

Chapter 2

Legislation, Regulation and Supervision

This chapter deals with the three elements of legislation, regulation and supervision. These are critical elements, because to make effective changes within the leasing sector, it is likely that changes will be necessary in the existing legislative framework.

This manual is intended to be a guideline in approaching all three of these elements. While based on “best practices” worldwide and IFC’s experience, the approach must also be tailored to local requirements and be pragmatic.

Legislation

In order to assist in the creation of appropriate leasing legislation, IFC has developed the following guidelines, based on IFC’s TA experience over the past five years around the world:

With any legislative change, amendments should be closely thought through to ensure that the most efficient and yet comprehensive changes are put forward.

Whether the relevant local legislation is based on Civil Code or Common Law, the development of a specific and separate leasing law may not be necessary, although this will ultimately depend on local circumstances and existing legislation. This assumes that it is possible to make additions and amendments to existing legislation, and that those amendments are not compromised by other elements of the local legislation.

All legislative changes need to be coordinated to ensure that there are no opportunities for conflict or contradiction. Experience worldwide has shown that contradictory legislation, which can be subject to widely different interpretations, is often the worst possible outcome.

Why Is a Legislative Framework Necessary?

Leasing is essentially a financial instrument that works based on its legal framework. Furthermore, its success rests on how well leasing legislation relates to legislation on finance.

Often, domestic legal frameworks are not conducive to the development of leasing. This may be due to several reasons/issues:

- There may be no leasing-specific legislation or clear definition of leasing.
- Contradictions exist between various elements of a country's legislative framework that prevent leasing from working effectively.
- Current legislation prevents the successful enforcement of leasing contracts.
- It is unclear whether lessors hold title to leased assets.
- It is unclear whether third parties can hold a security position in leased assets or have some kind of other claim on these assets.
- It may be difficult for a lessor to take possession of a leased asset when a lessee defaults. It may be unclear whether lessors can legally repossess nonperforming lease assets without costly and time-consuming court procedures or restrictive bureaucratic requirements.
- Definitions and legal implications of finance leases need to be specified in the legislation. Rules on these issues should be clear and written with users in mind.

Where there is an absence of leasing-specific legislation or where leasing legislation is imperfect, the question becomes: Can lease operations be established and function properly, or must legislation be enacted first?

Sometimes, successful leasing is done in countries without leasing-specific legislation (as in India) or where leasing legislation is not perfect. Technical assistance projects cannot hope to make national leasing systems perfect. The goal is to engineer a leasing environment that addresses the needs of lessors and lessees, and encourages the continued development and sustainability of the sector.

The framework that is developed may not solve all national issues, but should serve as a basis for developing operations that may not have previously existed or enable the continued improvement of the domestic leasing sector.

- Clarify rights and responsibilities of the parties to a lease
- Remove contradictions within the existing legislation
- Create non-judicial repossession mechanisms
- Ensure only the necessary level of leasing industry supervision and licensing

Legal Systems

In general terms, two different legal systems exist globally: those based on Common Law and those based on Civil Law. While the type of legal system (civil or common) present in the country of operations is important to how specific legislative changes are made, the essence of a lease should not be different in the two basic systems.

Elements of a Lease

This is an explanation of the elements in a lease—that is, the parties, asset, rentals, residual value, etc. This section also tries to detail the unique features of a lease as different from a regular financing transaction. In many cases, the legal distinctions between an operating and a financial lease may be unclear. While this manual focuses on financial leasing, the flexibility to allow for operating leases or elements of operating lease transactions, particularly in the long term, should be kept in mind as important tools for many economies.

Many jurisdictions will specify certain “essential elements” to a lease, particularly financial leases, that are in reality not essential. A pragmatic approach to these factors is important, since in many cases such factors depend on other elements of the legal or tax system; in other instances, such formal requirements are not serious impediments to leasing.

An important element is to retain maximum freedom of contract. It is impossible to foresee all elements of a lease that may be appropriate, and experience has shown that leasing is most effective when the parties to a lease transaction can tailor deals to suit their own needs and capabilities.

The transaction. The transaction of a lease is generally an asset-renting transaction, that is, the separation of legal ownership from economic use. The distinguishing factor between a lease and a loan is that in the latter money is lent out, while in a lease it is the asset that is lent out.

