

IFC ADVISORY SERVICES | ACCESS TO FINANCE

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# Leasing in Development

Guidelines for Emerging Economies



*2nd Edition*

In Partnership with:



**IFC** International  
Finance Corporation  
World Bank Group

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# Foreword

I am pleased to introduce the second edition of the *“Leasing in Development—Guidelines for Emerging Economies”*, a publication that is now considered the reference for leasing sector development in emerging markets, since it has been first published in 2005.

For 35 years, IFC has been actively promoting the role of a vibrant leasing sector in developing countries, through a combination of policy and regulatory advice, awareness-raising, and investments in equity, debt and structured finance facilities in leasing companies and banks. This is because lease financing has proven to be an important tool to provide access to investment finance for Small and Medium Enterprises (SMEs), especially in emerging economies where SMEs provide strong growth and employment opportunities, but lack access to financing due to a limited development of capital markets and banking sector.

This second edition builds on the initial Guidelines, and takes into account IFC most recent lessons learned with leasing, as well as recent market trends in developed and developing countries. Since 2005, a lot have happened indeed in the global leasing landscape. Many countries have implemented robust laws and regulations for leasing; bank and non-bank financial institutions all over the emerging world have realized the opportunity to better serve their SME clients; new developments in sustainable energy finance, Islamic finance, agriculture finance call for a still increased role for lease financing; new accounting rules for leasing have been established and offer new opportunities and threats that need to be well understood; finally, an unprecedented financial crisis is unravelling as we write these pages, and raises new questions on prudential regulation, deposit mobilization, and funding models.

At IFC we are proud of our leadership in leasing development in emerging markets. Much remains to be done, though, and in most regions of the World there is still a considerable potential to better use leasing as a way to increase access to finance for SMEs. These Guidelines are primarily intended for government bodies such as financial regulators, tax authorities, law makers and law enforcement agents. They will also be a useful tool for leasing practitioners in their constant interactions with policy-makers to promote leasing and convey a positive message for the development of local leasing markets.

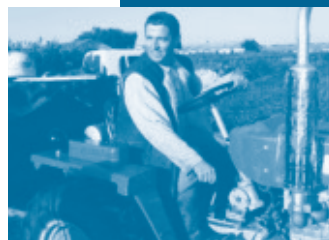
I would like to congratulate those who have worked tirelessly to help develop leasing around the World, showing tremendous focus and belief, and wish those who are embarking on leasing development projects every success in the future.



Peer Benno Walter Stein  
Global Business Line Leader  
International Finance Corporation



# Introduction



## The International Finance Corporation

The IFC is a member of the World Bank Group, and as such it shares the World Bank mission: “To fight poverty with passion and professionalism for lasting results. To help people help themselves and their environment by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors”.

IFC Vision is that people should have the opportunity to escape poverty and improve their lives.

IFC Purpose is to create opportunity for people to escape poverty and improve their lives by:

- Promoting open and competitive markets in developing countries
- Supporting companies and other private sector partners where there is a gap
- Helping to generate productive jobs and deliver essential services to the underserved.

In order to achieve its purpose, IFC offers development impact solutions through firm-level interventions (direct investments and advisory services), standard setting, and business enabling environment work. Our commitment to the private sector brings with it a powerful combination of financial products and advisory services that helps create value for our clients and shareholder governments and foster sustainable, results-oriented development.

IFC is the largest global development institution focused on the private sector. We combine financing that helps companies grow quickly and sustainably with advice that helps them innovate, raise standards, mitigate risk, and share knowledge across industries and regions. We also

mobilize additional resources from our many partners, enlarging the pool of available capital and expertise in countries that need it the most.

As of June 2009, IFC had 3,402 staff of which 46% work in its Washington, D.C. based headquarters, and the remainder located in more than 86 regional and/or country offices worldwide. IFC's committed portfolio, including off-balance sheet guarantees and risk management products was \$34.5 billion. In addition, it managed \$8 billion in syndications. The portfolio included investments in 1,579 companies in 122 countries.

IFC interventions target all industry sectors including infrastructure, manufacturing, oil gas and mining, the financial sector, transportation, information and communication technology, etc. The financial sector is however the largest sector in IFC, representing 35% of its total investment portfolio in June 2009.

## IFC's Role and Impact in Lease Market Development

For the past 35 years, IFC has helped countries around the world develop and enhance a viable and vibrant leasing industry. IFC's knowledge and expertise in leasing are well recognized by both private and public stakeholders, and it has contributed much to the development of the leasing industry in emerging markets through investments and advisory services. Its record of accomplishments includes the following:

- financed 222 leasing projects for 130 clients in 58 countries for \$1.4 billion;
- participated in the setup of the first leasing company in 30 countries;
- established or improved leasing regulations in 60 developing countries; and

- operated 30 leasing advisory services projects across the globe with more than \$21 million of its own and donor funding.

IFC's own financing and the donor funding it has mobilized—notably from the Swiss State Secretariat for Economic Affairs (SECO), the U.S. Agency for International Development (USAID), Japan, Dutch EVD, and the African Development Bank (ADB)—have been critical to the expansion of leasing industries in developing countries. They will continue to be used to good effect in the emerging economies of East Asia and the Pacific; Central and Eastern Europe; Latin America and the Caribbean; Middle East and North Africa; South Asia; Southern Europe; and Central Asia.

## Measuring Results

It is critical to IFC to measure development impact in order to assess if its mission of promoting sustainable private sector development is helping to reduce poverty and improve people's lives. IFC does this by monitoring and evaluating its **investment services** and **advisory services**.

Supporting SMEs is a key factor to alleviating poverty. A major barrier to their growth is a lack of access to finance. An effective approach to financing SMEs is by supporting leasing companies and other financial institutions that serve these enterprises.

For the last four years, IFC has collected and analyzed data from its SME focused financial

### Box 1-1. IFC Leasing Advisory Programs

South Korea's pathbreaking 1973 Leasing Industry Promotion Act drafted with IFC assistance marked the beginning of IFCs global advisory services activities. IFCs advisory services aimed to facilitate an enabling legal, regulatory, and fiscal environment for leasing to develop. In developing economies, the existence of a vibrant leasing industry is critical to small and medium enterprises (SMEs) that typically have difficulties accessing bank term loans due to lack of collateral.

In 1997, IFC established the first multi-donor funded program to develop Leasing in Russia. The program focused on establishing the basic building blocks from leasing laws and regulations to raising market awareness, investment promotion, and capacity-building. The Central Asia Leasing project (Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan) was established in 2001 based on the same model and subsequently projects in Southern Eastern Europe (Albania, Bosnia and Herzegovina, Macedonia, Serbia and Montenegro) in 2002.

Currently, a stronger focus has been put in frontier countries in MENA and Sub-Saharan Africa, with the ongoing implementation of successful activities in Afghanistan, Yemen, and East-Africa, and the establishment of new programs in West-Africa. IFC and its development partners have continued playing an active role in the development of the leasing industry.

IFC's leasing work, supported by SECO (Switzerland), led to the enactment in April of the new Financial Leasing Act in Tanzania in 2008. In Ukraine, the IFC leasing program, supported by the Netherlands achieved strong results over its three-year life-span.

To follow-up on the successful market development efforts undertaken so far in these countries, IFC advisory teams are increasingly shifting towards institution building activities to complement investments and help set up and expand strong leasing players.

IFCs advisory services are independent of whether the corporation decides to make a leasing investment. However, independent evaluations have indicated stronger impact in countries where IFC leveraged on its advisory services to provide investments.

institution investment clients to better understand the composition of their portfolios. In FY '08, IFC surveyed 197 of its MSME-focused FI clients in 73 countries, of which 25 were leasing investment clients.

IFC leasing investment clients spanning 18 countries extended **193,000 leases for a total disbursed amount of US\$5.2 billion to their MSME** clients globally in 2007.

- The average outstanding lease size was US\$3,180 for micro leases, \$20,498 for small leases, and \$207,146 for medium leases.
- The average rate of non-performing loans (NPLs) was 3% for micro, 2% for small, and 2% for medium leases.
- IFCs leasing clients MSME portfolio grew by 19% in number and 47% in volume.<sup>1</sup>

## IFC and Leasing Advisory Services

Many countries face structural obstacles in developing a leasing industry—the absence of clearly defined and predictable laws and regulations governing leasing transactions, unclear accounting standards, the lack of an appropriate tax regime, impaired funding abilities, and/or the absence of an appropriate regulatory and supervisory framework. IFC has found that leasing typically does not need to be granted any tax or regulatory advantage to develop. However, without specific texts and regulations, leasing is at disadvantage vis-à-vis bank loans that are better understood by the judicial system, and are often exempt from VAT on interest payments. Therefore, IFC has focused on helping governments establish a level-playing field for leasing, allowing increasing and fair competition between loans and leases, to the benefit of SME clients and the overall economic development. In many cases, regulations either did not exist, did not take into account the specific characteristics of leasing, or their application and interpretation were uncertain because of a lack of precedent. Recognizing such weaknesses,

more and more 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 advisory services projects, which are supported by its regional advisory services facilities. This approach ensures that previous experiences and best practices are taken into account in the implementation of IFC leasing development projects that are now increasingly focused on institutional building activities to help set up and expand strong leasing businesses and thereby facilitate the development of a strong and sustainable leasing industry.

IFC continues to be fully committed to leasing in emerging markets, and:

- invests in equity, debt, and structured finance products in leasing companies worldwide;
- helps commercial and retail banks set up leasing operations;
- provides broad support to the leasing industry in developing countries, addressing constraints through policy and regulatory work, advocacy and awareness-raising; and
- provides direct advisory services to leasing clients in the areas of governance, strategy, risk management, and operations.

## The Way Forward for Leasing in Developing Countries

The global leasing landscape in emerging markets is still very diverse today, with nascent leasing industries in the poorest countries in Africa and Asia, and maturing leasing markets in the most advanced economies of Latin America and Eastern Europe.

It remains critical to develop a vibrant leasing industry in countries where it does not exist. Leasing fosters economic development and job creation, by providing access to financing to micro, small and medium businesses that often cannot access other forms of financing.

1. CAGR: Compounded average growth rate based on 11 leasing clients that continuously reported from FY05 to FY07.

In countries where the leasing market has already built up, encouraging competition can help lower financing rates and expand financing volumes. At this stage, banks generally enter the leasing competition and start using leasing as a way to attract new clients, while stand-alone leasing companies are pushed to develop more specialized products and niches.

Even in markets where leasing is reaching maturity, new products offer opportunities for further growth. For the IFC, one of the most promising avenues for leasing in developing countries is still under-exploited—the rapid growth of investments in sustainable equipment

(i.e. energy efficiency, renewable energy, and cleaner production). These investments are critical to successfully tackle the global climate change challenge, and are supported by a strong political will worldwide. Because leasing is asset-backed and generally cash-flow based, it is a particularly relevant product to finance these equipments. IFC supports sustainable equipment financing by combining credit lines and risk-sharing facilities with advisory services that aim at building the capacity of leasing firms to identify opportunities, develop business, and appraise the risks and cash-flows of different types of equipments and sub-sectors.

### **Box 1-2. Leasing Development in Azerbaijan and Central Asia**

IFC, in partnership with SECO, has laid the ground for leasing development in Central Asia since 2002. Predecessor projects helped to create a transparent and viable legal and tax environment for leasing in the region and also revealed the need for more targeted advisory services to build overall institutional capacity and in particular to continue securing a favorable legislative environment for leasing. To respond to this market need, IFC created the Azerbaijan-Central Asia Leasing Facility Advisory Services Project (ACALF).

The overall goal of ACALF was aimed at expanding the leasing environment for SMEs through a significant advisory services program that would strengthen and build leasing capacity in four countries: Azerbaijan, the Kyrgyz Republic, Tajikistan, and Uzbekistan.

ACALF fully met the expectations of its stakeholders in the four countries of its operations. The Project significantly contributed to the institutional capacity development and increased investment attractiveness of its clients. It also played a substantial role in further legislative improvements related to leasing, in building overall market institutional capacity through training and other client consultations, and in raising public awareness about leasing markets.

The Project also helped governments draft and adopt 8 laws to facilitate leasing, including contribution into the new Tax Codes in the Kyrgyz Republic and Uzbekistan. The Project developed 65 training modules training 740 people in areas such as risk management, HR management, financial analysis, and monitoring of leases. The Project developed and delivered training modules on leasing basics, credit analysis in leasing, and microleasing.

Advisory leverage: each US\$1 spent by ACALF has generated  
US\$60 of new leasing deals by Participating Financial Institutions (PFIs)  
US\$8 of annual economic benefits to PFIs from MIS upgrades (once completed)  
US\$62 of foreign investments into PFIs  
US\$118 of growth in the overall leasing market

### **Box 1-3. Energy Efficiency and Leasing**

As the world's leading economies attempt to reduce their "carbon footprint," the focus on producing and using energy efficient products has increased. Leasing companies have always been aggressive in their search for new items to lease, especially in the equipment sector, with the result that they very quickly recognize the opportunities available for them in this "green" sector.

Lack of access to capital and sustainable energy equipment have been identified as one of the key barriers that inhibit the development of the sustainable efficiency industry. Leasing can help address this barrier and facilitate the financing of equipment in energy efficiency, renewable energy, and cleaner production.

Lease financing can be used in projects of all sizes from large industrial projects such as cogeneration, through small mass market programs such as compact florescent to residential appliances. It can also be applied in vendor financing, Energy Services Company (ESCO) projects, as part of utility programs or energy efficiency manufacturing ventures. In the US and Asia, some leasing companies are also providing ESCO business services providing a one-stop shop for clients financial and energy efficiency services. This model can be replicated in other countries.

Leasing can directly address the credit issues related to smaller-size investments and small businesses. It can also represent a large source of funding for projects and its flexibility offers opportunities for structuring and developing appropriate replicable models.

On the supply side, leasing can help banks, leasing companies and other financial institutions better manage the risks associated with financing the sustainable energy industry. It can help banks increase the range of products and thereby create value for both the bank and its clients, while increasing market share.





## CHAPTER 1

# The Importance of Leasing



### What Is Leasing?

In its simplest form, leasing is a means of providing access to finance and may be defined as **a contract between two parties wherein one party (the lessor) provides an asset for use 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.<sup>2</sup>

Leasing is a medium-term financial instrument for the procurement of machinery, equipment, vehicles and/or properties. Fundamentally, it is asset-based financing with the asset providing (in most situations) the security for the financing. Leasing institutions (lessors)—whether banks, leasing companies, insurance companies, equipment producers or suppliers, or nonbank financial institutions—purchase the equipment that has usually been selected by the lessee, and then allow the lessee use of that equipment for a specified period of time. For the duration of the lease, the lessee makes periodic payments to the lessor, at an agreed rate of interest and in an agreed currency. At the end of the lease period, the ownership (title) in the equipment is transferred to the lessee at a pre-agreed residual value, or the equipment is returned to the lessor, which may then sell it to a third party or declare it worthless and obsolete.

Leasing is based on the proposition that income is 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 on past credit

history. This explains why leasing is particularly advantageous for young companies, as well as small and medium 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. Because the lessor owns the equipment it can be repossessed relatively easily when the lessee fails to meet lease rental obligations.

### Finance v. Operating Leases

To date, the 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 can be equally important in the long term, but for various reasons are generally typical of a later stage of development.

IFC has been involved in the creation of leasing legislation in many countries and is aware of the important nuances that exist in the drafting of these laws in each country to ensure that the interpretation reflects legal objectives. The following information is presented as a commercial guide to definitions and differences between financial and operating leases rather than as strict legal definitions.<sup>3</sup> This discussion aims to provide an economic context for operating and finance leases and does not look to explain how they must be defined in laws, tax codes, or accounting rules.<sup>4</sup>

2. These guidelines refer primarily to equipment leasing. As used here, the term asset should therefore be taken to refer to equipment and vehicles.

