that was not a colony of the British Empire, including continental Europe, Quebec, Louisiana, and the former Soviet Union.

Collateral. The security that is made available to secure finance. Pledge of property and bank guarantees are commonly used as collateral in leasing.

Collateral Registry. A centralized public registry to record a charge or lien on fixed and movable collateral used as security.

Cost of Capital. The weighted average cost of funds a firm secures from debt and equity sources to fund its assets. The use of a firm's cost of capital is essential to make accurate decisions about capital budgeting and project investment.

Default. A condition whereby the lessee does not make the payments required by the lease contract.

Depreciation. A means for a firm to recover, over time, the cost of a purchased asset through periodic deductions or offsets to income. Depreciation is used in financial reporting and tax contexts. It is considered a tax benefit because the depreciation deductions cause taxable income to fall, lowering a firm's tax liability.

Discount Rate. An interest rate used to bring a series of future cash flows to their present value in order to state/value them in terms of current (i.e., today's) currency. Use of a discount rate removes the time value of money from future cash flows.

Early Termination. Premature termination of the contract occurring when a party to a lease fails to meet its obligations under the lease contract, to the extent that entitles the other party (under the law or the agreement) to demand such termination.

Economic Life of Leased Property. The estimated period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease.

Effective Interest Rate. The interest rate on a lease stated on an annual basis. The rate includes the compounding effect of interest during the year.

End-of-Term Options. Stated in the lease agreement, options give the lessee flexibility in its treatment of the leased equipment at the end of the lease term. Common end-of-term options include purchasing the equipment, renewing the lease, or returning the equipment to the lessor.

Equipment Schedule. A document incorporated by reference into the lease agreement that describes the equipment being leased in detail. The schedule may state the lease term, commencement date, repayment schedule, and location of the equipment.

Equipment Specifications. A specific description of a piece of equipment that is to be acquired, including, but not limited to, its make, model, configuration, and capacity requirements.

Estimated Residual Value of Leased Property. The estimated fair value of the property at the end of the lease term.

Fair Market Value (FMV). The value of a piece of equipment if it were to be sold in a transaction between a willing buyer and a willing seller, for equivalent property and under similar terms and conditions.

Finance Lease. Finance leases transfer substantially all the risks and rewards of ownership to the lessee.

Full-payout Lease. A lease in which the lessor recovers, through lease payments, all costs incurred in the lease plus an acceptable rate of return, without any reliance upon the leased equipment's future residual value.

Funding. The process of paying the manufacturer of the equipment for the equipment being placed on lease.

Funding Source. An entity that provides any part of the funds used to pay for the cost of the leased equipment. Funds can come from an equity funding source, such as the ultimate lessor in a lease transaction, or a debt funding source, such as a bank or other lending institution.

Inception of a Lease. The date of signing of the lease commitment or agreement where the property to be leased has been constructed or has been acquired by the lessor; otherwise, the date construction is completed or the property is acquired by the lessor.

Initial Direct Costs. Costs incurred by the lessor that are directly associated with negotiating and consummating a lease. These costs include but are not limited to commissions, legal fees, costs of credit investigations, and the cost of preparing and processing documents for new leases.

Interest. The difference between the total loan payments and original loan amount (principal). Interest is to a loan as earned income is to a lease.

Interest Expense. An amount paid to a lender in return for a loan. Typically the interest is paid out over time, accompanied by a reduction in loan principal.

Investment Yield. The income returns on an investment; expressed as an annual percentage.

Lease. A contract between the owner of an asset (the lessor) and its user (the lessee) for the hire of that asset. Ownership remains with the lessor, while the right to use the asset is given to the lessee for an agreed-upon period in return for a series of payments.

Lease Agreement. The contractual agreement between the lessor and the lessee that sets forth all the terms and conditions of the lease.

Lease Expiration. The time at which the original term of the lease contract has ended.