Therefore, a lease can be defined generally as a contract where a party being the owner (lessor) of an asset (leased asset) provides the asset for use by the lessee for consideration (rentals) that are either fixed or dependent on certain variables, for a certain period (fixed or flexible lease period). At the end of the lease period, subject to the embedded options of the lease, the asset may be either returned to the lessor or disposed of per the lessor’s instructions.

Parties to a lease. Both lessor and lessee (and the supplier in the three-party structures) can be legal entities as well as individuals (sole proprietors). There should not be restrictions allowing only leasing companies or other financial institutions to operate as lessors.

Two- or three-party leasing. Depending on local legislation, there will be at least two parties to a lease—the owner and the user (called the lessor and the lessee). In many jurisdictions, a third party may be required, that is, the supplier of the equipment.

The existence of the third party (the supplier), who is usually chosen by the lessee and from whom the lessor buys the leased asset upon instructions of the lessee, can be explained by the intention of lawmakers in some jurisdictions wishing to separate leasing from other forms of property hire.⁴

The argument is that in a three-party arrangement the lessor is a financial intermediary, and the lessee effectively “hires” the lessor’s money rather than the property. The lessor is seen as an investor who makes an investment by purchasing the leased asset and transferring it to the possession and use of the lessee.

If a lessor holds an asset in possession without buying the asset specifically following a lessee enquiry, the asset transfer may be considered a regular hire agreement. The third party is the distinguishing feature between the hire or rental of the asset within these jurisdictions.

While discussing three-party leasing, the International Institute for the Unification of Private Law (UNIDROIT) convention insists that finance leasing is a three-party arrangement.⁵ This convention regulates only cross-border leases, but supersedes national legislation in all countries that have signed up to the convention for cross-border leases.

Where countries accept legislation with a three-party structure—legislation then has to address the notion of “secondary leasing”—it remains the right of the lessor to lease the asset (which remains in the ownership of the lessor) after the first lease agreement has terminated or the leased asset is repossessed. If secondary leasing is not possible, the lessor will not be able to “lease the leased asset,” as in this transaction there would be no supplier from whom the lessor may purchase it initially.

⁴This is the case in most of the countries of the former Soviet Union, certain Eastern European countries, and now certain African countries.

⁵UNIDROIT is an independent intergovernmental organization based in Rome. Its purpose is to study needs and methods for modernizing, harmonizing and coordinating private and in particular commercial law as between States and groups of States. Set up in 1926 as an auxiliary organ of the League of Nations, the Institute was reestablished in 1940 on the basis of a multilateral agreement, the UNIDROIT Statute.

The leased asset. The leased asset must be non-consumable. Legislation can impose some restrictions to this general rule, for example to prohibit some articles being leased which are in limited free circulation or withdrawn from circulation (for example in some countries, land plots or natural sites cannot be leased). Therefore, anything that one cannot own or hold title to cannot be leased, because to act as a lessor one needs to buy the asset first.

Lease period. The term of lease (lease period) is the period for which the agreement of lease shall be in operation. In some jurisdictions, an essential element in a lease is the ability or potential by the lessee to return the asset at the end of the lease period (although lease terms may mean that this “right” is not likely to be exercised). It may also be necessary, depending on local jurisdictions, to include within the contract a certain period at the start of the lease where the lessee may be given a right of cancellation. Beyond this period, the lessee may be given a right of renewal. It is important to note that a lease cannot be viewed as a lease if it is possible to interpret it as a sale of an asset to the lessee.

In financial leases, it is common to differentiate between the primary lease period and the secondary lease period. The former is the period over which the lessor intends to recover its investment, while the latter is intended to allow the lessee to exhaust a substantial part of the remaining asset value. Alternatively, many jurisdictions stipulate that the disposal of the leased asset (either by sale, transfer to the lessee, or return to the lessor) must be specified in the lease contract.

The primary period is normally non-cancelable, and the secondary period is normally cancelable. Many jurisdictions restrict the minimum lease period; therefore, this must be checked in each specific jurisdiction. The minimum lease period is often related to the normal amortization period for a given asset, but in some cases it is stated as a specific time period.

Lease rentals (or lease payments). Lease rentals represent the consideration (usually monetary) for the lease transaction, that is, this is what the lessee pays to the lessor.

If the lease is a financial lease transaction, the rentals will usually be the recovery of the lessor’s principal and a certain rate of return on the outstanding principal. In other words, the rentals can be seen as bundled principal repayments and interest. In many cases, financial lease payments may include other costs such as insurance, regular maintenance, and certain taxes (such as property tax). These payments may be on a “pass-through” basis or otherwise structured.