3. Chapter 2 discusses the definition of leasing from a legal perspective.

4. Chapter 3 provides information on leasing from an accounting and tax standpoint.

A **finance lease** is a contract that allows the lessor, as owner, to retain legal ownership of an asset while transferring substantially all the risks and rewards of economic ownership to the lessee.<sup>5</sup> A finance lease may also be termed a full payout lease, as the leasing payments made during the term of the lease will repay all of the

original cost of the asset plus the interest charged by the lessor.

An **operating lease** is a contract that allows the lessor, as owner, to retain legal ownership of an asset but allows the lessee to enjoy the economic use of the asset for a predetermined period before returning the asset to the lessor.

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

Table 1-1 illustrates the differences and similarities of these two types of lease.

Table 1-1. Comparison of Finance Lease and Operating Lease		
Feature	Finance lease	Operating lease
Legal ownership	Lessor	Lessor
Right to economic usage	Lessee	Lessee
Responsibility for insuring asset	Lessee (although lessor may organize this and then recharge lessee)	Lessor (some transactions may stipulate the lessee)
Responsibility for maintenance of asset	Lessee	Either the lessee or the lessor, with the responsibility agreed on when the lease contract is signed
Transfer of ownership at end of lease	Lease agreement will typically include a condition of transfer of ownership: normally, legal ownership of the asset will be transferred to the lessee at a nominal charge; however, the parties may agree that the lessee return the asset to the lessor with no financial benefit being received by the lessee	Lessee has no rights of ownership at the end of the lease; it returns the asset to the lessor, which will either sell the asset to a third party (retaining all of the sale price) or lease the asset to a new lessee
Choice of asset supplier	Lessee	Lessee (unless the asset is already owned by the lessor; see above)
Balance sheet treatment	Leased equipment is normally treated as an asset of the lessee, which will claim all fiscal depreciation allowances as though it were the legal owner; <sup>a</sup> lessor has a receivable on its balance sheet equal to the future capital repayments owed by the lessee	Leased equipment is normally treated as an asset of the lessor, which will claim all fiscal depreciation allowances as the legal owner; operating leases are normally treated as “off-balance sheet” items for lessees
Profit and loss account treatment	Lessee depreciates asset and records the interest element of each lease repayment as an expense; lessor will enter the interest element received from the lessee as income	Lessee enters the total leasing repayment as an expense; lessor enters the total leasing repayment as income

a. Some countries have not adopted this accounting system.

However it is important to note that lessors and lessees will agree on the type of lease contract at the outset of the agreement. The terms and conditions of this lease contract will clearly state the responsibilities of each of the parties. A lease contract that has been agreed as a finance lease (or, conversely, as an operating lease) could only be redefined in the event that the terms and conditions were not in accordance with local (or international) laws and guidelines for that type of contract.

## Financial Leasing v. Loans

The critical difference between these two popular methods of asset financing is in the ownership of the asset that is the subject of the financing contract. Under the terms of a **finance lease**, the lessor (leasing company) is the legal owner of the asset. This ownership is normally achieved by the supplier of the asset invoicing the lessor, and the lessor paying the supplier directly. Under the terms of a **loan agreement**, the borrower is the legal owner of the asset. The supplier of the asset for which the loan has been created invoices the borrower directly, and the borrower uses the money that has been provided by the lender to pay the supplier. The treatment of the value added tax (VAT) may also vary between a finance lease and a loan. This issue is addressed later in this chapter.

The similarities between a loan and a financial lease include the following:

- The lessee and the borrower can choose whether to acquire the asset.

- The lessee (providing the terms of the lease are met) and the borrower are able to retain the asset once payments are complete.
- Over the period of both a lease and a loan, interest and capital (equipment cost) are repaid.
- Should there be a default on either the lease or the loan, both the lessor and the lender have the legal right to reclaim/repossess the asset, provided the loan is secured.
- The risks and costs of ownership, including maintenance and obsolescence, remain with the lessee and the borrower. Also, under both a financial lease or a loan, if the asset appreciates, neither the lessor nor the lender benefit.
- The agreements are noncancelable until either the lessor or the lender has recovered its outlay.<sup>6</sup>
- The lessee and the borrower can either settle the agreement or repay the loan early.

## Rationale for Leasing Sector Development

Leasing provides a means to deliver 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.

6. Termination conditions are outlined in the lease contract, and the contract can be terminated upon breach by either the lessor or lessee.

### Box 1-4. An Alternative Form of Financing: Hire-Purchase

In a hire-purchase transaction, the hirer (user) has, at the end of the fixed term of the hire, the option to buy the asset at a token value. This is called, in some countries, a conditional sale or deferred purchase. The term creates some confusion, as the word “hire” is more generally associated with operating than with leasing. A hire-purchase is actually similar to a secured loan, with the underlying asset being the security for the loan.

The hire-purchase device is of British origin and predates the popularity of leasing. It is still used extensively in the United Kingdom as well as such former British dominions as Australia, India, New Zealand, and Pakistan, as well as parts of Africa. Most of these countries have enacted specific laws addressing hire-purchase transactions.

### Box 1-5. Leasing Provides Access to Finance Uzbekistan's SMEs

Uzbek Leasing has been a partner in the IFC Leasing Advisory Program in Central Asia since 2002 and has further strengthened its operational capacity. The leasing sector in Uzbekistan is still small but growing rapidly. IFC has played a key role in the development of the leasing sector in Uzbekistan, helping to amend 11 pieces of legislation to facilitate leasing in the country. As a result of these regulatory improvements, targeted support at the company level, and increased awareness, the leasing market in Uzbekistan has grown by US\$220 million from 2001-2007.

The Company's clients are private SMEs, whose growth is critical for the development of Uzbekistan's economy. With total assets of \$7.1 billion equivalent and declining banking penetration rates, the financing needs of the private sector, particularly SMEs, were not being met. Without access to term finance, SMEs are unable to implement investment plans and modernize existing facilities. Many small companies raised funds on the curb market, in cash, and often at significantly higher interest rates. IFC provided advisory services to Uzbek Leasing and granted them a loan targeted at addressing the scarcity of term foreign currency financing available for businesses to fund imported production equipment. In addition to supplying funding and boosting domestic investment, the project should increase employment in the country and contribute to development of best practice.

In August 2008, IFC committed a \$3 million loan to Uzbek Leasing International, the first leasing company established in Uzbekistan. Today Uzbek Leasing, which has IFC as one of its four shareholders, is one of the leading and most successful leasing companies in the country. Uzbek Leasing has served as a model that has led other leasing companies to launch operations in Uzbekistan.

*"This new loan from IFC will create a strong platform for expanding our services to the SME sector," Zafar Mustafaev, CEO, Uzbek Leasing International.*

*"This loan will increase private companies' access to long-term finance in Uzbekistan and strengthen its growing leasing sector. It will also provide an important demonstration effect for others in the market." Lars Thunell, IFC Executive Vice-President and CEO*

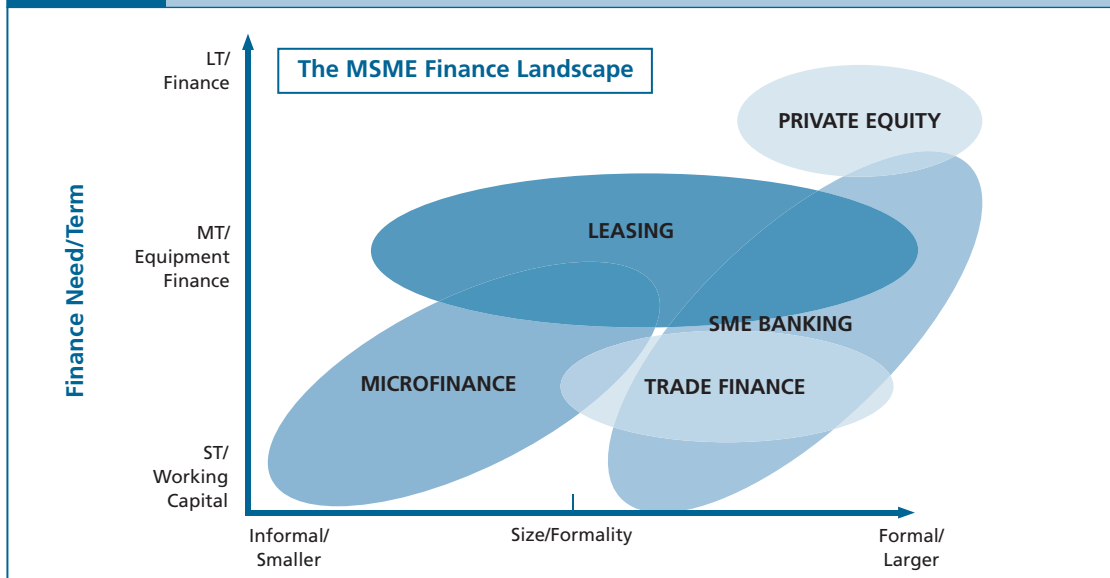
Although leasing is used as a means of asset financing by all business types from micro to global for assets worth from tens of dollars to those worth tens of millions of dollars, its key benefit is the access it provides those without a significant asset base: leasing enables small enterprises to leverage an initial cash deposit, with the inherent value of the asset being purchased acting as collateral. These small businesses do not have other assets that could serve as collateral for loans or other types of secured lending within countries where unsecured lending is not an option. Developing leasing allows smaller scale entrepreneurs to 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 creditor's rights

and collateral laws and registries—for instance, in countries where secured lenders do not have priority in the case of default.

As a result, leasing is sometimes the only financial tool available to provide small and medium businesses, especially the smallest and even informal, with medium term finance to support investments in productive and logistic assets. (see Figure 1-1)

Leasing also plays a critical role in bringing in small businesses into the formal financial system: as informal businesses have access to lease financing, they start building a history of financial transactions. When the appropriate credit information-sharing infrastructure is in place, banks and other financial institutions can access these records, better manage risks, and start

**Figure 1-1. The MSME Finance Landscape**



Source: IFC 2008

providing more comprehensive financial services to these small businesses. With this new opportunity, small businesses also find a new incentive to join the formal sector.

A dynamic leasing sector can greatly benefit the economy of a country as it creates access to finance that in turn can create employment opportunities.

An example of this could be an SME that recognizes an opportunity in its particular business sector. The SME cannot afford to purchase the equipment that will allow it to exploit this opportunity, nor has it any property of substance that it could offer to the bank as collateral for a loan. It can, however, afford to pay a down payment on the equipment to a leasing company. The SME has calculated, and the leasing company has verified, that the increased income for the business will enable it to afford to make the leasing repayments to the company and reap surplus income that may then be reinvested in the business. Taking this example further, the SME uses the surplus income from the leased asset to employ an operator for the asset. The SME will pay tax on its increased income. The

operator will pay tax on his earned income. The state will benefit from increased taxes and lower unemployment rates.

### Leasing in Emerging Economies

Emerging economies almost always have an undercapitalized banking system that can only offer its potential clients a limited range of products. For their part, the SMEs in emerging economies possess insufficient collateral or credit history to access more traditional bank finance. This results in a shortage of credit being 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 for businesses that would otherwise not have it, thus promoting domestic production, economic growth, and job creation.

Many developing countries suffer from weak or imperfect legal institutions. Although in principle secured lending and leasing should be roughly equivalent in terms of risk, experience in many jurisdictions has shown that legal ownership is recognized by all participants,

### Box 1-6. IFC Leasing Program Helps Rwandan Coffee Farmers

The humble bicycle is helping boost the income and better the lives of 1,200 coffee farmers in Rwanda, thanks in part to IFC's leasing program in the country.

Coffee is a major source of export income in Rwanda, a country that is still recovering from genocide and the resulting turmoil of the 1990s. Most of the country's 10 million people work in the agriculture industry or toil at their own small farms to survive. IFC, in partnership with a local subsidiary of an international nongovernmental organization, is expanding a program that allows local coffee farmers to lease durable, eight-gear bicycles with a specially fitted shelf to haul heavy loads.

#### **Working with Local Partners**

A program to lease custom-made bicycles to coffee farmers was initiated by USAID and Spread, a civil society organization. It has made a dramatic impact on an industry that still relies on strength, sweat, and stamina. IFC has teamed up with Vision Finance, the financial arm of World Vision International, to help expand and commercialize the program in Rwanda, allowing local coffee farmers to lease bicycles that can carry about four times as much as the strongest farmers can move on their backs. This enables farmers to bring their harvest to distant washing stations much faster, meaning the beans will be fresher and obtain a higher price at market.

*Issac Murenzi, a married father of four children, is a coffee farmer from Rwanda's southern Gitarama Province. He knows the hard work involved in hauling heavy bags of freshly picked coffee beans—some weighing up to 50 kilograms. "The coffee bike has changed my life," Murenzi said. "It allows us farmers to transport our coffee on the same day, improving the quality of coffee we deliver. This in turn has helped increase our earnings, since we have been able to meet the demands of the market both in quality and quantity."*

Some 1,200 farmers are now using the bicycles, which they purchase for about \$140 through a lease-to-own program that was designed largely by IFC. Payments are made over the course of a year, ensuring that the cost does not bite deeply into the farmers' monthly income.

#### **Leasing Benefits Smaller Businesses, Individuals**

Leasing is an excellent business model for individuals or small and medium enterprises in developing countries, where high interest rates and difficulty obtaining loans often rule out cash purchases of goods and equipment. But smaller businesses that could benefit most from a clearly regulated and reliable leasing industry have often been stymied by the challenge of introducing a comprehensive leasing framework at the national level. Risk-averse banks have been equally hesitant about introducing programs for smaller businesses or recognizing the benefits of leasing.

IFC launched a leasing program in Rwanda in 2006. In a short time, it helped the country introduce a legal framework for leasing, guide banks through the process of developing leasing products, and raised awareness among businesspeople about the advantages of leasing equipment to expand production and profitability. Through its advisory services program, IFC has also provided the necessary legal and technical knowledge for Rwandan banks and other financial institutions—including Vision Finance—to begin leasing programs.

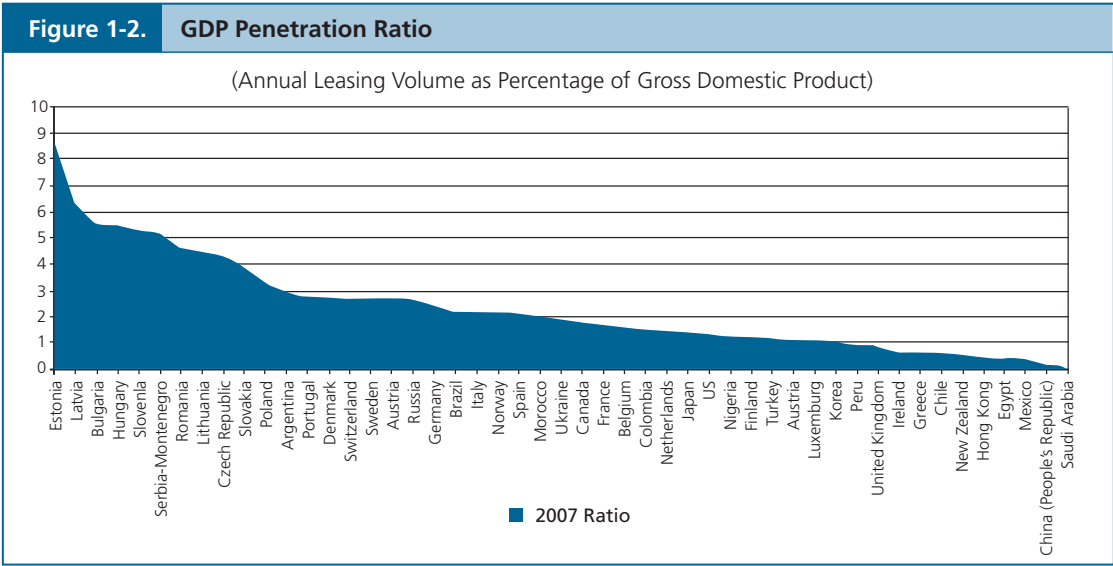
*IFC is a pioneer in introducing leasing programs to post-conflict countries like Rwanda," Thierry Tanoh, IFC Director for Sub-Saharan Africa. He noted that leasing helps businesses grow by giving them the chance to introduce vehicles or equipment that would otherwise be too expensive to buy. This ultimately benefits the economy by boosting employment and increasing the tax base.*

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 1-2 shows the level of lease penetration in relation to GDP in emerging and developed economies, and the room for growth in the use

of leasing. Leasing can provide a valuable additional source of finance within these markets.