Lease Origination. The process of uncovering (through a sales force), developing, and consummating lease transactions. Steps in the process include but are not limited to prospecting for new lease business, pricing potential transactions, performing credit reviews, and completing the necessary documentation.

Lease Payments. Also called rentals. The amount the lessee pays the lessor in return for using the leased equipment.

Lease Rate. The equivalent simple annual interest rate implicit in the minimum lease rentals. This is not the same as the interest rate implicit in a lease, which reflects the compounding effect.

Lease Term. The fixed, non-cancelable term of the lease. For accounting purposes, it includes all periods covered by fixed-rate renewal options, which for economic reasons appear likely to be exercised at the inception of the lease. For tax purposes, it includes all periods covered by fixed-rate renewal options.

Lessee. The user of the equipment being leased.

Lessor. The owner of the equipment being leased.

Leverage. The degree to which an investor or business is utilizing borrowed money. Stated as a ratio of total debt to total assets.

Lien. A security interest on property to protect the lender if the lessee defaults.

Net Present Value. The total discounted value of all cash inflows and outflows from a project or investment.

Off-Balance-Sheet Financing. Any form of financing that, for financial reporting purposes, is not required to be reported on a firm's balance sheet (e.g., an operating lease).

Operating Lease. A lease arrangement wherein the lessor seeks to recover his investment in a lease by leasing the equipment to more than one lessee. For financial accounting purposes, an operating lease is a lease that does not meet the criteria for a capital lease or direct financing lease. Also, used generally to describe a short-term lease whereby a lessee can acquire use of an asset for a fraction of its useful life. The lessor may provide services in connection with the lease, such as maintenance, insurance, and payment of personal property taxes.

Original Equipment Cost (OEC). The amount the lessor pays the vendor for the equipment at the beginning of the lease. Usually includes up-front sales tax.

Payment Stream. The rentals due in a lease.

Payments in Advance. A payment stream in which each lease payment is due at the beginning of each period during the lease.

Payments in Arrears. A payment stream in which each lease payment is due at the end of each period during the lease.

Present Value. The discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Present value represents a series of future cash flows expressed in today's money.

Pricing. The process of arriving at the periodic rental amount to charge a lessee. A lessor must factor many variables into its pricing, which may include lease term, lessor targeted yield, security deposits, residual value, and tax benefits.

Purchase Option. An option in the lease agreement that allows the lessee to purchase the leased equipment at the end of the lease term for either a fixed amount or at the future fair market value of the leased equipment.

Related Parties. In leasing transactions, a parent and its subsidiaries, an investor and its investees. The parent, owner, or investor has the ability to exercise significant influence over the financial and operating policies of the related party.

Remarketing. The process of selling or leasing the leased equipment to another party upon termination of the original lease term. The lessor can remarket the equipment or contract with another party, such as the manufacturer, to remarket the equipment in exchange for a remarketing fee.

Renewal Option. An option in the lease agreement that allows the lessee to extend the lease term for an additional period beyond the expiration of the initial lease term, in exchange for lease renewal payments.

Repossession. When a lessor reclaims and physically removes the leased equipment from the control of the lessee, usually because of payment default.

Residual or Residual Value. The prevailing market value of equipment at the end of the lease term.

Secured Party. The person or organization holding a security interest or lien against collateral.

Secured Transactions Law. A transaction based on a security agreement that concerns a security interest whereby personal or real property is pledged as collateral for performance or a debt.

Securitization. The process of selling lease receivables to a separate legal entity that issues stocks and bonds to investors. The investors' proceeds flow to the company that sold the receivables and the investors receive their returns from collecting lessee receivables.

Substance versus Form. A concept that implies that the form of a document is subordinate to the intent of the parties involved in the document.

Termination Value. The liability of the lessee when termination is set forth in a termination schedule that values the equipment at different times during the lease term. This value is designed to protect the lessor from loss of investment. If the equipment is sold at a price lower than the amount set forth in the schedule, the lessee pays the difference. If resale price is higher than in the termination schedule, excess amounts belong to the lessor. The termination schedule is not the same as the casualty value schedule, insured value schedule, or stipulated loss value schedule.