If the lease is an operating lease transaction, the rentals might include several elements depending upon the costs and risks borne by the lessor, such as:

- Interest on the lessor's investment
- Charges for certain costs borne by the lessor such as repairs, insurance, maintenance or operation costs
- Depreciation of the asset
- Servicing or packaging charges for providing a package of the above service

Residual value. Put simply, “residual value” is the value of the leased equipment at the end of the lease term.

Residual value is generally defined as market value (at the end of the lease). But in some contexts it may mean amortized (or balance sheet) value, value for tax purposes, or carry other definitions. These values may differ significantly, and these differences may have important implications. Residual value risk is another important term used in leasing and refers to the risk that the actual (realizable) value of the leased asset at the end of the leased term will differ substantially from the estimated residual value at the inception of the lease.

Residual values become important when discussing operating leases, where the cost of the operating lease depends to a large extent on the value of the asset at the end of the lease period—the higher the residual value, the less the amount to finance and hence the cheaper to lease the asset. Residual value financial leasing has also become an important aspect of leasing in the United States, but most emerging economies and many European countries still fully amortize such leases.

Residual values are important to consider during the underwriting process. If a lessee is leasing an asset with a fast depreciation rate with the asset only achieving a low residual value after the lease period, or if in the event of a default the lessor is forced to repossess the asset during the lease, the lessor faces the risk of not being able to recover sufficient capital value from the sale or disposal of the asset. Even though this may be recoverable from the lessee (or in some cases from the supplier), it may involve lengthy legal procedures to recover the shortfall.

End-of-term options. The options allowed to the lessee at the end of the primary lease period are called end-of-term options. Essentially, one or more of the following options will be given to the lessee at the end of the lease term:

- Option to buy (buyout option) at a bargain price or nominal value (typical in a hire-purchase transaction), called bargain buyout option

- Option to buy at a fair market value or substantial fixed value
- Option to renew the lease at nominal rentals, called bargain renewal option
- Option to renew the lease at fair market rentals or substantial rentals
- Option to return the equipment

Alternatively, the lease could be completely paid out and amortized to zero, at which point the equipment is automatically transferred to the lessee. This is typically the case in developing countries or new leasing markets.

In any lease the suitable option depends on the nature of the lease transaction, as well as the applicable regulations. For example, in a full payout financial lease the whole, or substantially the whole, of the lessor's investment would be recovered during the primary lease period. Therefore, it is quite natural that the lessee should be allowed to exhaust the whole of the remaining value of the equipment. Regulation permitting, the lessor provides the lessee with a bargain purchase option to allow the lessee to complete the purchase of the equipment.

A buyout option may characterize the lease as hire-purchase. However, in many jurisdictions it is the existence of such a buyout option that distinguishes leases from hire-purchase transactions. If the lessor is interested in structuring the lease as a lease and not a hire-purchase, the lessor would be advised not to provide any buyout option but to allow the lessee to renew the lease and continue using the asset. In essence, a renewal option achieves the same purpose as a purchase, but the lessor retains his ownership as well as his reversionary interest in the equipment.

Fair market value options, either for purchase of equipment or for its renewal, are typical of operating leases. But this mechanism does no more than assure the lessee continued use of the equipment. If equipment has to be bought at its prevailing market value, it can be bought from the market rather than from the lessor. Therefore, the higher the fair market value, the less the value of the option for the lessee.

Upfront payments. Lessors may require one or more of the following upfront, instant payments from a lessee:

- Initial lease rental, initial hire, or down payment
- Advance lease rental payment
- Security deposit
- Initial fees

Typically, deposits taken upfront by lessors act as a means of verifying the lessee's ability to service the lease. Taking deposits or advance payments also reduces the difference between the market value of the (delivered) equipment and the purchase

price, which may include delivery, modification, or installation fees. This is especially relevant in countries where there is no credit bureau or credit ratings, and checking credit histories is difficult. It is also important where equipment is highly specialized and the pool of potential buyers is limited.

These deposits are usually calculated on the basis of a number of monthly payments, and may be the equivalent of several months of advanced rental fees or a percentage of the total equipment cost. The amount depends on the equipment and the financial situation of the lessee. The advance payment also reduces the amount of the purchase price that the lessor must finance. Upfront payments represent an equity stake in the asset by the lessee and avoid, as is desirable, 100% financing.