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



Source: World Leasing Yearbook, 2009

### Box 1-7. Microleasing

Microfinance may be defined as “the supply of loans, savings, and other basic financial services to the poor.” The providing of loans per se is usually referred to as microcredit. Microleasing is a very important development of microfinance.

This area of the global financial markets is managed by MFIs (micro finance institutions, some of which are commercial enterprises and some NGOs) and has created critical access to finance for poor individuals and poor companies, many of them start-ups, allowing them to purchase small assets or even raw materials that have been used to create goods that can be sold at a small profit. The profit generated must be more than the loan repayments and must leave a surplus for the borrower.

Microleasing is an increasingly attractive product for microfinance institutions that offer it to those clients who have proven themselves able to make timely repayments for several microcredits in the past. It mainly refers to leases provided by MFIs with amounts from 1,000 to 10,000 USD for the financing of small equipment (e.g. sowing machines, small refrigerators, packing machines). Microleasing enables MFIs to move into a new area of financing larger transactions, as the asset provides the collateral for the microlease, thus reducing the MFI's risk.



## Various Stakeholder Perspectives on Leasing Development

A key consideration in developing a leasing market is the various goals and incentives of multiple stakeholders and their objectives for the development of leasing markets. Broadly, stakeholders are those individuals or groups that are either actively involved in developing leasing locally or may be affected by the development of the leasing sector. Such groups include government, banks, nonbank financial institutions, insurance companies, existing or potential lessors, existing or potential lessees, SMEs, equipment manufacturers and suppliers, and the professional services sector (lawyers and accountants, donors, and technical assistance providers).

In order to help target discussions with these stakeholders, the guidelines try to identify

objectives for each stakeholder group, and demonstrate how leasing can help achieve these objectives.

## Leasing Entities: Banks and Non-Banks

In most developed leasing markets there maybe three distinct types of companies offering leasing facilities namely:

- Banks, that offer leasing as part of their product mix through a specialized leasing unit or through their regular lending units
- Leasing companies that are subsidiaries of banks or banking groups; typically, banks have a significant share in the company
- Leasing companies that are privately owned and have no bank as a majority shareholder. These companies are often subsidiaries of

Table 1-2. Stakeholder Arguments for Developing Leasing		
Stakeholder	Possible objectives	How leasing can help achieve stakeholder objectives
Government	<ul style="list-style-type: none"><li>• Domestic production</li><li>• Industrial diversification</li></ul>	<ul style="list-style-type: none"><li>• 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.</li></ul>
	<ul style="list-style-type: none"><li>• Capital investment</li><li>• Government budget and tax revenue</li></ul>	<ul style="list-style-type: none"><li>• Leasing provides a diversified source of capital (equity, debt, lease, etc.).</li><li>• Leasing further contributes to the development of domestic increases financial markets.</li><li>• As leasing develops, there will be increased domestic liquidity through access to global markets.</li></ul>
	<ul style="list-style-type: none"><li>• SME development</li></ul>	<ul style="list-style-type: none"><li>• For reasons listed below (see Lessees/SMEs), the development of leasing aids the growth of the domestic SME sector and the private sector in general.</li></ul>
	<ul style="list-style-type: none"><li>• Infrastructure improvements</li></ul>	<ul style="list-style-type: none"><li>• Leasing can help increase the levels of public transport, the depth of communications networks, and allow municipal authorities and local entrepreneurs the means to acquire quality construction and maintenance equipment.</li></ul>
	<ul style="list-style-type: none"><li>• Climate Change</li><li>• Environmental and Social Sustainability</li></ul>	<ul style="list-style-type: none"><li>• Leasing can support the global climate change and sustainability agenda by financing energy efficiency, renewable energy, and cleaner production equipment. Lack of financing for energy efficiency equipment is identified as a major barrier to the development of the energy efficiency industry.</li></ul>



Table 1-2. Stakeholder Arguments for Developing Leasing (continued)		
Stakeholder	Possible objectives	How leasing can help achieve stakeholder objectives
Lessors (including banks)	<ul style="list-style-type: none"> <li>• Risk management/reduction</li> </ul>	<ul style="list-style-type: none"> <li>• The lessor maintains legal ownership of the asset.</li> <li>• The lessor is able to exert greater control over the investment.</li> <li>• The lessor can monitor assets more easily.</li> <li>• Lessors can actively apply specialized knowledge, such as equipment specialization.</li> </ul>
	<ul style="list-style-type: none"> <li>• Leasing market development</li> <li>• Product portfolio diversification</li> <li>• Customer base expansion</li> </ul>	<ul style="list-style-type: none"> <li>• Leasing provides not just an opportunity to extend product lines, but also to deepen the organizational structure.</li> <li>• In some cases, leasing may allow businesses to access both lease financing and additional bank financing without increasing their collateralized debt.</li> <li>• Leasing can provide additional marketing channels for financial services.</li> </ul>
Lessees/SMEs	<ul style="list-style-type: none"> <li>• Access to finance</li> </ul>	<ul style="list-style-type: none"> <li>• No/low collateral required.</li> <li>• The cost of lease finance is competitive with traditional credit, given the increased security held by lessors, and low transaction costs of processing a lease.</li> <li>• Leasing also offers matched maturity of assets/liabilities, since debt in emerging countries is often limited to short-term maturities.</li> <li>• Islamic compliance: in Muslim countries, leasing is seen as an interest-free product and considered the same as a rental. In Islamic finance, "<i>Ijarah</i>" is a kind of leasing, and especially relevant within the Middle East and North Africa region.</li> </ul>
	<ul style="list-style-type: none"> <li>• Access to equipment and production assets</li> </ul>	<ul style="list-style-type: none"> <li>• Increases flexibility, diversification of financing sources.</li> <li>• Enables investment in equipment that can modernize production, and improve productivity and profitability.</li> <li>• Reduces maintenance costs since equipment is newer.</li> <li>• Due to reduced upfront costs, it frees up capital for other business needs.</li> </ul>
	<ul style="list-style-type: none"> <li>• Ability to plan</li> <li>• Timeliness and flexibility</li> <li>• Negotiability</li> </ul>	<ul style="list-style-type: none"> <li>• Leasing enables companies to match income and expenditure.</li> <li>• 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 being a comparatively new development, lessors have to be fast and flexible to claim this as their unique selling proposition.</li> <li>• Leasing deals may make less use of restrictive covenants that appear in more traditional forms of lending.</li> <li>• Where lessors have asset knowledge or relations with suppliers, lessees may "outsource" certain tasks (such as negotiating with suppliers), reducing costs and risks.</li> <li>• Independence from bank borrowing: through leasing SMEs have alternate funding opportunities and are able to use a mix of funding options to finance their businesses.</li> </ul>

Table 1-2. Stakeholder Arguments for Developing Leasing (continued)		
Stakeholder	Possible objectives	How leasing can help achieve stakeholder objectives
Equipment Manufacturers	<ul style="list-style-type: none"> <li>Expanded market base for products</li> <li>Increased purchase options for clients</li> </ul>	<ul style="list-style-type: none"> <li>Leasing allows access to new equipment, by providing businesses with a mechanism to access equipment without incurring significant upfront costs.</li> <li>Development of the leasing sector opens up significant after-market products and services for equipment manufacturers.</li> <li>Leasing often provides an effective marketing channel for equipment, as leasing companies are also interested in increasing sales.</li> <li>Effective leasing companies may bear some of the burden of dealing with inexperienced equipment purchasers, thus reducing costs and improving efficiency.</li> </ul>
Legal/Accounting	<ul style="list-style-type: none"> <li>Lessors/banks may be clients of professional services companies</li> <li>Tax planning and accounting opportunities</li> <li>Systems development opportunities</li> </ul>	<ul style="list-style-type: none"> <li>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.</li> <li>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.</li> </ul>
Investors	<ul style="list-style-type: none"> <li>Increased ability to invest within a country</li> <li>Development of financial sector</li> <li>Growth in investee company opportunities</li> </ul>	<ul style="list-style-type: none"> <li>Improved credit scoring and processing systems that 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.</li> <li>Improves the local investment climate for all companies, increasing opportunities for investment and reducing/allocating risks more efficiently.</li> <li>The development of nonbank 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.</li> <li>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.</li> </ul>

### Box 1-8. Leasing in the Agricultural Sector

Every government must accept that it has a fundamental duty to feed its people. Leasing can play a key role in feeding the world.

Most leasing entities start to operate in what they may consider to be safe sectors. The normal trend is therefore firstly cars, then trucks and then finally equipment. It is the equipment sector that usually creates the most problems for a leasing entity from the perspectives of risk and sales as there are so many diverse types of equipment that may be suitable for leasing from, for example, a laptop computer to a production line. However, many leasing entities in the developed and developing world have taken the step into leasing agricultural equipment.

The critical issues that leasing entities face is understanding the huge variety of agricultural equipment that is used to facilitate the production of the world's food and also the assessment of the credit worthiness of the food producer. Farms, even in the same area of the same country, may vary in size from less than 1 hectare to tens of thousands of hectares. The productivity of these farms also varies hugely as it is determined by many factors such as location, soil type, quality of seed, quality (if any) of fertiliser and sprays, husbandry techniques and also the quality of the equipment. This list is mainly relevant for crop production but farms are also used for animal production from hens to cattle and pigs to ostriches.

Lessors must therefore understand food and farming before they enter this sector. Many leasing entities have employed agricultural experts within their companies rather than rely on general sales and risk people. However, regardless of whether experts are employed or not, leasing entities must understand how to assess the credit worthiness of a lessee from the agricultural sector by understanding the income generation from his/her crops and animals and also, critically, the seasonality of the cash flow generated. Not all farmers enjoy regular monthly incomes. Some do, such as dairy farmers and egg producers but many, especially cereal farmers, have a harvest (of crops and income) only once per year. Lessors must accept this situation and structure their leasing repayments accordingly.

In developing countries where farmers want to mechanise their farms for the first time there can be a critical problem of their being unable to fund the down payment required by a leasing company with a sensible risk policy. This requirement has, in many countries, prevented the development of leasing in this important sector.

Leasing entities must therefore be more creative in their sales and risk strategy. They must negotiate with all parties that will benefit from a growth in the mechanisation of the agricultural sector. Those parties include, in no particular order: equipment vendors, grain traders and fertiliser sellers. Banks will also benefit, as they will have access to customers that will be able to provide better financial results, as mechanisation will create higher incomes and profits for farmers.

As all of the above parties will benefit from the leasing entities agreeing to lease equipment to farmers then shouldn't these parties also accept some of the leasing entities' risk?

If we again consider the down payment as being the leasing entity's best risk mitigant, then if the farmer can provide this down payment, the leasing entity will be more encouraged to offer him/her a lease for the much needed equipment.

The bank could provide a short-term loan for the down payment and take security over the farmer's land and other assets. The grain company could offer crop financing by paying the farmer in advance for that season's grain harvest. The fertiliser company could supply the fertiliser with a delayed payment to the end of the year thus freeing some of the farmer's working capital facility.

The grain company can also sign a forward contract with the farmer agreeing to buy a quantity of his grain after harvest. The income from this contract may be pledged to the leasing entity as a security for its leasing payment.

### Box 1-8. Leasing in the Agricultural Sector (continued)

All companies that operate within a developing country's agricultural sector must work together. If they are going to share the gain when the agricultural sector starts to improve by using new techniques and equipment then so they should share in the initial pain in the start up phase. Leasing entities should not be expected to carry the burden of accepting all of the risk.

**Table 1-3. Comparisons of Three Types of Lessors**

Feature	Bank offering leasing as a product	Bank-owned leasing company	Nonbank-owned leasing company
Dedicated sales team	No	Yes	Yes
Dedicated back office staff	No	Yes	Yes
Dedicated credit risk department	No	Yes	Yes
Risk policies specifically for leasing	Not usually	Usually	Yes
Fast credit decision making	Not usually	Usually	Usually
Stand-alone information technology platform	Not usually	Usually	Yes
Funding	Self-funded	From bank and other local and international financial institutions (usually with guarantee or comfort from parent)	From local and international financial institutions plus the local or international capital markets
Typical sources of business (in order of individual priority)	<ul style="list-style-type: none"> <li>• Bank customers</li> </ul>	<ul style="list-style-type: none"> <li>• Vendors of equipment</li> <li>• Bank customers</li> <li>• Direct non-bank customers</li> </ul>	<ul style="list-style-type: none"> <li>• Vendors of equipment</li> <li>• Direct customers</li> </ul>

major equipment manufacturers or dealers, and practice “captive financing”, but there are also many totally stand-alone leasing companies globally (see table 1-3).

In emerging economies banks offer leasing as a product alongside their traditional products such as loans and overdrafts. Experience has demonstrated that bankers, or more correctly, loan officers, tend to sell the products with which they feel the most comfortable. This usually results in bank clients being offered a loan, with the bank taking collateral of the asset as well as additional

collateral, usually property. The concept of leasing as an asset-based financing tool with the asset serving as the sole collateral for the lease is often a highly unfamiliar and uncomfortable one for loan officers and credit risk managers.

As a result, banks that offer leasing through an internal unit generally focus on large ticket leasing (aircrafts, real-estate, vessels, etc) and view this product as part of their corporate lending activities, with clients that they deem less risky. These banks often miss an opportunity to acquire and develop small ticket leasing skills

on which they could leverage to build a new and profitable portfolio of SME clients, to whom they could in turn cross sell other banking products.

The local treatment of VAT can also influence the decision about whether or not a bank will offer leasing to its clients. In most countries, banks do not charge VAT on their services and therefore tend to be unable to reclaim input VAT. As VAT is normally charged, at least on some aspects of leasing products, this issue can create a barrier to entry of the leasing sector in a country.

### Bank-owned Leasing Companies

The management of many banks has accepted that leasing is a relatively simple product to sell and administer but that it requires different selling skills, different information technology solutions, and different credit risk policies than administering a loan or overdraft portfolio. This acceptance has resulted in most of the world's leading banks creating their own leasing

subsidiaries with unrelated management, sales, administration, and—most important—credit risk staff.

The leasing subsidiaries are normally initially incorporated in the country of the bank's origin; many then create branches in other countries which are serviced by the parent bank. Being a subsidiary of a bank normally helps a leasing company gain access to local funding that it may be required to raise from sources other than its parent bank. This is especially important during the start-up phase of a leasing company when it is incurring losses with resultant poor financial performance.

### Non-bank Leasing Companies

In many emerging economies, where leasing is a new product, nonbank-owned leasing companies tend to be first in the market. In many cases, they can be owned by local businesspeople who have created other successful businesses and have then decided to diversify into the leasing

#### Box 1-9. Ghana: Impact of Banks Entering the Leasing Sector

In 1993 the government of Ghana, drawing on IFC advice, passed the Finance Lease Law (PNDCL 331). IFC subsequently supplemented an existing equity investment in Ghana Leasing Company with a \$5 million loan. The leasing sector grew by 162% from 1996 to \$29.8 million in 2005. Six additional leasing companies were also established between 1994 and 2004.

In 2005, IFC launched the leasing program in Ghana with support from the State Secretariat for Economic Affairs of Switzerland (SECO). The program aimed to enhance the role of leasing as an alternative financing mechanism for SMEs and other businesses in Ghana.