Third-Party Lessor. An independent leasing company (i.e., lessor) that writes leases involving three parties: the unrelated manufacturer, the independent lessor, and the lessee.

Two-party Lessor. A captive leasing company (i.e., lessor) that writes leases involving two parties: the consolidated parent and/or captive leasing subsidiary and the lessee or end user of the equipment.

Useful Life. The period during which an asset will have economic value and be usable. Sometimes called *economic life*.

Vendor Leasing. Lease financing offered to an equipment end user in conjunction with the sale of equipment. Vendor leases can be provided by the equipment vendor (i.e., the manufacturer or dealer) or a third-party leasing company with a close working relationship with the equipment vendor.

Withholding Tax. Payable on the rentals received from many cross-border leases, depending on the double-taxation arrangements between the countries involved. May be prohibitively high.

Source: International Finance Corporation

ANNEX B. REFERENCES

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ANNEX C. LEASE STRUCTURES

<table>
<tr><th colspan="2">Lease Structures</th></tr>
<tr><td>Lease Term</td><td>The term of the lease is usually tied to the useful life of the equipment, though it can be shorter. When a lease is shorter than the useful life of the equipment, it will often amortize only that portion of the equipment's life. Depending on the equipment's residual value, this will sometimes lower the payment (compared with a loan or a lease that is fully amortized).</td></tr>
<tr><td>Payment Amount</td><td>Leases can be structured around a specific payment requirement for the lessee. The lease term and possible residual value are the adjustable factors to structure a lease to a targeted payment.</td></tr>
<tr><td>Payment Frequency</td><td>Payments can be structured monthly, quarterly, semi-annually, and annually. They can also be set according to a business's seasonality (i.e., certain months of the year are skipped). This is common in the agricultural industry, in which payments are scheduled around the collection of harvest payments.</td></tr>
<tr><td>Advance Payments</td><td>Advance payments are the number of lease payments (one, two, or more) that are made at the time the lease contract is signed. The advantage of advance payments to a lessee is that the overall monthly payment will be lower; the advantage to the lessor is less risk because more cash is collected up front.</td></tr>
<tr><td>Payment Calculations</td><td>Lease payments can be calculated in arrears, meaning the payment is due at the end of the period (e.g., the end of the first month) or in advance (e.g., due at the beginning of the period, though this is not considered a down payment). For example, when the payments are in arrears on a monthly-payment lease, the lessee has the use of the equipment for one month before the payment is due. Conversely, if payments are in advance, the lessee pays the month's payment before the equipment is used. These calculations affect the amount of the lease payment because of the time-value of money.</td></tr>
<tr><td>Security Deposits</td><td>Security deposits provide additional security to the lessor. This can lower lease payments for the lessee, because the lessor can invest the security deposit for additional earning. These additional earnings from the security deposit enable the lessor to reduce the yield on the lease, which lowers lease payments.</td></tr>
<tr><td>Capital Cost Reduction</td><td>A capital cost reduction is when the lessee pays an amount to the vendor who is selling the equipment to the lessor. The advantage is a reduced lease value, which lowers the lessee's lease payment.</td></tr>
<tr><td>Depreciation</td><td>Depreciation can be a valuable because it is a non-cash expense that reduces profit and, consequently, lowers the amount of profit tax due. The lessee and the lessor will determine in advance who has the greater need to utilize the depreciation. If the lessor utilizes the depreciation, the lessee will expense the full amount of the lease payment; if the lessee wants the depreciation, it will capitalize the equipment on their balance sheet and expense depreciation and the interest portion of the lease payment.</td></tr>
<tr><td>Residual Value</td><td>Residual value is the expected future value of a piece of equipment. Residual values can reduce lease payments because the full value of the equipment is not being amortized.</td></tr>
<tr><td>End of Lease Options</td><td>End-of-lease purchase options are negotiated in advance of the lease and can be structured in different ways. There are three end-of-lease alternatives that can be negotiated into the lease agreement.
1) The equipment can be returned to the lessor, at which time the lessor can:
a. Release the equipment to a new lessee
b. Sell the equipment to a third party
c. Salvage or scrap the equipment
2) The equipment can be released to the lessee at a renegotiated rate.
3) The lessee may purchase the equipment as negotiated at the beginning of the lease.
a. A guaranteed purchase by the lessee at a predetermined, fixed price. This could be as little as $1.00, or it may be stated as a percentage of the capitalized cost.
b. A purchase option at a predetermined, fixed price. The lessee is not required to purchase the equipment, but can do so at a price determined at the beginning of the lease.
c. A purchase option at the equipment's fair market value (an amount determined at the end of the lease term comparing what like equipment in similar condition is selling for). A method to determine fair market value must be included in the lease agreement.</td></tr>
</table>