Accounting Standards and Recommendations for Amended Legislation

It should always be kept in mind that different accounting standards exist, are designed for, and are used for different purposes. Tax accounting is used as the basis for calculating taxes payable, and often differs significantly from accounting systems used for other purposes.

International Accounting Standards or IAS (and local versions of Generally Accepted Accounting Principles or GAAP) are targeted at use by “arm’s length” stakeholders, such as shareholders and creditors; IAS are designed to reflect economic substance, usually with a conservative approach.

Management accounting systems are generally used by management for internal control and performance (and are often somewhat similar to IAS/GAAP). Owners and controlling shareholders may have their own modifications and approach to reflect their own goals and concerns.

The recommendations and discussion that follow are targeted at accounting standards for third-party stakeholders, but some degree of overlap and disagreement between the systems is highly likely, since they are designed for different purposes for use by different parties.

- Use IAS-17 as a basis for the definition of local leasing legislation, including accounting for leases.
 - IAS-17 provides a useful framework and guidelines for the development of domestic leasing legislation.
 - While the application of IAS may not be common to all countries, the adoption of IAS is a target for most countries. With this in mind, using IAS-17 as the basis for local leasing legislation, it is possible to build in a quality standard for that legislation.

- Classify leasing as an investment activity and a financial service.
 - Leasing should be classified as both an investment activity and a financial service. It is important for leasing to operate on the same level playing field as other forms of credit.
 - Classifying leasing as an investment activity may result in lessors' receiving additional benefits connected with domestic investment initiatives. These could include accelerated depreciation, among others.
 - If leasing is classified as a financial service, it may be possible that the interest portion of the lease payments will not attract value-added tax (in addition to the VAT that is levied on the equipment cost).
- Determine if there is a need for a prudent and appropriate minimum lease term, that is, at least 1 year and in some countries up to 3 years minimum.
 - The requirement for licensing of non-bank financial institutions to finance leases needs to be evaluated based on country-specific factors, balancing the need for prudential sector regulations to promote sector development and prevent bureaucratic hurdles. Many emerging economies with sound financial sectors have chosen not to require licensing for leasing.
 - Similarly, supervision of leasing (as an activity) by central bank structures should be determined based on country-specific factors. If the lease is financed by an institution that is already under central bank supervision, supervision by central bank structures would be prudent.
 - While establishing minimum capital requirements for leasing institutions could help weed out inadequately capitalized leasing companies, this restriction may also inhibit the development of the leasing industry, particularly in nascent markets where it may be slow to develop. Hence, setting up obligatory capital requirements for leasing needs to be carefully evaluated in the context of the existing legal and regulatory framework and other factors.

In some cases, market forces may provide an indirect regulation of leasing companies, such as the discipline imposed by the market when the leasing company raises funds from banks or other investors.

Legal Issues

Below is a discussion of legal issues pertaining to leasing in emerging markets.

Registration of leased assets. In emerging markets, the ability to register ownership (a lien) of an asset may not be straightforward. This ability, however, could be important for leasing (or other forms of secured lending) to develop.

With a registry, anyone purchasing an asset can check that the asset is not owned by another party. If someone buys an asset without consulting the registry, they are presumed not to have purchased the asset in good faith, and thus their title to the asset is at risk. They are, therefore, obligated to check the registry prior to purchase. Registries also enable leasing companies to protect their assets in instances where lessees are subject to judicial action aimed at recovering assets.

It may be that the leasing development project has to become involved in improving or even creating such a registry. Experience has shown, however, that although asset registration may be available, it should not necessarily be obligatory for owners to register their assets.

Many countries have followed the approach of a central registry for lodging liens (not solely for registering leased assets within country) with an efficient process available for checking if assets have a lien against them. Furthermore, it is not important whether a private owner or state owns the registry, but it is important that the registry has sufficient legal status to provide such assurance. This should be accompanied by legislation that provides a mechanism for the properly documented lien holder to recover the asset from an unsecured party. As with any monopoly, if only a single registry exists, the costs of registration and lien verification should be regulated; the ultimate goal is to ensure that the cost of registration and lien verification is as low as possible (while still covering costs, of course) so as to encourage use of the registry.

Obligatory registration of lease agreements may not be necessary, as this could lead to administrative barriers, higher costs, and indirect regulation of the industry. If institutions prefer to register agreements, this option should be available.

