

Chapter 1

Importance of Leasing and IFC's Role

What Is Leasing?

Leasing in its simplest form is a means of delivering finance, with leasing broadly defined as “a contract between two parties where one party (the lessor) provides an asset¹ for usage to another party (the lessee) for a specified period of time, in return for specified payments.” Leasing, in effect, separates the legal ownership of an asset from the economic use of that asset.

Leasing is a medium-term financial instrument for the procurement of machinery, equipment, vehicles, and/or properties. Leasing provides financing of assets—equipment, vehicles—rather than direct capital. Leasing institutions (lessors)—banks, leasing companies, insurance companies, equipment producers or suppliers, and non-bank financial institutions—purchase the equipment, usually as selected by the lessee, providing the equipment for a set period of time to businesses. For the duration of the lease, the lessee makes periodic payments to the lessor at an agreed rate of interest. At the end of the lease period, the equipment is either transferred to the ownership of the business, returned to the lessor, discarded, or sold to a third party. Under financial leasing, the lessee typically acquires or retains the asset.

It is important to remember during this discussion and throughout this manual that legal definitions, definitions for tax purposes, and definitions under local and international accounting standards may differ considerably in different jurisdictions. Discussion in this manual is generally directed at economic substance, which largely corresponds to international accounting treatments. This manual is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

¹ This manual is primarily for equipment leases. The term *asset* in this manual refers to equipment and/or vehicles.

Leasing is based on the proposition that profits are earned through the use of assets, rather than from their ownership. It focuses on the lessee's ability to generate cash flow from business operations to service the lease payment, rather than on the balance sheet or past credit history. This is why leasing is particularly advantageous for new, small and medium-size businesses that do not have a lengthy credit history or a significant asset base for collateral. Furthermore, the lack of a collateral requirement with leasing offers an important advantage in countries with weak business environments, particularly those with weak creditors' rights and collateral laws and registries, for instance, in countries where secured lenders do not have priority in the case of default.

It should be noted that, to date, IFC has focused mainly on the development of financial leasing. This is the primary stage in leasing development in most emerging and transitional economies. Operating leases (or rent) can be equally important in the long term, but for a number of reasons are generally typical of a later stage of development.

In some respects, operating leases are equivalent to "rental." In the English language, the definition of rental is arbitrary: operating leases are rental arrangements that are longer than one year. Other languages and jurisdictions may use the terms interchangeably or define them differently.

A finance lease is a contract that allows the lessor, as owner, to retain ownership of an asset while transferring substantially all the risks and rewards of ownership to the lessee.² A finance lease is also known as a full payout lease, because payments made during the term of the lease amortize the lessor's costs of purchasing the asset (there may be a residual value that usually does not exceed 20% of the cost). The payments also cover the lessor's funding costs and provide a profit. Despite the legal form of the transaction, the economic substance of a finance lease transaction is one of purchase financing rather than a mere rental.

In contrast, an operating lease is essentially a rental contract for, usually, the short-term or temporary use of an asset by the lessee. The maintenance and insurance responsibilities (and most risks associated with the ownership of the asset) remain with the lessor, who recovers the costs and profits from multiple rentals and the final sale of the asset.

Differences between Finance and Operating Leases

Table 1-1 lays out the difference between finance and operating leases. International Financial Reporting Standards state that a lease is a financial lease if it contains at least one of the features in the list on pages 3 and 4:

²These risks and rewards of ownership may be shared or otherwise allocated, such as insuring the equipment.