Source: Fletcher, 2005, p. 3

ANNEX D. LEASING LEGISLATION GUIDELINES

Every provision in a quality leasing law should be tested against three fundamental principles and included only if it passes these tests:

1. A definition of finance lease that is based on recognition of the three-party structure of modern financial leasing, not based on accounting or tax classification rules
2. Duties consistent with each party's role in the transaction
3. Freedom of contract in negotiating the parties' agreements

A quality leasing law must have certain essential provisions:

- Proper definition of finance lease
- Absolute minimum of mandated lease agreement terms (e.g., property description, payment start date and amounts, periods and term)
- Lessor's ownership right
- Lessor's warranty of quiet use and possession
- Lessor's absence of liability to third parties
- Lessee's absolute duty to pay lease payments after acceptance
- Lessee's bearing of the risk of loss;
- Lessor's absence of equipment responsibilities
- Lessee's recourse against the supplier for equipment defects and problems
- Freedom for lessors to assign the lease and a restraint for lessee to assign use
- Lessor's ability to expediently repossess upon a lessee default
- Lessor's ability to accelerate the remaining lease payment upon a lessee default
- Lessee's duty to return the leased property at expiry or termination
- Exclusion of the leased property from the lessee bankruptcy estate and its expedient return

These provisions are essential in the law because they are essential in industry practice. A financial leasing law that strives to rewrite the basic core business practices that distinguish leasing can do serious harm to everyone — lessors, lessees and the country's economic potential. A good commercial law will reflect business reality, not artificially direct it.

There are also unacceptable provisions that must be avoided because of their potential to constrict the development and flexibility of the leasing industry:

- Avoid a definition of finance lease based upon anything but the following criteria:
  - Lessee's selection of the equipment and the supplier
  - Lessor's acquisition of the equipment specifically for lease to the lessee
- Avoid a mandatory requirement that the leased property be transferred to the lessee at the end of the lease
- Avoid a mandatory requirement that the lessee have a purchase option (or renewal option)
- Avoid any provision that is contrary to the essential provisions above

Source: International Finance Corporation

ANNEX E. COMMONLY LEASED EQUIPMENT

SECTOR	TYPE OF EQUIPMENT
Agricultural, Forestry, and Fishing	Harvesting and planting Hay and cotton bailers Tractors Dairy machinery Food processing Livestock-related
Amusement	Arcade games Gaming machines Jukeboxes Pool tables Simulators
Banking	ATMs Check scanners Sorters Encoders
Computers	CAD/CAM systems File servers Hardware and software Macro- and micro-computers Mainframes PC networks Peripherals Plotters Printers and scanners Workstations
Construction	Bulldozers Cement trucks Compactors Concrete Cranes Earth-moving Excavators Jackhammers Portable construction lighting Shovels Surveying Tractors
Industrial and Manufacturing	Grinders Lathes Material-handling machines Production and packaging Punch/press machines Silkscreen Injection molding machinery Sewing/embroidery/quilting machines Textile machines
Material-Handling	Forklifts Pallet jacks Platform lifts Conveyers