Repossession of equipment under lease. Repossession is a key element of leasing, enabling credit providers to efficiently secure their asset and realize funds from the asset disposal. Without such ability, leasing is little different from other forms of unsecured finance.

To encourage the development of an efficient and fair repossession system, many countries have adopted the following: within the legislation, in the event of a default by the lessee, there should be scope to allow the lessee to voluntarily return the leased asset to the lessor without penalty.

Where the lessor tries to repossess the asset and the lessee disputes its grounds for repossession, the lessee should have access to the courts to challenge the repossession order. To encourage efficiency in repossession, a non-judicial process should be available either through a court order (an order issued by a judge outside of court proceedings and processed within a short time period, for example, 10 days) or a

notary writ (a writ issued by a notary which serves as a legal basis for repossession). Non-judicial mechanisms for repossession can be used in those cases where the lessee admits the default but does not voluntarily return the asset.

Where a lessor has already repossessed an asset but the lessee can demonstrate having fulfilled its obligations under the lease, the lessee will be entitled to go to court to claim damages.

“Self-help repossession” is a unilateral act by the lessor not supported by any legal process or permits. Basically the lessor, without asking or informing anybody, comes to the lessee’s premises and takes back the asset. It is important to note that this can only be done in certain common law jurisdictions, and that this repossession should be conducted in a way that does not “breach the peace” (another common law concept). In such jurisdictions, the lessor is liable for any damages. While lessors in many jurisdictions often lobby for this right, this practice could potentially be dangerous and highly problematic.

Efficiency is key for the whole process. If repossession takes too long, lessors will either resort to alternative, less equitable means of recovering assets, or not enter the marketplace to begin with. However, the process must also be balanced to prevent abuse by lessees, for example, ensuring that lessees fulfill 100% of the obligations of their lease.

Rights and responsibilities of the parties to a lease. The “freedom of contract” concept is a cornerstone of this issue. The parties should be given the maximum opportunity to provide in the contracts the full extent of their rights and responsibilities:

- ***Lessor rights and responsibilities.*** The lessor as owner of the leased asset retains the right to receive scheduled lease payments arising from the lease agreement. The lessor should, within the framework of local legislation and practice, also have the right to assign these rights to others. The lessor’s key responsibility is the obligation to deliver, at the outset, equipment that is “fit for purpose.”
- ***Lessee rights and responsibilities.*** The lessee retains the right under the lease to use the fixed asset. This is in exchange for the obligation to make scheduled lease payments, insure the asset, pay any applicable taxes, use the equipment responsibly and in accordance with local laws and regulations, and maintain it in good working order (subject to the lease agreement). It is important to highlight that the lessee, as the “operator” of the equipment, retains all responsibility and liability with respect to the operation of the equipment.

- In some situations, however, the law has to provide the framework/borders that parties should not be allowed to violate. This relates particularly to those jurisdictions which have accepted three-party leasing arrangements, and whose contractual relationships are consequently complex in character. The law should imperatively state in that situation that:
 - The lessor is not accountable to the lessee for the non-fulfillment of the sale-purchase contract except for those cases in which the selection of the supplier and the leased asset was conducted by the lessor, as well as cases when non-fulfillment of the sale-purchase contract was the result of wrongful acts (omissions) on the part of the lessor.
 - The lessee has the right to address all claims which stem from the sale-purchase contract directly to the supplier even though the lessee is not the party to that contract. As a result, the legislation imposes an obligation on the lessor to notify the supplier about the purpose of purchasing an asset.

Bankruptcy of the lessee or lessor. Where the lessee is deemed to be bankrupt and defaults on the lease, the lessor has the right to repossess the asset. The general norms of bankruptcy law apply, with the insolvent pool of assets consisting only of those that are owned by the insolvent company. What does not belong to the insolvent company should be returned to the owner (that is, the lessor). Note that in cases where the bankrupt lessee's liabilities are assumed by another party (there is no default on the lease agreement) the "successor" may retain the lessee's rights under the lease agreement. This may happen where temporary administration or wholesale purchase of a bankrupt lessee occurs, particularly where the leased asset is essential to the viability of the (former) lessee as a going concern.

Where the lessor is deemed bankrupt, this should have no effect on the lessee. The lessee, if perfectly solvent, retains the right to the use of the asset. It is important to clarify in law or regulation the procedure for asserting the right to receive lease payments in case of dispute, that is, the party to whom the lessee must make payments to avoid facing accusations of default when payments are made in good faith.