Table 1-1. Differences between Finance and Operating Leases

Finance Leases (or Full Payout Leases)	Operating Leases
<ul style="list-style-type: none"> ■ Risks and rewards of ownership are transferred to, and borne by, the lessee. This includes the risks of accidental ruin or damage of the asset (although these risks may be insured or otherwise assigned). Thus damage that renders an asset unusable does not exempt the lessee from financial liabilities before the lessor. ■ The goal of the lessee is either to acquire the asset or at least use the asset for most of its economic life. As such, the lessee will aim to cover all or most of the full cost of the asset during the lease term and therefore is likely to assume the title for the asset at the end of the lease term. The lessee may gain the title for the asset earlier, but not before the full cost of the asset has been paid off. ■ The lessor retains legal ownership for the duration of the lease term, though the lessee may or may not buy out the leased asset at the end of the lease, with the lessor charging only a nominal fee for the transfer of asset to the lessee. ■ The lessee chooses the supplier of the asset and applies to the lessor for funding. This is significant because the leasing company that funds the transaction should not be liable for the asset quality, technical characteristics, and completeness, even though it retains the legal ownership of the asset. The lessee will also generally retain some rights with respect to the supplier, as if it had purchased the asset directly. 	<ul style="list-style-type: none"> ■ Economic ownership with all corresponding rights and responsibilities are borne by the lessor. The lessor buys insurance and undertakes responsibility for maintenance. ■ The goal of the lessee is usage of the leased asset for a specific temporary need, and hence the operating lease contract covers only the short-term use of the asset. Further, the duration of an operating lease is usually much shorter than the useful life of the asset. ■ It is not the lessee's intention to acquire the asset, and lease payments are determined accordingly. In addition, an asset under an operating lease may subsequently be rented out. ■ The present value of all lease payments is significantly less than the full asset price.

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable, and at the inception of the lease, it is reasonably certain that the option will be exercised.
- The lease term is for a majority of the useful life of the asset and where the title to ownership may or may not eventually be transferred.

- The present value of the minimum lease payments at the inception of the lease is greater than or equal to the fair value of the leased asset.
- The leased assets are of such a specialized nature that only the lessee can use them without major modifications.

Leases that do not have any of these characteristics are considered to be operating leases.

The Difference between Financial Leasing and Loans

From the lessee's perspective, there is only one substantive difference between a loan and a lease: with a loan, the asset belongs to the borrower, whereas with a lease, the asset belongs to the lessor.

The many similarities between a loan and a financial lease include:

- The lessee and borrower have the choice over the acquisition of the asset. The borrower and lessee (providing the terms of the lease are met) would be able to retain the asset once payments are complete.
- Over the period of both a loan and a lease, interest and capital (equipment cost) are repaid.
- Should there be default on either a loan or a lease, as long as the loan is secured, both the lender and lessor have legal rights to reclaim/repossess assets.
- The risks and costs of ownership, including maintenance and obsolescence, remain with the borrower and lessee. Also, under both a loan or a financial lease, if the asset appreciates, neither the lender nor the lessor benefits.
- The agreements are non-cancelable until either the lessor or the lender has recovered its outlay.
- The borrower or lessee can either settle the agreement (in the case of the lease) or repay the loan early.

Why Is Leasing Different from Bank Financing?

With both leasing and bank financing involving credit decisions and financial risks, the key differences are that two additional factors apply to leasing companies:

First, they have knowledge of the asset (and often the industry), and hence are lending to some degree on an asset basis. This is different from collateral-based lending, however, in that they are lending based on the ability of the asset to contribute to cash flow (either to the lessee or in case of forced sale/liquidation). Banks and other lenders tend to look at the balance sheet value of collateral.

The second is that leasing companies are more sales and service oriented—they are using their specialized knowledge to “bridge the gap” between suppliers and pur-

chasers, and the specialized knowledge of leasing companies may also give them an advantage in disposing of the repossessed leased assets. Suppliers are generally not specialists in finance or credit decisions, while lessees are not specialists in finance or equipment acquisition; leasing companies specialize in finance, credit and equipment acquisition and disposal (equipment dealing). In effect, both the supplier and the lessee are “outsourcing” certain portions of their business to a service provider that also happens to have a certain capacity to borrow and lend money.

Financial Leases and Hire Purchase

In some countries, a distinction is made between lease and hire-purchase transactions. A hire-purchase transaction is usually defined as one where the hirer (user) has, at the end of the fixed term of hire, an option to buy the asset at a token value. In other words, financial leases with a bargain buyout option at the end of the term can be called a hire-purchase transaction.

Hire-purchase is decisively a financial lease transaction, but in some cases it is necessary to provide the cancellation option in hire-purchase transactions by statute. That is, the hirer has to be provided with the option of returning the asset and walking away from the deal. If such an option is embedded, hire-purchase becomes significantly different from a financial lease as the risk of obsolescence gets shifted to the hire-vendor. Under these circumstances, if the asset were to become obsolete during the hire term, the hirer may off-hire the asset and close the contract, leaving the owner (the lessor) with less than a full payout from the lease.