SECTOR	TYPE OF EQUIPMENT
Medical	Blood analyzers CT scanners Exam tables Dental Heart monitors Lab testing Optical Physical therapy X-ray
Mining, Oil, and Gas Extraction	Blast hole drills Concrete transit machinery Draglines Electric and hydraulic shovels Extraction machinery Loaders Pumps
Office	Copiers Embossers/folders Facsimile File cabinets Furniture Labeling machines Postage Telephones
Printing/Publishing	Binders/cutters Colorimeters Computerized press Graphic cameras Photo processing Printing presses Typesetting
Restaurant	Bar Countertop griddles Electric slicers Food warmers Fryers Furniture Neon signs Grills Hot dog Ice machines Microwaves Paging systems Popcorn makers
Telecommunications	Switches Telephone systems Transformers
Transportation	Aircraft Buses Containers Fresh/saltwater Garbage trucks Passenger vans Tow trucks Railroad Trailers Trucks
Vending	Candy/snack machines Change machines Soft drink dispensers

Source: Equipment Leasing and Finance Association, www.elfaonline.org

ANNEX F. SAMPLE DCA CONCEPT DOCUMENT

OFFICE OF DEVELOPMENT CREDIT

Concept Document

For DCA Lease Portfolio Residual Guarantee

1. Project Management Information

a. Mission/Bureau: USAID/Caucasus

b. Project manager name: **Title**:

Email: **Phone**: **Fax**:

c. Funding: amount available for DCA credit subsidy: $

d. Date obligation expected: Second quarter of 2006

e. Name of the RLA: Yastishock, Ann Marie

2. Project Description and Development Analysis Information

a. Brief Project Description: 15% DCA guarantee (fixed amount of capitalized equipment lease cost) on a $3 million lease credit facility to TBC Leasing. 7 year program term. Lease terms would be 3-5 year on a non-cancelable lease. Program leverage 7:1. Eligible leases: New equipment (e.g. manufacturing equipment, production equipment, trucks trailers, tractors). Industry limitations: none – agricultural sector highly encouraged.

Leasing in Georgia has proven itself as a viable option for finaning of equipment in Georgia with it's portfolio more than doubeling in each of the past two years. In addition, the demand for leasing is established at more than $20 Million per year. Furthermore, leasing is virturaly the only source of long-term (3-5 year) financing available for equipment. Unfortunatley, Georgian banks lack the source of long-term liquidity for extending loans much beyond two years, plus they require 150% to 200% of collateral, including real estate assets. These conditions are nearly impossible for SME meet. Leasing companies, however, are soely in the business of financing equipment for 3-5 years without requiring any additional collateral or security other than the ownership of the equipment being leased.

Currently there is only one lease product offered in Georgia, and in reality it is not much more than a loan, labeled as a lease. But Georiga is now ready for the introduction of new lease

products; products that will diffierenate themselves from bank loans. The technique of residual based pricing, utilized in modern leasing, offers all of the regular leasing benefits, plus it lowers the lease payments to the lessee.

In residual based lease pricing, the leasing company assusmes that at the equipment will have a market value of X% of the origianl equipment cost, at the end of the lease term. If at the end of the lease term, the equipment sells for more than the residual value assumed, then the leasing company earns an additional profit. However if the equipment sells for less than the residual value, the company absorbs the loss. Therefore, in residual based pricing transactions the leasing company takes both a credit risk and an equipment risk.

Residual based pricing is very effective leasing tool and one of the reasons why leasing accounts for more than 30% of all financing in developed markets. Georgia is ready for such modern leasing practices and SME need a lower cost source of financing, but because no secondary market for equipment existis in Georgia, leasing companies are hesitant to introduce such products.

The purpose of this program is to provide the needed stimulus and support that will induce leasing companies to offer new residual based pricing products. These products include: Fixed Purchae Option and Fair Market Value Purchase Option leases. Leases for accounting purposes are classified as “financial leases”.