The Ghana leasing industry experienced substantial growth with the value of new lease increasing 196% within a year to over \$93 million in 2007. The number of new lease contracts signed also increased from 536 to 1,381 over the same period. The rapid growth in the industry is attributed mainly to bank lessors. The portfolio of bank lessors increased 220% to over \$71 million from 2006 to 2007. Banks controlled over 65% of the total lease market as compared to just 20% in 2005.

The Universal Banking Act was passed in 2004. As a result, banks in Ghana can engage in leasing without obtaining any special license. Prior to that, banks were not permitted by law to offer leasing directly except through a subsidiary. This has fueled the increase in the number of banks with leasing operations; number of leasing operators increased 100% from 2005 to 14 in 2007 with 64% being bank lessors. Bank lessors have become important and will continue to play a significant role in the industry.

Funding still remains critical for leasing in Ghana. However, the dynamics of the leasing market have changed with banks in leasing. While banks do not face funding problems, they generally do not have access to long-term funds which limits the typical lease term banks are able to offer.

### Box 1-10. Growth of a Privately Owned Leasing Company in Poland

A good example of this is a leasing company that was incorporated in 1991 in Poland as one of the first leasing companies and was subsequently sold in 2001 to a major international banking group. The company had remained under the sole ownership of the founder from its incorporation until its sale and had maintained its position as the largest leasing company in Poland until being purchased by the banking group.

The company was one of approximately five leasing companies that ventured into the sector shortly after the break-up of the Soviet Union. The strategy was quite clear from the start. It would lease almost everything from a mobile phone, to kitchen appliances to production lines. The strategy worked and the company became bigger than all of its competitors combined.

The unusual part of this story is that the company did not lose its place as number one in the Polish market when the bank owned leasing companies entered the Polish leasing sector. This was partly due to its ability to fund its business from the very liquid Polish banks. Even in the late 1990s when most Polish banks stopped lending to leasing companies that were not wholly owned by them or were not subsidiaries of an even stronger parent bank than the lender itself, it was still able to attract sufficient funding to continue its growth.

sector. As banks tend to be heavily regulated, leasing offers these entrepreneurs the opportunity to enter the financial services sector without having to qualify for a banking license.

Experience has demonstrated that although many of these privately owned leasing companies do not survive, especially when the bank-owned leasing companies arrive in a country, others have gone on to become extremely successful.

Potential lessees may feel more comfortable entering into leasing contracts with subsidiaries of banks, as they will recognize the name associated with the subsidiary. However, as long as the country's leasing legislation protects the lessee in the event of the lessor becoming bankrupt, the lessee is at no risk in working with reputable leasing companies whose lease contracts adhere to the leasing laws.

The leasing sector in many developing countries in which IFC has been active has been started by privately owned companies. The sector then normally develops and expands, with the arrival of bank-owned leasing companies, which either purchase an existing private leasing company or start their own. As the sector further develops,

many small private leasing companies are bought up by their larger rivals or cease trading, either because they are unable to attract local funding or their funding is too costly to allow them to compete with their rivals. A key success factor in the sustainability of lease operations and market development is a solid lessor funding strategy.

### 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 (e.g. agriculture, aircraft, etc.) 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 the good and distorts the market.

Fundamentally, this analysis is no different than 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,

### **Box 1-11. Bank Owned v. Stand-alone Leasing Companies**

With very few exceptions (see Polish example on p 20 (Box 1-10) bank owned leasing companies have dominated leasing markets. They enjoy great advantages over stand-alone leasing companies by virtue of their having access to the bank's customers (cross selling is a major activity within banking and leasing groups); by having access to funding from the bank; by enjoying the strength of the bank's balance sheet and by using group guarantees to access local funding.

Stand-alone leasing companies, on the other hand, have no parent from whom to receive assured funding. This situation therefore restricts the speed of growth of these companies, as they must grow their balance sheets from retained profits or from equity investments to allow them to leverage their funding requirements. Many bank-owned leasing companies will have debt-to-equity ratios of 10:1 (or even more) but stand-alones will only be permitted (by their funders) to leverage up to around 7:1 and in their early phase perhaps only 2 or 3:1.

Although stand-alone companies have formed the initial drive of many leasing sectors, it is a direct reflection on the above issues that they either get squeezed out of business by bank-owned companies who use their marketing might and interest rate advantage aggressively or, if they are fortunate, they may be purchased by a bank that wishes to have a fast start in a new country.

An alternative growth strategy for a stand-alone leasing company is to build on a specific competitive advantage that it can sustain on the long term. For instance, operating leases require a very specific focus and specialized skills to organize the servicing of the leased equipment, which banks rarely develop. Also, with higher margins in operating leases and stronger accounting incentives, operating lease companies can be less leveraged and continue accessing funding sources through the local and international capital markets.

IFCs experience indicates that stand-alone leasing companies can sustain profitable leasing operations if they secure a reliable source of local currency funding, and strong technical partners and management. However, bank leasing companies tend to be more competitive in the long run with lower cost resources and large branch networks that they can leverage to build a strong portfolio of SME leases.

In context of the current global financial crisis, the viability of the non deposit-taking financial institution model has clearly been challenged. However, IFC engagements carefully balance development impact and economic performance of its investments. Stand-alone leasing companies may be more fragile than bank leasing operations, but at early stages of market development they are often a key driver for innovation and growth of the industry. IFC continues supporting these companies, when they have a strong strategic vision and excellent management skills needed to ensure their long-term sustainability. Generally, IFC has recognized that loans tend to be more suitable and sustainable than equity for financing stand-alone leasing companies at early stages of development.

it often distorts and hides the problem. As with any subsidy, if these are determined to be needed or necessary, the intervention should be well designed and implemented with an effective exit strategy. The negative impact should be minimized as much as possible.

#### Box 1-12. Sri Lanka

A Sri Lankan leasing company in which IFC had an investment found that it was facing competition from two government-owned development finance institutions (DFIs) that offered potential borrowers both leasing and loans. The DFIs had a considerable funding advantage: they were allowed access to subsidized funds and their financings were not subject to the turnover taxes levied on private leasing companies. Nevertheless, the independent leasing company was able to compete successfully by exploiting its areas of comparative advantage:

- speedy processing. Its average processing time for a lease was one week, compared to 4-8 weeks for the DFIs;
- aggressive marketing;
- leasing relatively small items; and
- close client relationships, which facilitate processing and supervision.

## Leasing And the Global Credit Crisis

**At the time of writing these leasing guidelines the world is experiencing a financial crisis more severe than most people can recall.**

While it is not within the objectives of this manual to comment on the cause of the crisis, it is sensible to comment on its early effects. The following article by Ary Naïm and Debra Perry, from IFC, has first been published in the online publication “World Leasing News”<sup>7</sup>, a useful tool for leasing professionals across the globe:

The current credit crunch has led to a substantial reduction in capital flows to emerging market countries. This has manifested itself in a lack of liquidity to these markets and a subsequent drying up of funding for many financial institutions and corporate in these regions dependent on wholesale borrowings. In addition, the impact of reduced demand for exports from the developed world—mainly US and Western Europe—has led to markedly slower economic growth for many countries in these markets. Credit squeeze and slow-down in demand will likely result in increasing defaults for all commercial lending activities. These effects will have adverse consequences on the leasing industry in emerging

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7. By Sudhir P. Amemba and Lisa Rafter, [www.worldleasingnews.com](http://www.worldleasingnews.com)



markets throughout 2009 and are forecast to continue for some time thereafter.

The immediate consequences of the crisis will be that leasing companies that are part of a solid bank with a stable source of retail deposit funding will have more chances of surviving the crisis while those stand-alone leasing companies dependent on whole-sale borrowings will inevitably suffer. This is due to the fact that a stand-alone leasing company without secure financing can find its sources of funding totally disappearing and, even if it can have access to finance, its cost of funds will inevitably rise, not only affecting its profits but also its ability to on-lend at a reasonable cost. A secondary consequence of the crisis will be that leasing companies will experience a fall in demand as their clients cannot afford to enter into new equipment leases, preferring in some cases to stretch out the use of their existing equipment, or also suffer from lack of funding due to the crisis. Nevertheless, even having said this, leasing companies located in countries and regions with strong capital markets that have not dried up—perhaps because they are less inter-connected globally than some other markets—should see less of an impact of the global credit crunch.

To counteract the effects of the global downturn, and, in some cases, to even ensure survival, leasing companies can do several things. Firstly, they can try and find a strong banking group in

the region as a sponsor, preferably one that has a stable retail funding base and can benefit in a business sense from leasing. Alternatively, if a leasing company is lucky enough to already be in a position of having a strong bank in its shareholder structure, it can consider incorporating itself as part of the bank group. Another strategy for a stand-alone leasing company would be to try to partner with a strong institutional investor which can give it stable access to funding.

On the assets side, priority will be given to strengthening early recoveries, bad debt management and workouts. In crisis times, every dollar collected on a provisioned lease becomes an invaluable contribution to the bottom-line. As deleveraging and tightening asset and liability mismatch will become critical, a new focus will need to be put on pricing lease operations, differentiating from traditional banking competition, and developing value-added services that do not consume economic capital.

Finally, even at times of crisis, the strongest leasing players will continue looking for good business opportunities. Sustainable Equipment Financing (Energy Efficiency, Cleaner Production, Renewable Energies) are a safe bet. Not only do they benefit from a strong political push, but they offer a fantastic opportunity for leasing players to differentiate from other financial players through their specific asset management and cash-flow lending skills.



## CHAPTER 2

# Legislation, Regulation, and Supervision



The success of a country's leasing sector is determined by the structure and content of its leasing legislation and how it is affected by other finance and fiscal legislation. To this end, this chapter explores the legislative framework and legal issues relating to the leasing sector. It also addresses some aspects of regulation and supervision—notably, with regard to licensing—deriving from and supporting national leasing legislation. The guidelines presented here are based on best practices worldwide and IFC's experience. Note, however, that **the specific approach taken must be tailored to local requirements and must be pragmatic.**

### Box 2-1. Finance v. Operating Leases

IFC has focused its efforts on creating an environment conducive to the development of finance leasing. This does not in any way imply that IFC underestimates the importance of operating leasing as a financial tool; rather, experience has demonstrated that it is easier to introduce leasing—a fundamentally simple product—into a developing country's financial sector if the leasing industry focuses on offering finance leases. Operating leases tend to be offered as a product by leasing companies when the business sector has become accustomed to using (finance) leasing, and the players in the leasing sector—especially equipment vendors and more sophisticated lessees—demand more tax-based products.

The law on operating leasing is often already covered by existing laws and codes related to hiring. Consequently, leasing companies can accommodate these rules within the terms and conditions of their operating lease products. For these reasons, this chapter focuses on finance leases.

### Legislation

In order to assist in the creation of appropriate leasing legislation, IFC has developed the following guidelines. This is based on the IFC's experience providing advisory services over the past 12 years around the world:

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With any legislative change, amendments should be closely thought through to ensure the most efficient and yet comprehensive changes are put forward. Legislation must also allow local leasing companies to develop the leasing sector in a commercial and profitable manner.

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.**

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## Need for a Conducive Legislative Framework

Often, domestic legal frameworks are not conducive to the development of leasing. For example,

- there may be no leasing-specific legislation or clear definition of leasing;
- contradictions may exist between various elements of a country's legislative framework that prevent leasing from working effectively, particularly with regard to certain fiscal issues;
- current legislation prevents the successful enforcement of leasing contracts;
- it is unclear under existing law 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; and

- definitions and legal implications of finance leases are not specified in the legislation.

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 accomplished in countries without leasing-specific legislation; however, such jurisdictions typically have well-advanced contract law provisions. In many emerging economies, a specific law on leasing is imperative, both because it will help fill legislative gaps and will address the rather complex tripartite legal structure implicit in a leasing transaction which involves the third party—the supplier from whom the lessor buys the leased asset. (For example, although the lease is between a lessor and a lessee, the latter is the de facto beneficiary of the supply contract signed

### Box 2-2. Yemen

In 2007, the president of Yemen formally signed the new leasing law that had been developed by the Central Bank of Yemen, drawing on IFCs advice.

The law specifically establishes a clear set of rights and responsibilities for the parties of a lease and a new registry system for leased assets. In addition, it introduces speedy leased asset repossession procedures and sets out basic tax and accounting structures that create a level playing field between leasing and other types of financing, such as bank loans. IFC continues to work with tax authorities, helping them develop provisions on tax and accounting, as well as related legislation that is crucial to the sustainable development of leasing in Yemen.

In an interview with the local media, Ahmed Al-Samawi, governor of the Central Bank of Yemen noted, “The adoption of this law is the result of the partnership between the Central Bank and IFC. There is no doubt that the leasing law will benefit small and medium enterprises, encourage banks and investors to invest in financial leasing, and establish leasing companies. These will provide the local economy with a new financing tool that will help reduce unemployment and poverty in Yemen.”

Prior to the passing of the law, only one bank was offering leasing services. By the end of 2008, three new lessors had entered the market with one lessor (Todhamon International Bank) being quoted as saying that “the adoption of the Law on Leasing resulted in the Bank’s decision to launch a leasing product.” This Bank had agreed to USD5.2 million worth of leases by the end of 2008.

Overall, the number and volume of leases in Yemen increased four-fold since IFC began working on the adoption of the law. The total leasing portfolio of all lessors at the middle of 2009 stood at USD56 million (an increase from USD13 million in just 18 months).

between the lessor and the supplier, making for a complicated third-party relationship that requires sophisticated legal delimitation in terms of defaults, expertise, and responsibility.)

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In very general terms, two different legal systems exist around the world: those based on common law and those based on civil law. While the type of legal system (common or civil) in effect in the country of operations dictates how specific legislative changes are made, the essence of a lease is usually not different under the two systems.

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### Legislative Goals for Achieving a Sustainable Leasing Sector

- Clarify rights and responsibilities of the parties to a lease, particularly the lessor and lessee
  - Remove contradictions within existing legislation
  - Create non-judicial repossession mechanisms
  - Ensure the minimum level of leasing industry supervision and licensing
  - Create a level playing field between leasing, bank loan and other credit instruments
- **Fiscal benefits.** The interest on bank loans is normally a tax-deductible expense for the borrower. The interest payable on a finance lease should be treated in the same manner for the lessee. The borrower normally benefits from fiscal depreciation on the asset subject of the bank loan. IFC's experience indicates that it is preferable that the lessee benefit from the fiscal depreciation on the leased asset.
  - **Accounting treatment.** An entrepreneur using a bank loan will benefit from having the equipment as an asset on his or her balance

This last is the one that will undoubtedly have the most impact on the lessors' success in introducing leasing as a new financial instrument. Most entrepreneurs the world over understand the procedures involved in obtaining a bank loan. Most also understand the banks' requirements for collateral; many are familiar with the fiscal and accounting implications of using a bank loan to finance their asset acquisition requirements. Where leasing is a new product, it is likely that entrepreneurs will be unaware of the implications to their business of entering into a finance lease. IFC therefore recommends that finance leases be treated similarly to bank loans as much as possible, including with regard to fiscal benefits, accounting, and VAT treatment as well as legal protection. Examples of equitable treatment include the following:

#### Box 2-3. Tanzania

In April 2008, the Tanzanian Parliament endorsed the bill for the Financial Leasing Act. The bill had been presented to the National Assembly by the Minister for Finance in November 2007 and was passed by the National Assembly on April 11, 2008, during its third sitting.

The creation of this law was the result of an IFC initiative sponsored by SECO (the Swiss State Secretariat for Economic Affairs) with the objective of stimulating capital investment and creating access to finance for local and international entrepreneurs, SMEs and corporates in Tanzania.

IFC worked closely with several leasing companies during the drafting phase of this law and has continued their work with capacity building, including developing and presenting training programmes and seminars using international leasing experts and practitioners to present the information and share their knowledge with interested parties.