Hire-purchase is of British origin—the device originated long before leases became popular—and spread to countries that were then British dominions. The device is still popular in Australia, Britain, India, New Zealand, Pakistan, and in several African countries. Most of these countries have enacted, in line with the United Kingdom, specific laws addressing hire-purchase transactions.

Why Develop Leasing?

Leasing provides a means for delivering increased domestic investment within economies. By developing additional financial tools such as leasing or mortgages, countries are able to deepen the activities of their financial sector by introducing new products and/or industry players.

The key benefit of leasing,³ however, is the access it provides to those that do not have a significant asset base already by enabling small enterprises to leverage off an initial cash deposit, with the inherent value of the asset being purchased acting as col-

³This manual does not address the pros and cons of leasing versus secured lending. Preferences may vary depending on a number of factors including legislative framework, cost, level of financial market development, availability of diverse financial instruments, etc.

lateral. These small businesses are a portion of the population that do not have other assets that can act as collateral for loans or other types of secured lending within countries where unsecured lending is not an option. By developing leasing, smaller scale entrepreneurs can become more economically active by enabling access to finance and, subsequently, access to income-producing assets. Also, leasing offers an important advantage in countries with weak business environments, particularly those with weak creditors' rights and collateral laws and registries, for instance, in countries where secured lenders do not have priority in the case of default.

Leasing is an instrument that allows participants to manage or allocate risk. One considerable advantage is that, where feasible, leasing often allows participants to allocate certain risks (for example, residual value risk) to those parties that are best able to bear that risk.

Leasing in Emerging Economies

Emerging economies face several challenges, including the need for investment. This is compounded by an under-capitalized banking system that is only able to offer its potential clients a limited range of products. In turn, small and medium-size companies possess insufficient collateral or credit history to access more traditional bank finance. This results in a shortage of credit available to domestic entrepreneurs.

Developing the leasing sector as a means of delivering finance increases the range of financial products in the marketplace and provides a route for accessing finance to businesses that would otherwise not have it, thus promoting domestic production, economic growth, and job creation.

In addition, many developed countries suffer from underdeveloped or imperfect legal institutions. Although in principle secured lending and leasing should be roughly equivalent in terms of risk, in many jurisdictions experience has shown that legal

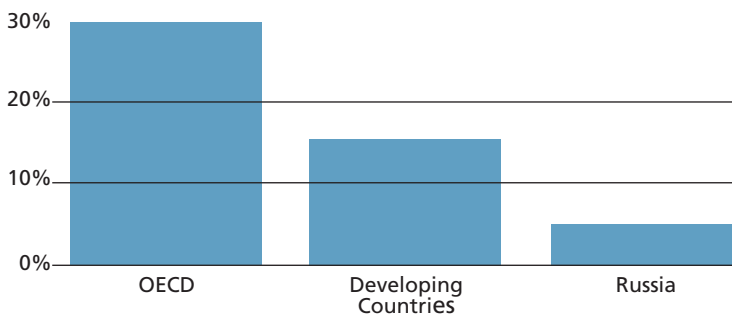


Figure 1-1. Leasing as Share of Investment in Fixed Assets

Source: IFC Russian Leasing Development Group, 2002.

ownership is recognized by all participants, especially courts, more readily and consistently than secured lending. This can reduce the risk to lenders (lessors) considerably. The value of this advantage of leasing should not be underestimated, particularly in more challenging environments.

Figure 1-1 shows the role leasing plays in emerging economies and in developed economies, and the room for growth in the use of leasing in emerging economies. The chart shows that leasing can provide a valuable additional source of finance within these markets.

The effect of leasing can be further accelerated and strengthened where the in-country conditions allow for investment by IFC and other international financial institutions, with these institutions recognizing the positive effects of leasing and introducing medium-term finance into markets where no alternative currently exists.

In many markets, discussion of leasing often focuses on “large-ticket” leasing, cross-border structures, or tax implications. While these are also important, any discussion of leasing should be kept as broad as possible and consider the effects for all businesses, including small and medium-size enterprises.

Stakeholder Arguments for Developing Leasing

A key consideration in developing leasing is identifying the goals of stakeholders, and their objectives for the development of leasing markets.