The DCA gurantee is limited to the residual amount, not to exceed 15% of the original cost of the equipment and the leasing company is responsible for the remaining 85% risk. However, in the event that the lease is terminated, in default, or otherwise is not fulfilled to the end of the lease term, the leasing company will not have any claim aginist any DCA guarantee. The DCA guarantee is designed to support the leasing companies in their seconday market risks of the equipment, not in the credit risks of the lessee.

Mobilizing credits for SMEs and agribusiness entities directly support the mission’s ongoing activities to stimulate access to credit. The DCA Guarantee will stimulate the growth of a lower cost financing product to SMEs and the agricultural sector by demonstrating a new leasing products to these sectors is viable, when risk is prudently managed.

Objectives: Increase 3-5 year equipment financing to qualified SME and agriclutural borrowers. Demonstrate the viability of Fixed Purchae Option, Fair Market Value Purchase Option, Tax Based Pricing.

Expected Results: At least 50 leases introducing new technology into the Georgian economy; Increased availability of new leasing product, Increased access to equipment financing; lower cost of financing alternatives, Increased knowledge and experience to the leasing industry. Program start-up, and lease product development training can be provided by existing USAID Access to Credit projects.

b. Linked SO(s): SO 1.31 "Accelerated development and growth of private enterprises to create jobs."
IR#1.31.2 “Increased access to financial services” and IR#1.31.2.2 Financial Institutions Developed.”

c. Economic justification. Financing of equipment is a significant barrier to Georgia economic growth. Without new equipment introduced, Georgia products cannot reach the quality needed to compete on the international market, no new jobs are created, and no additional economic activity is stimulated.

This program will help to increase access to commercial investments by providing residual guarantees for leases up to 5 years. It will also encourage the participating leasing company to offer new financing products that lower cost for borrowers. The aggregate principal amount of all qualifying loans covered under this agreement at any one time shall not exceed U.S. dollars 3,000,000 or the local currency equivalent of this amount in Georgian lari.

- **Market imperfections**
- Lack of long term (3-5 year) financing equipment financing.
- High real rates of interest (current average of dollar rates exceeds 16% per annum);
- Requirements for collateral more than 150% of exposure on loan principal, which only wealthier borrowers can meet;
- Lack of credit available outside Tbilisi.
- Lack of experience and expertise in financing SME and agribusiness projects.
- Under-developed agricultural infrastructure.

Will the DCA guarantee help create additional credit availability not replacing or competing with existing source of financing?

- Leasing is a complementary service to the banking sector and why bank own leasing companies.
- Bank loans require as much a 150%, including some form of real estate for loans, which eliminates SME from accessing credit. Leasing eliminates this issue by owing the equipment under lease.
- Agriculture receives around 2% of loans from financial institutions, which indicates that this market is underserved.
- Georgian banks have almost no long term resources to finance loans with terms of one year or more. Leasing companies raise funds through debt and equity and are not subject to depositor's withdrawals or the National Bank of Georgia's deposit reserve requirements. Leasing's only product is long-term (3-5 year) equipment financing.
- Banks underestimate the value of the collateral consequently limiting the borrowing capacity of the rural borrowers.

3-1. Financial Institution (FI) Information, if available

a. Name & Address: TBC Leasing

b. Contact person name: Thea Lordkipanidze **Title**: Director

Email: thea@tbcleasing.ge **Phone**: 995 (32) 27 27 32 **Fax**: 995 (32)

c. Is the FI majority owned by the private sector? Yes _X__ No____

d. Is the FI present or past DCA partner? Yes ____ No__X_

e. Has the FI been profitable in:

Last Fiscal year? Yes __X_ No____

Year before? Yes ____ No__X_

Two years before? Yes _N/A No____

f. Has the FI been audited in:

Last Fiscal year?	Yes _X__ No____
Year before?	Yes _X__ No____
Two years before?	Yes _N/A No____
g. Has the FI been rated?	Yes ____ No_X_

h. If yes, please give the name of the rating agency:

4. Basic Anticipated Terms

a. Type of guarantee. Check one: LPG (**X**) LG ( ) BG ( ) or PG ( )

b. Total facility amount (i.e., total credit to be disbursed): $3,000,000

c. Term of guarantee: 7 years

d. USAID guarantee percentage: 15% DCA guarantee (fixed amount based on capitalized equipment lease cost).

e. Guarantee ceiling (maximum USAID liability): $450,000

f. Final date for disbursing qualified loans under the guarantee: 7 years

g. Guarantee expiration date: December, 2013

h. Currency of loans, is there a mismatch? All leases are issued in US Dollars

i. Estimated pricing – interest rate, fees: TBD. Currently commercial banks charge 17-22 percent on loans denominated in US dollars.

j. Basic anticipated credit criteria for asset class (e.g. collateral requirements, credit history): Borrowers will demonstrate their credit ability to service lease payments. Equipment leased is owned by the lessor (TBC Leasing), therefore no additional collateral is required. DCA Guarantee is only on the lease residual, provided the lease fulfills the full terms of the lease.

5. Borrower Information:

Complete this section for loan portfolio guarantee (LPG) or bond guarantee (BG) with multiple end-borrowers. If applying for other products, skip this section and go to the next section.

a. What is the borrowers' industry sector? SME (light manufacturing, construction, medical, IT) and agriculture (including farm equipment, processing and packaging equipment)

b. How are they meeting their current financing needs? Personal equity, family, informal sources. Large unmet demand

c. Average lease size: $50,000

d. Average lease term: **4 years**

e. Purpose of the loan: Working capital ( ) Asset purchase (X) Other ( )

f. Has this group borrowed from any FI in the past?	Yes__X__ No_____
g. Has there been a study on the borrower group or the industry sector?	Yes_X___ No____

Studies prepared in 2004 include the following:
1. SME Environment Assessment, 2/05

2. Assessment of Policy, Legal and Regulatory Reform.
3. Assessment of Specific Constraints to Agribusiness in Georgia.
4. DCA Agricultural assessment, 8/05.

h. Have the borrowers received or are receiving any technical assistance? Yes_X___ No_____

i. If the answer is yes to h, please give a very brief description of the assistance and the length of the assistance:

The following types of technical assistance are being provided to borrowers. This TA will be on going through December, 2007.

Agricultural Production-related:
1. Introducing and implementing improved production technologies and practices to increase productivity and product quality (orchard and field layout, land preparation, improved seeds and seeding, transplanting techniques, weed and pest control, irrigation, harvesting, etc).

Agricultural Processing-related:
1. Identifying and assessing value-added processing opportunities.
2. Introducing new/improved processing technologies and processes.
3. Identifying and introducing improved processing and packaging equipment.
4. Providing specialized assistance to introduce HACCP and ISO programs and to help processing companies implement these programs.
5. Providing specialized assistance to introduce a Total Quality Management Programs

USAID/SME Support Project provides SME with technical assistance through business support organizations, business training, self-certification, legal and policy advocacy support.

6. Borrower Information:
Complete this section for loan guarantee (LG), bond guarantee (BG) for a single borrower, or portable guarantee (PG). If applying for loan portfolio guarantee (LPG), skip this section.

a. Borrower Name and address:

b. Contact person name: **Title**:

Email: **Phone**: **Fax**:

c. Primary Business:

d. Date Established:

e. Legal form:

f. Last full year **Revenue**: **Profit**:

g. Purpose of the loan: Working capital ( ) Capital purchase ( ) Other ( )

h. Has the borrower have experience in the purpose area? Yes____ No___

i. Does the borrower have present/past borrowing experience? Yes____ No___

j. Is the borrower present/past DCA partner? Yes____No___

Date Submitted*: March 29, 2006* ***Date Reviewed****:*

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