By the end of 2008 the leasing market volume had grown to around USD100 million or 3% penetration in financing investment in the Tanzanian economy. This compares to around USD20 million or 1% penetration in 2005.

sheet. IFC recommends that an asset that is the subject of a finance lease be similarly placed on the lessee's balance sheet in line with International Financial Reporting Standards.

- **VAT treatment.** Although this tax is in common use, the timing of its payment and, when allowed, its reclamation, must be similar for both bank loans and finance leases. (This issue is treated in detail in Chapter 3.)

**Legal Issues:** In accordance with the above goals, a variety of lease-related issues must be fitted into a country's legislative framework in order to develop a comprehensive and cohesive law on leasing.

## Elements of a Finance Lease

### The Transaction

The transaction of a lease is the granting of economic use of an asset by the owner (lessor) to a second party (lessee) in consideration of rentals being paid by the lessee for a fixed amount for a fixed period of time. The fixed amount and the fixed term (tenor) can be varied if permissible under the terms and conditions of the lease

agreement. At the end of the lease period, the asset may be, depending on the type of lease and the terms and conditions of the contract, purchased by the lessee or returned to the lessor, or the use of the asset may continue for an additional period.

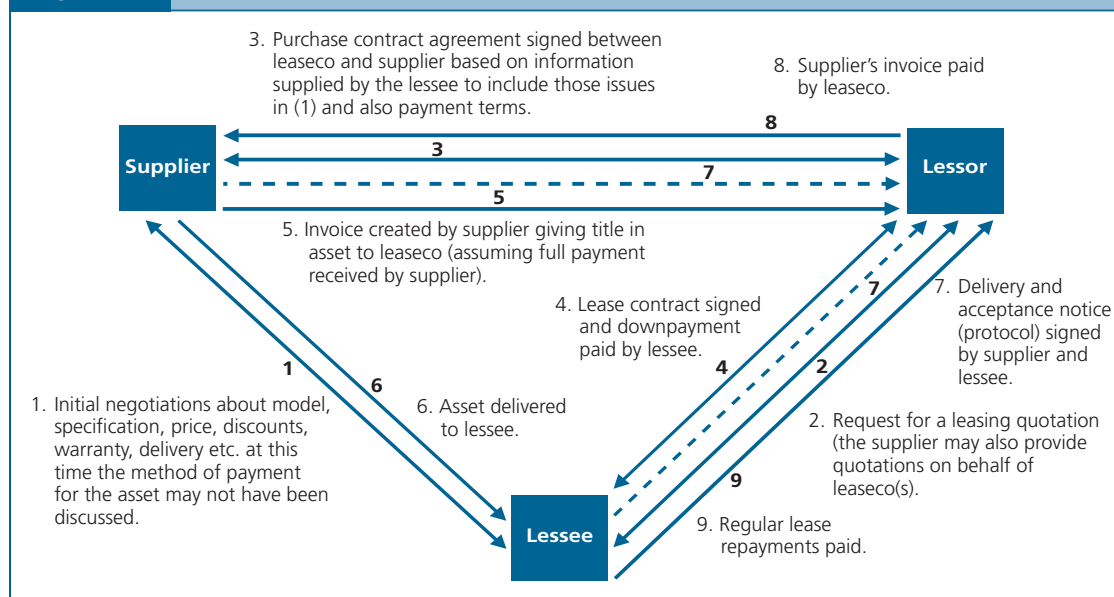
### Parties to a Lease

As parties to the leasing agreement, the lessor, lessee, and supplier can be either legal entities (incorporated) or individuals (sole proprietors). There should be no restrictions specifying that only leasing companies or other financial institutions can operate as lessors.

### The Leased Asset

The leased asset must be identifiable and non-consumable (that is, the asset is not destroyed or transferred into another form or condition once used and retains its original form during its use while depreciating gradually). In developed leasing markets, the industry has expanded from simple manufactured tangible products into leasing software (usually via software licenses) and also animals such as breeding livestock. Legislation can impose some restrictions on this general

**Figure 2-1. Finance Lease Transaction**



Source: IFC, 2008

rule; for example, to prohibit the leasing of certain articles that are in limited free circulation or withdrawn from circulation (such as designated land plots or natural sites). In general, anything that cannot be owned or held title to cannot be leased, because to act as a lessor one needs to buy the asset first.

## Lease Period

The term of lease (tenor) is the period for which the agreement of the lease is in operation. Some finance lease contracts may stipulate that the period of leasing be divided into two distinct parts, the primary and secondary periods of lease. In the primary period, the lessor will recover all of the cost of the equipment plus any fees and interest chargeable. The secondary period may be an option for the lessee to continue economic usage of the asset without taking

ownership (where this is possible). During this secondary period, the lessee pays rentals that are much smaller than those paid during the primary period. The primary period is normally noncancelable—that is, neither the lessor nor the lessee may break the contractual terms of the lease as long as both parties are adhering fully to its terms and conditions; the secondary period is normally cancelable.

In some jurisdictions, an essential element in a lease is the ability or potential ability on the part of 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 be necessary, depending on the local jurisdiction, to include in the contract a certain period at the start of the lease where the lessee may be given a right of cancellation. Beyond

### Box 2-4. Finance Lease: Two Party or Three Party Arrangement?

As in any other lease, the lessor in a finance lease is the legal owner of the leased asset and grants the right to use and possess the leased asset to the lessee for a specified period of time in return for specified payments.

The existence of a third party, which is usually chosen by the lessee and from which the lessor buys the leased asset at the request of the lessee, is what often differentiates a finance lease from other forms of property hire for legal purposes. The supplier does not have to be a party to the leasing agreement or to sign such an agreement; however, the supplier must be part of the arrangement.

The International Institute for the Unification of Private Law (UNIDROIT, an independent intergovernmental organization based in Rome whose purpose is to study needs and methods for modernizing, harmonizing, and coordinating private and commercial law across states and groups of states), in its 1988 Convention on International Financial Leasing, maintains that finance leasing is a three-party arrangement. This convention regulates only cross-border leases, but supersedes national legislation in all countries that are signatories to the convention. Further, the UNIDROIT Model Law on Leasing, which is used as a template by states in developing their own national legislation, defines a financial lease as a lease in which an asset is purchased from a supplier in connection with a lease, and the lessee chooses the leased asset and the supplier.

In a finance lease, the leased asset is typically transferred to the ownership of the lessee, or the lessee has a purchase option at the end of the lease term. This transfer of title at the end of the lease term to the lessee does not, however, classify a finance lease, which may or may not contain an option to purchase.

Several jurisdictions include additional classification criterion to define a financial lease according to which the rentals must be calculated to take into account compensation of the whole or substantial part of the cost of the leased asset. This criterion may be very important in defining finance leases for tax purposes (see chapter 3); but is not necessarily relevant when defining a lease for legal purposes; that is because the UNIDROIT Model Law on Leasing provides that, in a finance lease, the rentals take into account, or do not take into account, the amortization of the whole or substantial part of the investment of the lessor, effectively leaving the issue open for the states to decide depending on the peculiarities of their legal systems.

### Box 2-5. Uzbekistan

Before amendments were made into the Law on Leasing in Uzbekistan in 2002, the law provided for a definition of financial and operating lease. Civil Code provided for a definition of financing rent, which was different from the definition stipulated in the law, then accounting standards provided for its own definition of financial and operating lease. Before amendments were made, Uzbekistan exemplified a case of how easily a jurisdiction can fall into the trap of various terminologies with an outcome being total confusion in the market.

Many countries attempt to regulate several types of leases and introduce various definitions without accepting the fact that it is critical to ensure consistency and simplicity of legislation. The definition of leasing must serve a purpose and must deal with a particular area of regulation that it has been drafted for. For example, in Uzbekistan, the Law before amendments stated that an operating lease is any lease that is not a financial lease. However, this “lease other than financial lease” was already addressed by other legislation, namely the Civil Code and was known as a property hire. As a result, legislation introduced an artificial term that only led to confusion in the sector. It was subsequently removed after amendments were introduced in 2002.

### Box 2-6. Jordan

Jordanian Leasing Law adopted in 2003 before it was amended in 2008, created confusion in the market about what really constituted a financial lease. The critical problem within that law was the fundamental lack of a clear definition of a finance lease in comparison with a regular rent. The drafters of this law had relied too much on their stating that a finance lease was defined as a financial transaction in which the asset is transferred (by means of a purchase option) from the lessor to the lessee. Under the existing Jordanian Civil Code this transfer can also take place under a regular rental agreement.

This lack of clarity resulted in lessors losing court cases as lawyers and judges could not agree which law, Leasing Law or Civil Code, governed which contract. The matter was resolved in 2008 when a new definition based on the tri-partite principle was introduced.

this period, the lessee may be given a right of renewal. 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.

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.

Many jurisdictions restrict the minimum lease period. This must be verified in each specific jurisdiction. The minimum lease period is often related to the normal amortization period for a given asset; 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; this is what the lessee pays to the lessor.

Most financial leases are amortized on the basis of constant payments (lease rentals) over the lease period. Interest rate can be fixed or variable. Finance lease rentals include principal and interest portions. In many cases, financial lease payments may include other costs such as insurance, regular maintenance, and certain tax costs (such as property tax). These payments may be on a “pass-through” basis or otherwise structured.



In a finance lease, periodic payments (lease rentals) are most frequently calculated on the basis of an amortization plan with fixed payments.

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

### Rights and Responsibilities of the Parties to a Lease

The “freedom of contract” concept is a cornerstone of leasing parties’ rights and responsibilities. The parties should be given the maximum opportunity to provide in the contracts the full extent of their rights and responsibilities. This feature may be especially relevant to some Islamic jurisdictions where, in order for a leasing contract to be fully compliant with Share’a (that is, for it to qualify as an *Ijarah* contract; see box 2-1), the parties to a lease may agree on a different scope of their rights and responsibilities—for example, with respect to maintenance and insurance obligations.

In some situations, the legislation has to provide the framework that parties should not be allowed to derogate from. For example, lessee’s direct recourse against equipment supplier clause, discussed below, typically should be established in the law without subject to the freedom of the contract provision.

The following are the most important principles laws need to address regarding parties’ rights and responsibilities to ensure that the legal framework is effective:

- **Limitation of lessor’s equipment responsibilities and third-party liability.** The lessor

shall not be accountable to the lessee for the nonfulfilment of the sale-purchase contract by the supplier. Further, the lessor, when acting in its capacity as owner shall not be liable to the lessee or third party for death, personal injury, or damage caused by the leased asset or its use.

- **Lessee’s absolute duty to pay leasing payments.** Known as a “hell and high water” clause, this principle ensures that the lessee’s obligation to perform its obligations (especially monetary obligations) are irrevocable and do not depend on any circumstances (for example, destruction of the asset or inability to use the asset due to damage). This principle helps ensure a level playing field with other credit instruments.
- **Lessee’s direct recourse against the supplier.** In a finance lease, the lessee is the beneficiary of the supply agreement, and the legislation must provide the lessee with the legal status the lessor has in its capacity as a buyer of the asset under the prevailing legislation. Since the lessee typically is not a party to a supply contract, the law will provide the lessee with the right to address all claims that stem from the supply contract directly to the supplier as if the lessee were a party to that contract.

### Leasing Arrangements in Islamic Countries: The *Ijarah* Contract

Islamic leasing, or *Ijarah*—referring to *Ijarah Muntahia Bittamleek* (lease to own)—is the most rapidly growing of Islamic financial product. Because debt typically cannot be resold in Islamic countries, but must instead once created be held to maturity by the originator of the transaction, the ability of *Ijarah* leases to be sold on secondary markets makes them an increasingly desirable product.

Literally, *Ijarah* 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.

Despite their fulfilling essentially the same function, there are a number of differences between *Ijarah* and conventional leasing, as listed in the table below. The key differences are highlighted in Box 2-7.

## Registration of Leased Assets and the Lease as a Security Interest

One common element of a project to develop leasing of movable assets, generally equipment, in an emerging market is a registry in which the lessor may publicize its interest in the leased asset. The rationale for registration is to give a potential buyer, or perhaps a potential secured creditor, a means by which to determine whether an asset it proposes to buy or to accept as collateral is free of prior interests, specifically the lessor's ownership interest. By registering its interest, the lessor establishes its priority in the asset against such later interests. A buyer or

secured creditor that fails to check the registry cannot claim to be an innocent purchaser or secured creditor, because registration gives constructive notice. The rationale for registration applies to both finance leases and long-term operating leases, since both lease types are not discernible without publicity.

In many emerging market countries, secured transactions—or collateral, law, and registry development—occur in the same timeframe as leasing development. Those registries provide the same type of notice and priority benefits as leasing registries. In fact, a lessor's interest and a secured creditor's interest are similar, in that both depend on registration to preserve priority against later interests. In both cases, the interest may not be discernible by a potential buyer or later secured creditor unless it is publicized in a registry. Since the concerns are the same, and since the types of assets may be the same, both types of interests should be registered in the same registry in jurisdictions where both leasing and secured transaction laws exist.

The registry model recommended by IFC for secured transactions is **notice registration**, where only a simple notice is registered rather than the whole agreement. All rights between the parties are established by the agreement without registration. The only purposes of registration are to publicize the interest of the

### Box 2-7. Differences Between *Ijarah* and Conventional Leasing

- **Ownership responsibilities.** A conventional 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 assets.** An asset subject to an *Ijarah* contract must not be haram (unacceptable under Islamic standards). Thus, *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.

Source: "The Islamic Lease", W.R Johnnie Johnson, Euromoney Leasing Yearbook, 2005.

Table 2-1.		Conventional v. Islamic Lease	
Feature	Conventional	Ijarah	Comments
Accounting treatment	Finance or operating	Either finance or operating, if to be accounted for under either international or U.S. financial standards; operating only, if accounted for under the standards of the Accounting and Auditing Organization for Islamic Financial Institutions	Treating all leasing transactions as operating leases means that lease payments are expenses and the leased asset does not appear on the lessee's balance sheet, thus potentially understating a lessee's liabilities and assets
Ownership responsibilities	Legal and contractual terms aim to remove all ownership responsibilities from lessor	Shari'a principles require lessor to maintain basic ownership responsibilities, including major maintenance, insurance, and taxes	<i>Ijarah</i> imposes greater ownership responsibilities and risks on lessor compared with conventional leasing
Lessee purchase options	Flexible purchase option are commonly used which can be exercised at the discretion of the lessee	Shari'a may require a clear "promise to buy" by the lessee or "promise to sell" by the lessor to avoid any uncertainty in the transaction	To be compliant with Shari'a, financial contracts must typically define unambiguous obligations for the respective parties: because an option clause leaves it unclear whether the title will transfer or not, it is generally not allowed, and, Islamic leases instead require a clear statement of intent to buy or sell
Insurance	Lessee typically responsible for insurance	Lessor responsible for insurance and its cost	Cost of insurance paid by an Islamic lessor may be passed on to the lessee
Maintenance	Lessee typically responsible for all maintenance	Lessor responsible for major maintenance	Islamic lessors have greater maintenance responsibilities which increase complexity and, at times, cost relative to conventional leasing
Late fees and interest on past due amounts	Late fees commonly charged along with interest on amounts past due	Not usually allowed, and if collected, must be donated to charity; lessor may ask lessee to make an early payment to compensate for a late payment	The inability of Islamic lessors to collect late fees and related interest could have pricing implications for <i>Ijarah</i> contracts and could lessen incentives to pay
Type of assets leased	Unrestricted	Assets that are used in relation to activities or products prohibited under Islam are not permitted.	Conventional lessors can lease a broader range of assets, possibly giving them a competitive advantage

### Box 2-8. *Ijarah*

Islamic Share'a principles and traditions have created problems within the interpretation of leasing laws. In the Republic of the Maldives the leasing law defines a finance lease as a lease in which the lessee assumes all maintenance responsibilities. In Islamic jurisprudence parties are required to share their risks among each other, so a debate has focused on the fact that Islamic institutions that conduct *Ijarah* operations are effectively not able to benefit from provisions of the leasing law because in their contracts lessor may assume certain level of equipment responsibilities.