Broadly, stakeholders are those individuals or groups who either are actively involved in developing leasing locally or may be affected by the development of the leasing sector. Key stakeholder groups include government, banks, non-bank financial institutions, existing or potential lessors, existing or potential lessees, SMEs, equipment manufacturers, and the professional services sector, that is, lawyers and accountants, donors, and technical assistance providers.

In order to help target discussions with these stakeholders, this manual tries to identify objectives for each stakeholder group, and demonstrate how leasing can help achieve these objectives (see table 1-2).

Table 1-2. Stakeholders, Objectives, and How Leasing Can Help Achieve Stakeholder Objectives

Stakeholder	Possible Objectives	How Leasing Can Help Achieve Stakeholder Objectives
<p>Government</p>	<ul style="list-style-type: none"> ■ Domestic production ■ Industrial diversification ■ Capital investment ■ Government budget ■ SME development ■ Infrastructure improvements 	<ul style="list-style-type: none"> ■ Leasing aids the development of local processing and production. While manufacturing equipment may come from overseas, this equipment enables domestic processing of locally produced raw materials, thus replacing imported items. ■ Leasing lowers the overall costs of economic development. ■ Leasing provides a diversified source of capital (equity, debt, tax revenue) ■ Leasing further contributes to the development of domestic financial markets. ■ As leasing develops, there will be increased domestic liquidity through access to global markets. ■ For reasons listed below (see Lessees/SMEs), the development of leasing aids the growth of the domestic SME sector. ■ Leasing can help increase the levels of public transport and the depth of communications networks, and allow municipal authorities the means to acquire quality construction and maintenance equipment.
<p>Lessors (including banks)</p>	<ul style="list-style-type: none"> ■ Risk management/reduction ■ Leasing market development ■ Product portfolio diversification ■ Customer base expansion 	<ul style="list-style-type: none"> ■ The lessor maintains legal ownership of the asset. ■ The lessor is able to exert greater control over the investment. ■ The lessor can monitor assets more easily. ■ Lessors can actively apply specialized knowledge, such as equipment specialization. ■ Leasing provides not just an opportunity to extend product lines, but also to deepen the organizational structure. ■ In some cases, leasing may allow businesses to access both lease financing and additional bank financing without increasing their collateralized debt. ■ Leasing can provide additional marketing channels for financial services.

Stakeholder	Possible Objectives	How Leasing Can Help Achieve Stakeholder Objectives
Lessees/SMEs	<ul style="list-style-type: none"> ■ Access to finance 	<ul style="list-style-type: none"> ■ No/low collateral required. ■ The cost of lease finance is competitive with traditional credit, given the increased security held by lessors and the low transaction costs of processing a lease. ■ Leasing also offers matched maturity of assets/liabilities, since debt in emerging countries is often limited to short-term maturities. ■ Islamic compliance: in Muslim countries, leasing is seen as an interest-free product and considered the same as a rental. In Islamic finance, “ijara” is a kind of leasing, and especially relevant within the Middle East and North Africa.
	<ul style="list-style-type: none"> ■ Access to equipment and production assets 	<ul style="list-style-type: none"> ■ Leasing increases flexibility and diversification of financing sources. ■ Leasing enables investment in equipment that can modernize production and improve productivity and profitability. ■ Leasing reduces maintenance cost, since equipment is newer. ■ Due to reduced upfront costs, leasing frees up capital for other business needs.
	<ul style="list-style-type: none"> ■ Ability to plan ■ Timeliness and flexibility ■ Negotiability 	<ul style="list-style-type: none"> ■ Leasing enables companies to match income and expenditure. ■ Leasing also has advantages of a quick decision-making process, flexibility, and negotiability. This is in large part because the lessors operate in a less-regulated, more proprietary environment than bankers or traditional lenders. It may also owe something to the fact that, since leasing is a comparatively new development, lessors have to be fast and flexible to claim this as their unique selling proposition. ■ Leasing deals may make less use of the restrictive covenants that appear in more traditional forms of lending. ■ Where lessors have asset knowledge or relations with suppliers, lessees may “outsource” certain tasks (such as negotiating with suppliers), reducing costs and risks. ■ Independence from bank borrowing: through leasing, SMEs have alternative funding opportunities and are able to use a mix of funding options to finance their businesses.