The party that acquires the lessor's assets as a result of the latter's default is able to enforce the rights of the original lessor only under the lease, that is, the receipt of lease payments. The new owners are not able to take possession of the asset for all cases in which the lessee is still meeting its obligations under the lease. The obligations and rights are simply assigned from the original lessor (in default) to a new party. This has to be supported by legislation which provides that the transfer of ownership does not lead to termination of the agreement and cannot be considered grounds for such termination.

Regulation, Supervision and Applications to Lessors

Regulation is a good idea where lessors are deposit-takers (that is, where leasing companies are effectively “banks”). Regulation would also be prudent in situations where lessors are able to take receipt of deposits. There are several key tests for public regulation by which these recommendations are guided:

- Regulations should be implemented only where there is a clear public interest. Deposit-taking institutions (generally, banking institutions) provide the best example of a clear public interest.
- Regulate the activity at an appropriate level. For example, there is often regulation of the trading of public securities (and the forms by which these securities are offered). In the case of leasing companies issuing tradable securities, it is not the leasing activity that generates the need for regulation, but the act of issuing securities.

Regulation

Non-bank, non-deposit-taking leasing institutions may not need the same level of stringent regulations as deposit-taking commercial banks, and in some cases, no specific regulation may be necessary. The necessity and level of regulations depend on a variety of factors, including the overall legal and regulatory framework, and should be assessed on a case-by-case basis. Note that the absence of regulation may affect the availability of financing or pricing of financing to a leasing company versus a bank.

Supervision

Supervision of leasing institutions would be necessary only when specific regulations have been established for leasing institutions. In such a case, existing supervisory institutions, such as banking supervisor agencies, may be able to perform such supervision. Specific leasing supervisory bodies may be necessary only in special circumstances.

IFC Approach to Regulation and Supervision

There are several tenets to IFC’s approach toward supervision of leasing (and many other activities). Good supervision and regulation are essential to a functioning marketplace, and governments are the prime defender of the public good. In addition, the government can often provide certain services for the benefit of the market. IFC experience as outlined in the Doing Business series (see *Doing Business in 2005: Removing Obstacles to Growth*, for example) also demonstrates clearly that poorly executed and designed regulations are often a major impediment to business.

Where leasing is at an early stage of its development, with a limited level of understanding as to its impact, there may be a need to regulate and supervise leasing activities. This need should be balanced by an understanding that the regulation or supervision of lessors, where previously imposed in other countries, has been in some cases counter-productive. Regulation can give external institutions the opportunity to interfere in, and could adversely affect the activities of others directly involved in, the sector. Regulation may also provide institutions with weak corporate governance the opportunity to profit from the development of the leasing sector. In some cases, regulation can give rise to corruption.

The market itself could act as the regulator for lessors in some cases, that is, the lessor's funding sources and its clients, who are well able to judge how well the company is run, rather than an external body with less understanding of the demands under which lessors operate. Companies with poor corporate governance and weak internal controls will have limited ability to raise investment in the market, and so their development and ability to do business will be restricted.

Further, supervisory groups charged with overseeing the development of leasing may find it difficult to acquire the skills and the ability to properly assist lessors in developing their internal controls. In addition, if regulation and supervision are not executed in the proper manner, this could adversely affect the competitive nature of a domestic leasing industry and in some cases introduce artificial barriers to the development of the leasing sector, including entry.

Common Types of Regulation for Non-Bank Lessors

There are two main types of regulation for non-bank lessors: minimum capital requirements (MCR) and licensing of leasing activity. Each type calls for different considerations.

Minimum capital requirements. The imposition of MCR for financial organizations means that companies need to retain a proportion of their assets as liquid to satisfy any immediate demands placed upon their business, thus limiting their lending to a proportion of their net asset value. The imposition of MCR for non-bank lessors acts as a form of regulation and requires supervision of the companies affected. This policy does not cover deposit-taking lessors.

Factors to consider in imposing minimum capital requirements for lessors. Clear distinction has to be made between the activity of the lessors and banks, insurance companies, etc., and the necessity of imposing MCR with this regard.

Establishing MCR is a necessary prerequisite for the deposit-taking institutions to meet their liabilities in case of default within the framework of the Basel accords on issues such as capital adequacy ratios. For such institutions, it is important that liabilities are met to avoid any negative implications for depositors.