It is important to ensure that leasing laws are inclusive and are designed to address the needs of various finance institutions that want to structure their deals in different ways. For example, in Yemen, the Law on Leasing that was passed in 2007 did not provide for restrictive definition and also allowed the parties in many instances to agree on terms other than the ones stipulated by the law. For example, the hell and high water principle (the lessee's unconditional obligation to perform his/her obligations) in some conservative Islamic jurisdictions has not been considered to be compliant with Share'a whereas more liberal Islamic schools such as in Egypt consider hell and high water to be compliant with Share'a. Given these varieties of approaches, the law would be better if it provided a freedom of contract clause that allowed the parties in a contract to agree on terms deemed acceptable in the context of their transaction and their beliefs.

Islamic jurisdictions that are experienced in various Islamic finance products including *Ijarah* may react faster to the changes in legislation and use them to their benefit. For example, in Yemen before the law was introduced in 2007 only one Islamic Bank provided *Ijarah*. At the end of 2008 three new Islamic banks entered the *Ijarah* market with the total leasing portfolio growing 400% (from USD 13 million to USD 56 million) in one year.

secured creditor in the asset and, by so doing, to establish priority in the asset in the event enforcement is necessary. The notice consists only of identification of the debtor, identification and contact information for the secured creditor, and a description of the secured asset. Since registration does not create rights between the parties, it does not require formalities such as signatures or notarization. Registration is voluntary; if the secured creditor is not concerned about the risk of later interests in the asset, it is not necessary to register.

The same model is appropriate for publicizing a lessor's interest in a leased asset. Therefore, notice registration is the recommended solution for a combined leased asset and secured transaction registry.

The registry may, and should, also be used to publicize types of otherwise hidden interests in movable assets as well. These might include the interest of a consignor of consigned goods or the

interest of a buyer of accounts or secured sales contracts.

Note that the lessor effectively holds a purchase-money security interest in the asset and therefore is a secured creditor for the purposes of the secured finance transaction legislation. In practice, this means that the leasing law shall not establish exclusive priority rules for leases and that the lessors' priority right must be governed by the legislation on secured finance transactions.

### Repossession of Equipment Under Lease

Repossession is a key element of leasing, enabling credit providers to secure their asset efficiently and to realize funds from asset disposal. Without this 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:

### Box 2-9. Registration of Assets and Security Interests

Some governments, such as Egypt, still require the registering of lease contracts whereby representatives of the lessee and the lessor must be present in a registrar's office when the contract is signed. Unfortunately, this form over substance practice adds no benefit to either the lessor or the lessee. Rather, it is an unnecessary administrative and expensive burden that may even prevent leasing companies entering the market (especially microleasing institutions) if the registration cost is prohibitively high (in Jordan, for example, the cost was USD 75 before this burden was removed in 2008).

In Jordan, the 2008 Law on Leasing now requires that only notices of lessor's interest in assets be registered—a practice that can greatly benefit leasing industry.

- In the event of a default by the lessee, there should be scope within the legislation to allow it to voluntarily return the leased asset to the lessor without penalty other than its obligations under the lease, which will of course include its obligation to repay all outstanding capital plus accrued interest, overdue interest, and any agreed fees.
- Where the lessor attempts 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. However, such lawsuit that the lessee may file shall not prevent the repossession order from being executed and enforced and lessor should be free to sell the leased asset regardless of the action of the lessee.
- 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 such as 10 days) or notary writ (a writ issued by a notary that 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.

When considering repossession, lessors must not only consult the law on leasing and the contractual terms and conditions but also other laws that may be relevant such as the Civil Code. If any of these laws may be considered to be superior or even equal to the leasing law and do not permit self-help repossession then the lessor must seek guidance, efficiency is critical to 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. The process must be balanced to prevent abuse by lessees—that is, to ensure that lessees fulfill 100 percent of the obligation of their lease.

In normal commercial leasing sectors, the lessors will attempt to resolve any default in a fair manner and will only repossess the asset as a last resort. The lessor would normally inform the lessee to make the asset available for repossession and may even agree on a specific time for its collection.

### Box 2-10. Self-Help Repossession

“Self-help repossession” is a unilateral act by the lessor supported by no legal process or permits. Basically, the lessor, without asking or informing anyone, comes to the lessee's premises and takes back the asset. This self-activated method of repossession can positively affect the leasing industry if allowed by the legislation. However, it must be conducted in a way that does not breach the peace.

### Box 2-11. Repossession

The right of a lessor to repossess leased assets from a lessee in the event of the lessee's breach of the terms of the lease contract should be one of the fundamental elements of all leasing law. Ideally the repossession should be initiated with no requirement of the lessor to apply for any additional permission from any court or government department if the leasing law clearly states that the lessor has the right of repossession. However, the lessor must also ensure that he is not in breach of any other local laws that prohibit his repossessing assets subject to lease contracts that are in breach of the contractual terms and conditions. If any such law, such as the Civil Code, prohibits repossession without a court order then the lessor must comply with the legislation.

## Bankruptcy of the Lessee or Lessor

In cases 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 (the lessor). In cases where the bankrupt lessee's liabilities are assumed by another party and there is no default on the lease agreement, the successor may retain the lessee's rights under the lease agreement. This will require the acceptance of the lessor, which will assess the creditworthiness of the new party and request that a new lease contract be signed. This situation may arise when 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.

In cases where the **lessor** is deemed bankrupt, this should have no practical effect on the lessee. If the lessee respects his lease agreement obligations, 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 which 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 only able to enforce the rights of the original lessor 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 the new party. This must be supported by legislation that provides that the transfer of ownership does not lead to termination of the agreement and cannot be considered grounds for such termination.

## Insurance of the Leased Asset

A functioning, effective insurance industry is critical to the development of the leasing industry, as insurance provides coverage to protect the asset under lease. Hence, **all leased assets must be insured.**

Every leasing company controls the insurance of its assets in two ways. Firstly, at the commencement of the lease and before the leasing company pays the invoice of the equipment supplier, either the leasing company or the lessee must organize and pay for a fully comprehensive and all-risks insurance of the asset subject of the lease. The insurance must start at the delivery of the asset, and it doesn't need to be linked to the payment of the supplier's equipment invoice. For example, in the case of a supplier credit, where the supplier agrees that the payment of the asset can be delayed, the start of the insurance is not tied to the payment of the equipment invoice. In all instances, the equipment should be insured from the delivery day.



Some leasing companies insist that the insuring procedure is controlled by them and also insist that the lessee only uses an independent insurer that is acceptable to the leasing company. Secondly, most insurance policies are only valid for a period of 12 months (although this may be longer in more mature markets). The leasing company must therefore confirm with the lessee and receive tangible proof that the leased asset has been reinsured for another 12 months and then annually until the end of the lease.

The insurance policy must clearly state that the leasing company has an interest in the asset subject of the policy. In the event of any insurable claim whether for damage or for total loss the leasing company must receive all payments from the insurance company. The insurance company shall notify (inform) the lessor if the lessee cancels the insurance agreement or contract or if the lessee does not renew the leasing contract or decides to change the insurance company.

Although the leasing company may control the insurance procedure, the full cost of the insurance for the complete duration of the lease is payable by the lessee. Some leasing companies choose to pay the annual premium directly to the insurance company and then invoice the amount of the premium (sometimes with a handling fee) to the lessee. Although this procedure generates additional work for the leasing company it does ensure that the assets within their portfolio are continuously covered against damage or total loss.

However, in the majority of emerging markets SMEs cannot afford the annual all-risks insurance because it's too expensive. To overcome this obstacle and facilitate the introduction of equipment insurance, some leasing companies have established a monthly insurance agreement with insurance companies, and the premium is integrated in the monthly lease instalments. The lessee pays the monthly lease instalment and the leasing company pays the premium to the insurance company, regardless of the lessee's capability to service

the lease. This type of solution makes the fully comprehensive and all-risks insurance accessible to lessees in emerging markets, and gives a lasting guarantee to the leasing company that the leased asset is insured. Hence, leasing is not only a useful equipment financing tool for SMEs, but it often facilitates the development of the insurance culture in the SME sector.

Generally speaking, the development of the leasing business generates the development of the insurance market for two main reasons:

- the insurance company is considered as one of the important funding sources or solutions for the leasing company; and
- the fully comprehensive and all-risks insurance of the asset that is subject of the lease is key to developing the leasing market in developing countries.

## Fiscal and Accounting Considerations

The question of accounting and taxation rules for leasing, that is developed in details in Chapter 3 below, has often been a source of confusion and delayed implementation when it comes to how best to implement tax and accounting amendments into an existing legal framework. It is tempting to include fiscal issues within the law on leasing and to recommend adoption of International Accounting Standard (IAS) 17, Leases, as the framework for incorporation within leasing legislation. However, IFC's experience in preparing leasing legislation in many countries has proven that the law on leasing will have greater relevance without reference to accounting or fiscal issues.

This experience has established that attempting to address the various aspects of a lease—including tax, legal, and accounting—in a single act could create potential conflicts between it and other specialized laws such as the tax code, the law of enforcement, and so on. IFC therefore recommends that a comprehensive approach to legislative reform be undertaken that includes adopting/amending the law on leasing

as a part of the civil regulation framework and revising existing tax codes, enforcement laws, accounting regulations, and so on, to ensure that leasing issues are properly addressed in all aspects of the legislation.

## Prudential Regulation

Regulated financial institutions tend to be better able to attract funding from the capital markets, and therefore to be more sustainable on the long term. However, overly regulating may prevent innovation at early stages, and many success stories of leasing development have occurred in non-regulated leasing markets. At early stages of development of the leasing sector, it may therefore be harmful to over-regulate the market. As the leasing sector develops, it may then be useful to regulate and supervise leasing activities as leasing companies raise funds from various sources and start playing a significant role in the local

financial sector, in terms of asset size. Overall, minimal regulation is recommended for leasing companies as most of them are non-bank financial institutions who do not accept deposits.

The need for regulation should be balanced by an understanding that it can be, and demonstrably has been in some countries, counterproductive. IFC has found that poorly executed and designed regulations are often a major impediment to business. 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

### Box 2-12. Factors to Consider When Imposing Prudential Regulation for Non-deposit Taking Lessors

- In case of the lessor's default, there is no risk for the lessees. The lessee 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 an entrepreneurial risk 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 than it would in any other enterprise.
- If regulation of lessors is aimed at deterring potential abuse of possible tax privileges, setting clear parameters and classifications on the lease transaction should give the tax authority and other regulating bodies sufficient definition to classify and reject nonconforming leases that exist only to exploit tax advantages. Prudential regulation does not create a shield against potential tax abuses.
- 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 noncompetitive position.
- Many developed countries only require non-deposit taking lending institutions to comply with non-prudential regulation. For example, a lessor may be required to file annual audited statements as good disclosure/transparency requirements, be subject to fit and proper screening, abide by anti-money laundering legislation, etc.
- Argument is often made that "bad" leasing companies may harm the entire industry. While this may be true, it is no different for example than "bad" (incompetent) shoemakers producing bad shoes, and harming the reputation of the industry. Good (effective) companies will survive and prosper, while ineffective companies that do not adapt will inevitably be put out of business by market forces.



sources and its clients are in a better position to judge how well the lessor company is being run as opposed to 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.

The type of lessor involved also plays a role in determining the need and kind of regulation to be applied. Nonbank, nondeposit-taking leasing institutions may not need the same level of stringent regulation as deposit-taking commercial banks; and, in some cases, no specific prudential<sup>8</sup> regulation may be necessary. The necessity and level of regulation depends on a variety of factors, including the overall legal and regulatory framework, and needs to be assessed on a case-by-case basis.

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8. Regulation is prudential when it is aimed specifically at protecting financial system as a whole and governs financial soundness of licensed lessors in order to prevent financial system instability and losses to small unsophisticated depositors.

## Supervision

As used by IFC, **supervision** refers to an external oversight over activities of lessors aimed at determining and enforcing compliance with regulation either prudential or non-prudential.

Within financial sectors, it is commonly agreed that any institution that has the authority and ability to accept deposits from the general public should be supervised. However, non-deposit taking nonbank financial institutions are treated by the relevant authorities in many diverse ways on an international level. This varies from no prudential supervision at all, with any individual or company able to offer leasing, to leasing companies being regulated by very high minimum capital requirements and being supervised in the same manner as local banks.

In some cases (for example in the case of Thailand highlighted above) prudential regulation of non-deposit taking lessors can be considered to prevent instability of financial system as whole. In such case, existing supervisory institutions, such as banking supervisor agencies, would be better positioned to perform a supervisory function.

### Box 2-13. Supervision

If supervision is deemed to be necessary it must be imposed in a transparent and consistent manner with no room for interpretation.

In Jordan, before the law in 2008 abolished licensing requirements, all companies in order to conduct their leasing activity were required to obtain a license from the Ministry of Industry and Trade. The MIT would grant this license on the condition that a leasing company had a paid-in capital of USD 1.4 million. The MIT did not carry out any prudential or non-prudential regulation of lessors simply because it did not have adequate capacity and the Central Bank rejected the idea of taking supervisory control over leasing companies, explaining that they were not deposit taking institutions and did not need to be supervised.

Since the ministry did not (and did not plan in the future) to exercise supervision of leasing companies, the government decided to abolish the licensing and minimum capital requirement (MCR) for lessors considering such practice to be unnecessary. In Jordan, no one supervised the lessors and their number was not that significant to limit or consolidate the market. The maintenance of MCR to ensure that the company has sufficient capital in case of its potential bankruptcy was not considered by the Jordanian government as a good reason for maintaining the MCR limits, as it has been proven that MCR does not necessarily help to protect stakeholders in the case of a company's insolvency.

In many jurisdictions where leasing markets only beginning to develop there would be no need to conduct prudential supervision and only non-prudential supervision could be considered which is limited to for example, “fit and proper” screening, analysis of audited financial statements, etc. In such case, existing supervisory institutions, such as banking supervisor agencies, may not be the best body to perform supervision of leasing operations. Their experience in dealing with complex banking regulations may not transfer to supervising leasing companies that may be a one-product operation, with average customer exposures much smaller than those within the banking sector, and various accounting procedures and policies.

As with regulation, lessors will always be supervised by their potential customers and by their competitors. This form of market self-

supervision has proven to be very successful in many countries with a highly developed leasing sector.

### Minimum Capital Requirements and Licensing

The minimum capital requirement (MCR) means that active financial organizations are expected to retain a minimum level of capital to serve as a foundation for future growth and provide liquidity as a cushion against its unexpected losses. The MCR thus limits their lending to a proportion of their net asset value. MCR plays a key role in the regulation and supervision of financial organizations. Only those entities that can meet MCR are licensed<sup>9</sup>.

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9. License is a formal government permission to engage in leasing activity that will subject the license-holding lessors to supervision (typically prudential).

#### Box 2-14. 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 lessors (banks) to meet their liabilities. Further, MCR is typically established by regulators only to limit the number of entities to exercise effective supervision. Thus, if no supervision is contemplated then there might be no compelling reason to impose MCR.

Lessors conduct ordinary entrepreneurial activity and are most of the times non deposit-taking institutions. Their default is typically 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 microleases, but does not have the necessary amount of capital required by legislation.

Typically, most lessors would ensure that their company has sufficient capital to run successful leasing operation and raise funds from outside investors. Those lessors who set small capital will have difficulties growing and expanding their businesses and will eventually have to raise the capital or merge with other small companies. However, there is no need to discipline or consolidate the market with MCR unless supervision is sought.

## CHAPTER 3

# Accounting for and Taxation of Leases



This chapter discusses the financial treatment of leases and leasing. Specifically, it examines the procedures and issues involved in (1) accounting for leases in accordance with international accounting standards and (2) the tax treatment of leases vis-à-vis the value added tax and income tax, as well as the effects of any tax benefits applied.