Stakeholder	Possible Objectives	How Leasing Can Help Achieve Stakeholder Objectives
Equipment Manufacturers	<ul style="list-style-type: none"> ■ Expanded market base for products ■ Increased purchase options for clients 	<ul style="list-style-type: none"> ■ Leasing allows access to new equipment, by providing businesses with a mechanism to purchase equipment without incurring significant upfront costs. ■ Development of the leasing sector opens up significant after-market products and services for equipment manufacturers. ■ Leasing often provides an effective marketing channel for equipment, as leasing companies are also interested in increasing sales. ■ Effective leasing companies may bear some of the burden of dealing with inexperienced equipment purchasers, thus reducing costs and improving efficiency.
Legal/Accounting	<ul style="list-style-type: none"> ■ Lessors/banks may be clients of professional services companies ■ Tax planning and accounting opportunities ■ Systems development opportunities 	<ul style="list-style-type: none"> ■ In terms of compliance, professional advisors should be contracted by lessors to ensure that all agreements comply with local legislation and permit the lessor to utilize tax or other benefits. ■ Lessors, in order to reduce transaction costs and because of the nature of leasing, will aim to utilize credit management systems for the monitoring and control of their lease portfolios. Professional advisors have an excellent opportunity to assist in the development of business processes and systems.
Investors	<ul style="list-style-type: none"> ■ Increased ability to invest within a country ■ Development of financial sector ■ Growth in investee company opportunities 	<ul style="list-style-type: none"> ■ Improved credit scoring and processing systems can be applied across all elements of the finance sector, from leasing through to banking, thereby allowing the whole sector to take a more prudent and controlled approach to finance. ■ Leasing improves the local investment climate for all companies, increasing opportunities for investment and reducing/allocating risks more efficiently. ■ The development of non-bank lessors increases competition within the financial sector, introducing the need for finance companies to reduce transaction costs, improve business and credit management, and source funding at cheaper levels. This has the effect of reducing the cost of finance throughout the sector at the same time as increasing its level of sophistication and ability to optimize risk. ■ As lessors develop, they may expand to issuing commercial paper and to securitizing lease receivables, which can assist in deepening the securities market and creating new investment products.

IFC's Role in Leasing

IFC's Vision for Leasing Development

Leasing development TA projects within IFC fall under the wider umbrella of financial sector development TA. This hints at IFC's view that it is involved in the development of leasing, specifically the development of local financial industries, in an attempt to increase domestic access to finance and the flow of investment. Another motivation for IFC involvement is that in developed markets, leasing companies are generally financed with debt and/or commercial paper and securitizations. IFC can play an important role in emerging countries with underdeveloped debt markets through its financing mechanisms. An effective leasing industry also improves the prospects for investment in many other sectors, particularly in capital-intensive industries.

Based on the success of leasing development projects around the world, IFC and associated donors have identified leasing development TA projects as an effective, value-for-money means of developing local financial markets with positive, tangible, and far reaching results. Because of this success and the impact that reform and development of the leasing sector can bring to the wider economies of emerging markets, IFC is working to provide significant support and assistance to leasing development teams around the world.

IFC's Experience and Reach

Having invested in over 100 leasing companies in 50 different countries (including 35 in Europe, the Middle East and Central Asia), IFC has a long history in financing leasing programs throughout the world.

- IFC has helped establish the first leasing companies in 25 countries.
- IFC's total investment in leasing over the last 30 years has been over \$1 billion in 181 leasing investments in 56 countries (between 1977 and 2003).
- IFC has advised on leasing legislation in 35 countries.
- IFC currently manages more than \$5 million in leasing TA programs.

IFC and Leasing Technical Assistance

Many countries face structural obstacles in developing a leasing industry: the absence of clearly defined and predictable laws governing leasing transactions, unclear accounting standards, lack of an appropriate tax regime, impaired funding abilities, and the absence of an appropriate regulatory and supervisory framework. Regulations either do not exist or do not take into account the specific characteris-

tics of leasing, or their application and interpretation are uncertain because of a lack of precedent. Recognizing such weaknesses, governments have turned to IFC for help in laying out the groundwork for leasing development.

IFC usually helps countries develop a leasing industry through one or more leasing development TA projects that are supported by IFC regional technical assistance facilities. This ensures that previous experiences and best practices are taken into account in the implementation of IFC leasing development projects.