Other factors Lessors conduct ordinary entrepreneurial activity and are not deposit-taking institutions. Their default is harmful only to their stakeholders. In this respect, lessors are in the same position as any other company, with banks financing lessors the same as any other borrower regardless of MCR.

The establishment of MCR, depending on the amount of MCR, could affect the development of the leasing services, as many companies might be excluded from the market. For instance, problems may arise when a lessor is interested in financing micro-leases, but does not have the necessary amount of capital required by legislation.

In practice, it may be difficult to determine the “right” threshold for the MCR. There are companies that specialize in micro-leasing as well as those that finance mainly “big ticket” transactions. In most jurisdictions, sub-lease provisions within the legislation envisaged for a lessor apply equally to the sub-lessor. This creates potential difficulties for a lessee/sub-lessor to transfer an asset subject to a sub-lease, as the MCR would also apply to sub-lessors, which in most cases are SMEs without sufficient capital.

Licensing of Leasing Activity. Leasing has not typically required licensing in many countries for the following reasons:

- Usually, licensing is necessary only for those activities that can cause considerable public loss, are detrimental to public safety, or cannot be regulated by any other method. Leasing companies are not deposit-taking institutions, and their bankruptcy would not influence the economy in the same way bankruptcy of a bank would.
- In case of the lessor’s default, there is no risk for the lessees. The lessees can continue the existing lease agreement with the new owner of an asset, and legislation can provide for the protection of their rights in these cases. Only the lessor’s shareholders suffer the loss, but their loss is no different from any other company. This is an entrepreneurial risk that is mitigated through the mechanisms of corporate and shareholder control (that is, the problem is one of corporate governance and applies to any other company). As for the lessor’s creditors, employees and other stakeholders, their position is also no different from that of any other enterprise.

- Experience has shown that licensing of leasing as an administrative barrier could be an impediment for the development of this market, as it could limit not only the possibilities for local enterprises but also investments by non-resident lessors who find it easier to lease in those countries that do not license leasing.
- If there is pressure to introduce licensing of leasing because of potential abuse of the possible tax privileges (the stated reason for licensing), it should be sufficient to set clear parameters and classifications on a lease transaction for the tax authority and other regulating bodies to have sufficient definition to classify and reject non-conforming leases that exist only to capture tax advantages. Licensing of leasing typically does not create a shield against potential tax abuses.
- Issuance of a leasing license for a specific period can potentially create problems for lessors. If the law provides that the license is issued for five years, then what would the framework of operations be for a lessor whose license is due to expire prior to the expiration of the lease agreement? The legality of these agreements can thus be put in question.
- It is not clear whether a sub-lessor is entitled to transfer the leased asset in a sub-lease without a license. Taking into account that in most jurisdictions the legal status of the sub-lessor equates with that of the lessor (all provisions of the law envisaged for the lessor also extend to the sub-lessor), the former may be obliged to obtain a license prior to the transfer of a leased asset to a sub-lease.
- In those jurisdictions that impose the restriction that a lessor operate exclusively in the leasing business (or set exact proportions on the income from leasing activities that a leasing company may earn), leasing companies face the challenge of flexibly adapting to the changing market situation or otherwise fall into a non-competitive position.
- A leasing license usually does not contain many requirements that a license for securities or banking operations contains and therefore, in most cases, it is nothing but some type of “registration procedure.”
- Many developed countries only require non-deposit-taking lending institutions to file annual audited statements as good disclosure/transparency requirements.
- It should be noted that the argument is often made that “bad” leasing companies may harm the entire industry. While this may be true, it is no different for example from “bad” (incompetent) shoemakers producing bad shoes and harming the reputation of the industry. Good (effective) companies will survive and prosper, while ineffective companies that don’t adapt will inevitably be put out of business by market forces.

Subsidization of Leasing Companies/Government Funding

Experience has shown that direct subsidization of leasing companies has been harmful to the development of the leasing industry. In many countries, it is perceived that providing lease finance to certain sectors (for example, agriculture, aircraft) will provide a means to overcome the difficulties these sectors face. This is rarely effective, and may actually even negatively affect both the (market-based) leasing sector and the subsidized sector—bad money chases away good and distorts the market.

Fundamentally, this analysis is the same as for subsidized financing provided directly to any industry. Disguising the approach as “by means of leasing” does not reduce or change the inherent costs, risks, or problems. Instead, it often distorts and hides the problem. As with any subsidy, if these are determined to be needed, the negative impact should be minimized as much as possible.