### The Dilemma of Lease Accounting

A key difficulty in lease transactions is how the leasing parties should account for them, given that the lessee does not have legal ownership of the asset, yet has the right to its use for most, if not all, of its productive life.

Before leasing accounting standards were formally established, the lessee would record the transaction as a simple rental in its profit and loss account and would not record it in its balance sheet—thus making the leased asset an off-balance sheet item (which was once considered to be a particular advantage of lease financing). While fully justified from a legal perspective, this approach created at problems several aspects, including:

- **Understatement of operating assets.** Based on the fact that they did not have legal ownership of the leased assets, companies were not recording them in their financial accounts. A company that acquired a substantial proportion of its assets under finance lease arrangements was thus understating the amount of fixed assets it was using in its balance sheet. Therefore, its return on capital employed was overstated and misleading.
- **Ambiguity regarding debt level.** A lease creates a commitment by the lessee to make future lease payments. These financial commitments were not properly captured in the lessee's accounts, thus obscuring a company's

overall debt position and understating its debt-to-equity (gearing) ratio.

Various local and international accounting boards sought to remedy these shortfalls and ensure accurate and transparent accounting for leases. Chief among them was the International Accounting Standards Board, which issued comprehensive guidance as IAS 17 in 1982.<sup>10</sup> The standard attempted to address the root of the leasing accounting dilemma by essentially endorsing substance over form. Under IAS 17, the lessee is recognized as the economic owner of the asset, with the leased asset recorded on the lessee's balance sheet along with its other wholly owned assets.

### Toward International Harmonization of Lease Accounting

Beyond improved transparency and accuracy, reform of lease accounting had another objective: to harmonize practices across countries, as well as across individual businesses.

The importance of international harmonization of accounting practices is now widely accepted for several reasons:

- The rapid development of international capital markets is strengthening the dominant role of the financial market as an economic resource distributor. The methodologies (and, importantly, the transparency) by which information is disclosed to the market is a central issue in ensuring market efficiency.

10. This guidance was revised in 1997 and is primarily interpreted under SIC (Standing Interpretations Committee) 15, Operating Leases—Incentives. Note that standards issued by the International Accounting Standards Board prior to 2001 were called “International Accounting Standards,” standards issued subsequently are referred to as “International Financial Reporting Standards.”

- The increasingly common practice of multinational corporations listing their equity stocks on more than one stock exchange has generated an urgent need for a single universal set of accounting standards for these companies in order to reduce information production cost and send out a unified, reliable message to the market.
- The activities of major investors are becoming more and more internationalized. Their presence in foreign markets is forcing domestically listed companies to accept the global rules of accounting.

The adoption of international standards means that global rules control and restrict the once commonplace opportunities available for claiming tax allowances in more than one country. In leasing, this practice was most prevalent where cross-border leasing was used in the absence of a domestic leasing industry (see box 3-1). As leasing develops and its accounting treatment becomes more unified across countries, the necessity and desirability of cross-border leasing diminish.

### Lease Accounting Standards

Having established the need for an international accounting standard for leasing, a question remains about which of the several that have been

developed should be adopted. Of the various standards that address the issue of accounting for lease contracts, IFC encourages the adoption of IAS 17, which is the standard generally adopted by lessors and lessees in many of the developed leasing markets. IAS 17 removes the uncertainty of accounting policy for these key parties in a lease contract and helps ensure that local accountants and tax authorities have clear references that have been adopted at the international level. IAS 17 provides clear direction for the beneficiary of fiscal depreciation; the treatment of interest payable and receivable; and acknowledgement of the importance of economic ownership.

Apart from IAS 17, there are two other important standards that have been developed to address lease accounting; the Statement of Standard Accounting Practice (SSAP 21), Accounting for Leases and Hire Purchase Contracts, and the Federal Accounting Standard (FAS 13),—Accounting for Leases. In order to highlight differences, and indeed similarities, between these two standards and IAS 17, a broad framework for SSAP 21 and the FAS 13 is highlighted in the next page.

SSAP 21 was implemented in 1984 by the Institute of Chartered Accountants in England and

#### Box 3-1. Cross-border Leasing

Cross-border leasing is the creation of a leasing contract between a lessor and a lessee that are each registered in a different country. It often involves particularly expensive capital assets, such as aircraft, and its tax implications can be highly complicated. Additionally, it is often incorrectly associated with foreign investment.

In principle, no special fiscal incentives should be required, and in practice they rarely are. If the import of certain assets is desirable, it should be encouraged directly and not through cross-border leasing.

Internationally, assets that are leased on a cross-border basis are typically limited to those that are actually used across borders, such as airplanes, certain rail equipment, ships, and transport vessels. Most other types of assets are simply leased domestically.

Ideally, cross-border leasing should have no particular advantages or disadvantages over domestic leasing. In practice, relatively small amounts of equipment are financed on a cross-border basis worldwide, although the amounts are significant in certain industries such as those using the equipment mentioned above.

Wales, and is applicable in the United Kingdom and Ireland. It takes an approach similar to that of IAS 17. Both standards define a finance lease as one that transfers substantially all of the risks and rewards of ownership to the lessee. However, IAS 17 goes a little further in that it provides examples that would assist an accountant in making a judgment as to whether a lease is a finance or operating lease.

The Financial Accounting Standards Board of the United States issued the FAS 13, Accounting for Leases, in 1976. Under the recommendations of FAS 13, any lease meeting one of the following four criteria is a capital (that is, finance) lease:

1. The present value of the minimum lease payments (as calculated and documented at the start of the lease term) equals or exceeds 90 percent of the fair value (normally accepted as being the original cost or invoice value) of the asset.
2. The lease transfers ownership of the asset to the lessee at end of lease.
3. The lease contains a purchase option.
4. The lease term is equal to 75 percent or more of the estimated remaining economic life of the asset. However, if the lease term begins within the last 25 percent of the total economic life of the asset, then this criterion should not be used for the purpose of classifying the lease.

The FAS 13 gives an accountant very little scope for judgment and thus increases the likelihood that similar leases will be treated in a similar fashion.

While all main lease accounting standards share the same basic principle (prevalence of substance over legal form), the main differences between IAS 17 and SSAP 21 are their guidelines about determining whether a lease is a finance or operating lease. Table 3-1 summarizes the main feature of all three standards.

However, choosing to adopt the IAS 17 raises the question of how to implement it. In implementing an international accounting standard, a number of issues must be taken into consideration. The first is the level of economic and social development in each country. Such variation in development levels would require in some cases the need to have more elaboration on the definitions and guideline of lease accounting issues. Also implementation of the IAS 17 guidelines for the lease accounting must cope with the extent of knowledge and needs of the different users of accounting standard.

### Accounting for Finance Leases Under International Financial Reporting Standards (IFRS)

Under IAS 17, accounting for the lease transaction is based on the economic substance of the transaction rather than its legal form. In this view, the lessee is essentially buying the asset

Table 3-1. Characteristics of Main Accounting Standards		
Basic	Principle	Lease Classification Criteria
IAS 17	Financial leasing transfers substantially all of the risks and rewards of ownership	Provides only examples for what can be a financial leasing, but without definite cutoff points.
SSAP 21	Financial leasing transfers substantially all of the risks and rewards of ownership	Does not provide examples, rather, one single cutoff point is set (Present value of lease payments $\geq$ 90 percent of the fair value of the leased asset.
FAS 13	Financial leasing transfers substantially all of the risks and rewards of ownership	Does not provide examples, rather, provides a clear cutoff conditions.

from the lessor. Or, put another way, rather than paying cash for the asset, the lessee is financing the asset purchase with a loan from the lessor.

As shown in figure 3-1, under IFRS, a lease is considered a finance lease if it has at least one of the following characteristics; otherwise, it should be treated as an operating lease.

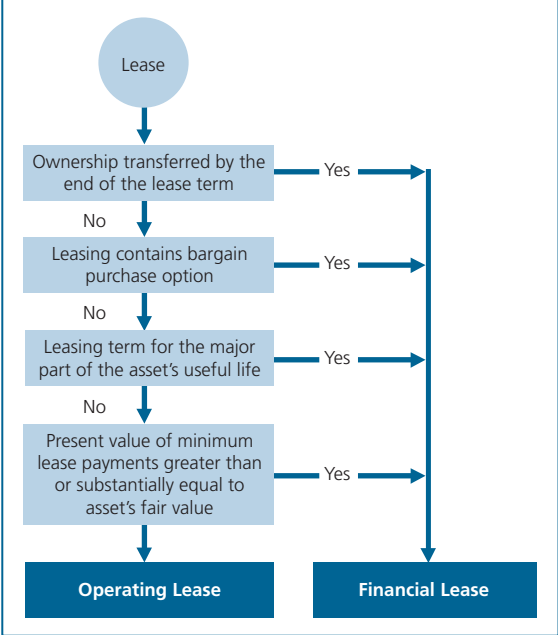
- The lease transfers ownership of the asset to the lessee at the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable on the condition that, at the inception of the lease, it is reasonably certain the option will be exercised.
- The lease term is for a majority of the useful life of the asset and where 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 asset is of such a specialized nature that only the lessee can use it without major modifications.

With the application of IFRS for the accounting for leases, a number of distinguishing features emerge between a lease and a conventional bank loan. These are listed in the table next page:

### Tax Treatment of Leases

IFC’s experience has shown that the tax treatment of leases for both the lessor and the lessee is a major determinant of whether a country develops leasing as a successful financial product. Both in reviewing existing leasing legislation and in drafting new legislation, IFC has found that those countries with laws that create no discernible tax treatment differences between finance leasing and bank loans have the most vibrant leasing sectors. Thus, the main principle to keep in mind when drafting leasing tax legislation is the need to create a level playing field between leasing and other forms of credit.

**Figure 3-1. Classification of Lease Contracts**



Source: IFC 2004

This section looks at the major aspects of the two main taxes that affect leasing, the value added tax and income tax. While these two taxes are particularly relevant to leasing, other fiscal taxes and fees, such as capital gains tax and custom duty, have a profound impact on leasing as well. However, as the Income and Added Value taxes have the most profound effect on the development of leasing in any particular country, we focus our following discussion of these two taxes.

### General Considerations

#### Preferential Tax Treatment

Governments should retain the right to introduce preferential tax treatment to leasing in the interests of developing the sector domestically by encouraging investment. Note, however, that the main reason for providing preferential tax treatment should be to increase domestic investment, not to stimulate the leasing sector.

If governments do decide to introduce preferential tax treatment for leasing, three elements should be taken into consideration.



Table 3-2. Differences Between Lease and Conventional Bank Loan			
Feature	Bank loan	Finance lease	Operating lease
Economic ownership	As the legal owner of the asset the borrower is also the economic owner of the asset.	The lessee is the economic owner of the asset. This right is given to him by the lessor in consideration of his signing a legally enforceable finance contract that obligates the lessee to make regular repayments.	The lessor is the economic owner of the asset. The lessee only has the right of temporary usage.
Balance sheet	The borrower will place the asset on his balance sheet	The lessee will place the asset on his balance sheet	The lessor will place the asset on his balance sheet
Accounting depreciation	The borrower will benefit from any fiscal depreciation	The lessee will benefit from any fiscal depreciation <sup>11</sup>	The lessor will benefit from any fiscal depreciation
Profit and loss account	The lender will treat <i>interest</i> paid by the borrower during the accounting period as (taxable) income. The borrower will treat <i>interest</i> paid during the accounting period as a (tax deductible) expense.	The lessor will treat <i>interest</i> received from the lessee during the accounting period as (taxable) income. The lessee will treat <i>interest</i> paid during the accounting period as (tax accounting deductible) expense.	The lessor will treat <i>lease rentals</i> receivable during the accounting period as (taxable) income. The lessee will treat <i>lease rentals</i> paid period during the as a (tax deductible) expense.

11. In some counties (including Russia), the legislation allows the lessee and the lessor to choose which of them benefits from any fiscal depreciation.

- **Tax benefits should be moderate.** The over-endowment of preferential tax treatments for leasing may cause distortions in domestic markets and ultimately a negative effect on the general financial sector.
- **Preferences should be limited.** Any preferential treatment should be for a limited time period only, and that period should be established at the time of introduction to enable the sector to plan accordingly. Ultimately, the whole tax system must be considered. In many cases, some tax benefits are given to offset other disadvantages; this approach may be pragmatic and effective. Judgments must be made on an individual country basis as to what is appropriate.
- **Preferences should be targeted.** Any preferential treatment should be directed to specific industry sectors or equipment the government wishes to favor for whatever reason. In general,

if such incentives are left open in absolute terms, it will create an opportunity for abuse, with benefits being enjoyed in the wrong areas.

### Defining Leasing for Tax Purposes

The best definitions are those that leave no room for interpretation. Unfortunately, the development of the leasing sector has suffered not only from differences in interpretation but also from a lack of definitions. The existence of leasing legislation seldom mitigates this problem, as the content does not define leasing for tax purposes. Some tax authorities have accepted the accounting definition of leasing and use this in their tax assessment calculations. For tax (and other) purposes, a country's leasing industry must have in place an unambiguous and transparent definition of what constitutes a leasing transaction.

## Value Added Tax

The level playing field between bank loans and finance leases depends to a large extent on the application of the VAT in leasing transactions. This section provides a general description of the VAT and examines the major issues related to the VAT in this regard: the classification of leasing transactions as a supply of goods or a rendering of services, VAT set-off rights in leasing transactions, and VAT tax credits.

### VAT Definition and Features

The VAT is a tax on consumer spending collected by VAT-registered traders on their supplies of goods and services to their customers. Each trader in the chain of supply 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. Thus, the VAT is a consumption tax borne ultimately by the final consumer and is not a charge on businesses.

The 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. The VAT is paid to the tax authorities by the seller of the goods, but it is actually paid by the buyer to the seller as part of the price. It is thus an indirect tax.

There are two distinct types of VAT that all business types registered to charge and reclaim the VAT must account for:

- **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 distinctive feature of the VAT is the offset mechanism. The VAT is collected fractionally, via a system of partial payments whereby taxable entities (that is, VAT-registered businesses) deduct from the VAT they have collected the amount of VAT tax they have paid to other taxable entities on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved. Table 3-3 illustrates how this works with a VAT rate of 20 percent.

### Box 3-2. Sales Tax Treatment in Jordan

The relevant legislation for the treatment of leasing sales tax (which is similar to VAT) in Jordan predates the use of leasing as a financing tool. Thus, it does not clearly address the sales tax treatment of financial leasing transactions. Consequently, leasing tax treatment has been based on judicial interpretation of general sales tax law articles, resulting in differing tax treatments for various types of lessors.

- Leasing transactions provided by banks were exempt from tax.
- Leasing transactions provided by bank-affiliated lessors were partially exempt.
- Leasing transactions provided by stand-alone lessors were completely subject to sales tax.

While this uneven treatment provided a cost advantage for some lessors and a disadvantage for others, the whole leasing market was negatively affected. Treatment was not only unfair, but was based on a judgment that could be changed at anytime by a new legal interpretation. Approximately 70 percent of registered lessors decided not to participate in the market until this ambiguity is removed.

The problems of these differing tax treatments of leases have increased as the financial markets have developed. Both government authorities and lessors now recognize the importance of resolving this situation. The government of Jordan is currently considering two options: (1) to subject all financial intermediary services to sales tax or (2) to exempt leasing transactions provided by all categories of lessors from sales tax. Both options will create clarity and ensure a level playing field.



Tracking the transaction in table 3-3 through stages 1 to 10 (and then back to 1), the consumer pays a total of 600 for the finished product, of which 100 is VAT; the tax authority receives the 100 VAT in stages during the sales process from the manufacturer to the ultimate consumer. The example here assumes that the end consumer is not registered for the VAT and therefore cannot recover the 100 VAT.

In the event that the final consumer *is* registered for the VAT, the full transaction would change as shown in table 3-4.

The tax authority therefore receives no benefit from the VAT (except from the timing difference of having received the VAT from the manufacturer, wholesaler, distributor, and retailer before returning the total received to the VAT-registered consumer). So, the main noticeable difference between the final consumer being registered or non-registered, is that the registered consumer will be able to reclaim the VAT amount it has paid and hence, VAT will have natural effect on the cost of the purchases. This is not possible for the non-registered consumer. VAT for the latter will be considered part of the cost.

**Table 3-3. Application of VAT in Different Stages of Added Value Chain**

Purchase transactions					Sales transactions				
Added value phase	Price paid (ex VAT)	VAT	Total purchase price	Value added	Price charged (ex VAT)	VAT	Total sales price	Credit for VAT paid	Net to tax authority
1	2	3	4	5	6	7	8	9	10
Manufacturer	–	–	–	100	100	20	120	0	20
Wholesaler	100	20	120	100	200	40	240	20	20
Distributor	200	40	240	100	300	60	360	40	20
Retailer	300	60	360	200	500	100	600	60	40
Consumer	500	100	600	–	–	–	–	–	–
				500					100

**Table 3-4. Purchase, Sales Transactions for VAT-registered Consumers**

Purchase transactions					Sales transactions				
Added Value Phase	Price Paid (exVAT)	VAT	Total Purchase Price	Value Added	Price Charged (ExVAT)	VAT	Total Sales Price	Credit for VAT Paid	Net to Tax Authority
1	2	3	4	5	6	7	8	9	10
Manufacturer	–	–	–	100	100	20	120	0	20
Wholesaler	100	20	120	100	200	40	240	20	20
Distributor	200	40	240	100	300	60	360	40	20
Retailer	300	60	360	200	500	100	600	60	40
Consumer	500	100	600					100	-100
				500					0

The above construction may be modified slightly to illustrate the VAT movements in a typical finance lease (where the lessee is registered to reclaim the VAT), as shown in table 3-5.

Some countries’ tax authorities make exceptions for cars that are specifically required for business purposes; some authorities allow partial recovery of the VAT, as they assume there will always be some private use of a business car.

In leasing transactions, many tax authorities are reluctant to grant the end user the right to set-off VAT. Where the end user is a lessee, tax authorities find it hard to grant the lessee the VAT set-off right bearing that the purchasing invoice

is not issued in the name of the lessee and hence, the latter does not have the legal ownership.

Another reason for tax authorities’ reluctance arises when the leasing added value is exempted from VAT. In such a case, and based on the VAT rule that states “if the supplier’s sales are VAT exempt, the supplier cannot claim VAT paid on the purchases directly connected to these exempted sales. Based on such a rule, if the leasing services (the sales) are exempted from VAT, the lessor (the supplier in leasing truncation) will not be able to collect the VAT paid on the leased asset, hence, lessor will factor VAT in the leasing contract as being part of leased asset cost, and accordingly, increasing the cost of the leased

Table 3-5.

VAT Movements in Typical Finance Lease

Purchase transactions					Sales transactions				
Added Value Phase	Price Paid (ex VAT)	VAT	Total Purchase Price	Value Added	Price Charged (ex VAT)	VAT	Total Sales Price	Credit for VAT Paid	Net to Tax Authority
1	2	3	4	5	6	7	8	9	10
Equipment Manufacturer	–	–	–	100	100	20	120	0	20
Equipment Distributor	100	20	120	100	200	40	240	20	20
Equipment Dealer	200	40	240	100	300	60	360	40	20
Lessor	300	60	360	0 <sup>a</sup>	300	60	360	60	0
Lessee	300	60	360					60	-60
				300					0

a. In case that finance lease added value (interest) is not subject to VAT.

### Box 3-3. The VAT and Leased Cars

In many countries, the VAT payable on new or used cars is not recoverable by either the lessor or the lessee on the invoice value of the car. The rationale behind this is that the tax authorities do not, in most cases, consider a car to be a productive asset for a company. Lessors will therefore consider the lease value of a car to be the VAT-inclusive price (in table 3-5, this is 360) and will charge interest on this amount. This maintains the level playing field approach: If the car were financed with a bank loan rather than a lease, the loan amount (assuming no down payment) would be 360 and the borrower would be unable to reclaim the VAT paid for the car.

asset from a lessee stand point. The implications of this attitude can greatly affect the successful and sustainable development of a leasing sector as it undermines lessors' ability to compete with normal banking credits.

### Leasing Under the VAT: Sale of Goods or Supply of Services?

The VAT treatment of a leasing transaction varies from country to country. One of the reasons for this variation is whether the country tax authority determines leasing to be a sale of goods or a supply of services. This classification is the fundamental issue in determining whether leasing is or is not subject to the VAT—and, if it is subject to the VAT, what mechanism will be used for applying and collecting the VAT when due.

In a number of jurisdictions, financial services, like bank loans, are exempt from the VAT. Where leasing is classified as a financial service<sup>12</sup>, the VAT is charged on the leased asset value, while the lease transaction added value (the interest) is exempted (and a level playing field achieved).

12. While countries differ, the International Standard Industry Classification (ISIC) categorizes leasing as part of the Financial Intermediary Services. Under ISIC Leasing is identified under code no. 6491 (ISIC Classification: Section: K - Financial and insurance activities, Division: 64 - Financial intermediation, except insurance and pension funding, Group: 649 - Other financial intermediation, Class: 6491 - Finance leasing.). With such classification leasing is identified as a financial service equal to loans and other forms of credit.

### Methods of Charging the VAT on Lease Rentals

IFC has found that there are, in general, four different methods for levying the VAT on finance lease rentals (table 3-6). All four have been used successfully in various jurisdictions where the leasing sector continues to develop. In selecting a levying method, the taxing authority should ensure that the method:

- suits the particular legal environment;
- does not inhibit the VAT's offset mechanism; and
- ensures a level playing field with bank financing.<sup>13</sup>

In most of the methods, the VAT is payable on the down payment (that is, the amount payable by the lessee at the commencement of the lease) and on the lease rental (each rental being a combination of capital repayable and interest).

If the lessee is able to recover its VAT payments from the tax authorities, there is not much difference among the four methods (apart from a cash flow and timing issue). In method 4, however, the lessee pays the VAT on the interest element of the lease; even though is recoverable, it makes this method compare unfavorably with

13. Method 4 does not fulfill this last requirement. However, it reflects the normal VAT treatment for an operating lease. Because an operating lease should not be compared to a bank loan, the requirement for a level playing field is not relevant.

Table 3-6. Charging VAT on Lease Rentals				
Method	VAT payable on			Level playing field?
	Down payment (capital element)	Lease rental (interest element)	Lease rental	
1	No	No	No	Yes
2	Yes	Yes	No	Yes
3	Yes (VAT payable on the full asset value)	No	No	Yes
4	Yes	Yes	Yes	No

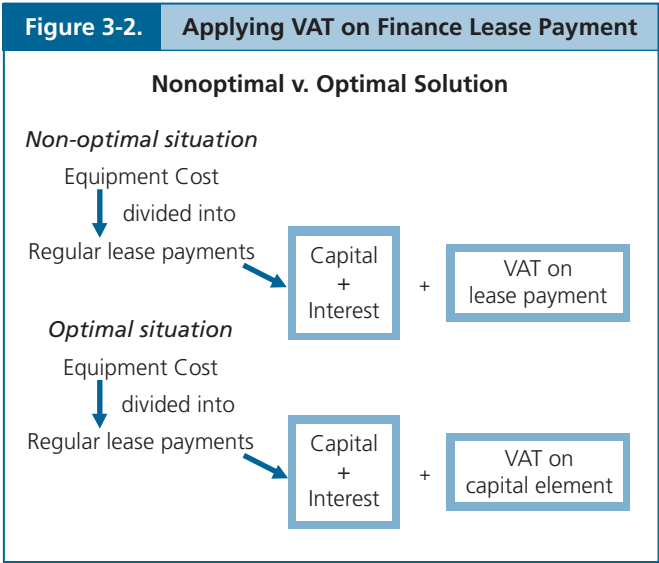
a bank loan where there is no VAT payable on the interest charged.

VAT Treatment of Finance Leases: The Options

Regardless of the way tax authorities classify a leasing transaction (as a sale of goods, supply of services, or a combination of both), or the method they select to charge the VAT on lease payments, the major issue in VAT treatment of leasing transactions is to maintain the rights of

both parties to a lease to offset the VAT. In cases where the lessee is not considered the owner of the asset (because the asset was not issued in its name), the lessee might not be able to offset/recover the VAT paid on the leased asset. Consequently, the cost of financing the asset will be higher.

Table 3-7 compares three possible methods of financing the same asset. To illustrate the differences more clearly, it is assumed that:



- none of the three methods incur any interest cost;
- the leasing company is registered for the VAT; and
- the lessee is registered for the VAT.

If the borrower chooses to finance the asset with a bank loan, then it will use the VAT invoice received from the vendor to reclaim the VAT. If the borrower chooses to use a finance lease from a leasing company, the leasing company will provide the borrower with the VAT invoices to recover the VAT payable on (the capital amount of) each payment. If the borrower chooses to use a finance lease with a bank

Table 3-7. VAT's Effect on Cost of Financing for Bank Loan, Bank Lease, Leasing Company Lease									
	<table><tr><td>Equipment cost</td><td>1,000.00</td></tr><tr><td>VAT at 20%</td><td>200.00</td></tr><tr><td>Invoice value</td><td>1,200.00</td></tr></table>			Equipment cost	1,000.00	VAT at 20%	200.00	Invoice value	1,200.00
Equipment cost	1,000.00								
VAT at 20%	200.00								
Invoice value	1,200.00								
	Bank Loan	Bank Lease	Leasing company lease						
Equipment vendor invoices	Borrower	Bank	Leasing company						
Financing value	1,200.00	1,200.00	1,000.00						
Monthly payments	25.00	25.00	20.83+VAT=25.00						
Total VAT recovered by borrower/lessee	200.00	0.00	200.00						
Total cost of finance transaction for borrower/lease after VAT recovery	1,000.00	1,200.00	1,000.00						

(which is not registered for the VAT), then it will be unable to recover any VAT.

The above illustration demonstrates one of the reasons why most banks create separate leasing companies that are indeed registered for the VAT.

### Finance Lease VAT Tax Credits

Before considering the VAT tax credit treatment of a finance lease, it is useful to look at two very simple and typical examples of VAT treatment for a small business that is registered for the VAT. In the examples, the VAT rate is assumed to be 10 percent.

In the first example, shown in table 3-8, the business has, during the VAT period (which is usually three months but may be as little as one month), sold items for a total value of 18,500 and has charged the purchasers of these items

a total of 1,850 in output VAT. During the same period, the business has made purchases of 10,500 and has paid input VAT of 1,050. In other words, the business has received 800 more in VAT than it has paid. It will now transfer the 800 to the tax authority.

In the second example, shown in Table 3-9, this business has during the VAT period sold items for a total value of 11,500 and has charged the purchasers of these items a total of 1,150 in output VAT. During the same period, the business has made purchases of 23,700 and has paid input VAT of 2,370. In other words, the business has paid 1,220 more VAT than it has paid. It will now recover the 1,220 from the tax authority.

Although the situation in the first example is commonly practiced in most, if not all, countries (that is, that the tax authority receives “cash”

**Table 3-8. VAT Set-off in Lease Transactions – Example One**

Sales		Purchases	
Sales	Output VAT	Cost	Input VAT
2,000	200	8,000	800
3,000	300	2,500	250
12,450	1,245		
1,050	105		
18,500	1,850	10,500	1,050

**Table 3-9. VAT Set-off in Lease Transactions – Example Two**

Sales		Purchases	
Sales	Output VAT	Cost	Input VAT
5,000	500	12,000	1,200
1,000	100	4,500	450
2,450	245	7,200	720
3,050	305		
11,500	1,150	23,700	2,370

from businesses that have excess output VAT), this is not the case for the second example. In many countries, the tax authority will not actually refund cash to a business that has excess input VAT, but will merely authorize a tax credit. This credit is effectively a note stating that the business is allowed to offset the amount in question (1,220 in the example) against any future excess output VAT in future VAT reporting.

The tax authority effectively benefits from an interest-free loan. The business has reduced cash flow and will also have to either pay interest to its lenders on the equivalent amount of the tax credit (if it uses an overdraft). If it is in the fortunate position of not being a borrower, it will however be unable to invest (and receive interest on) the equivalent value of the tax credit.

Because leasing companies invariably pay more input VAT (on the purchase of assets for leasing to lessees) than they receive in output VAT (on the lease rentals), the tax authority effectively removes valuable funding facilities from the sector, thus slowing its growth.

Many countries have adopted this policy without fully appreciating the significance of its effects. Moldova is noteworthy in this regard, having made an exception for leasing companies to be able to reclaim the VAT in cash rather than receive a tax credit. Other countries have allowed the tax credit to be used against any form of tax payable by the leasing company (such as corporation tax); this is certainly an improvement over their receiving tax credits only, but is still far from the ideal scenario of leasing companies receiving cash.

## Income Tax

Like the VAT, income tax entails a complex set of issues for lessees and lessors. Many of these issues stem from a lack of understanding on the part of tax authorities of leasing as a financial product. However, these same authorities are fully aware of, and completely conversant with, the tax implications for all parties of a bank loan. This familiarity is another reason why the

leasing industry wants to have finance leasing considered, for tax and other purposes, to be similar to a bank loan.

## Who Should Pay?

In some jurisdictions, policymakers have taken the very aggressive approach of allowing leasing companies to pay no income tax on their activities. While this obviously acts as an incentive for the establishment of a leasing company, it is typically not recommended as either a prudent or sustainable benefit to be attached to leasing. In fact, its effects are likely to distort the leasing sector and to prove negative over the long term as it gives lessors a significant advantage over other credit providers while doing nothing to encourage them to develop or improve their business practices.

## Treatment of Interest Payments and Interest Expense

At a minimum, lessees should be able to deduct the interest portion of their repayment from gross income (as discussed in see accounting section). In certain jurisdictions, policymakers have taken additional steps to allow lessees to claim the whole amount of the repayment against income (corporate profits) tax. Typically, lessees can deduct the whole payment in cases where the lessor remains the balance sheet holder of the leased asset for tax purposes.

In the interests of ensuring a level playing field with bank loan procedures, lessees should be allowed to deduct interest expenses paid on their financial leases. This benefit is enjoyed by borrowers taking out bank loans and should be a key element of the tax treatment for leasing.

## Depreciation

There are two types of depreciation: accounting depreciation and fiscal depreciation.

- **Accounting depreciation** may be defined as a noncash expense that reduces the value of an asset as a result of wear and tear, age, or obsolescence. Most assets lose their value over time (in other words, they depreciate), and must

Table 3-10.	Effect of Several Fiscal Policies on Leasing Development
Policy	Effect
Lessors are not subject to income (corporate profits) tax	<p>Significant</p> <p>This excuses lessors from paying the income tax that would normally be levied on business profits.</p> <p>Pros: Encourages the promotion of leasing as a financing tool.</p> <p>Cons: Development of leasing may not reflect the real domestic demand, but rather only take advantage of avoiding paying corporate income tax.</p> <p>Conclusion: For most countries, this benefit at best is unnecessary in encouraging the development of lessors, and at worst is damaging to the long term sustainability and development of the sector.</p>
Lessees are able to deduct a portion of their repayments from gross income, reducing corporate profits tax payable.	<p>Mild to significant, depending on "portion."</p> <p>This allows lessees to deduct a portion, either at a minimum the interest element or more generously the entire repayment, from gross income.</p> <p>Pros: At least provides a level playing field for leasing vs. other forms of credit (specifically bank loan), and encourages borrowers to choose the lease option.</p> <p>Cons: There are no negatives in allowing interest to be deducted from gross income. However, where more than the interest and especially the whole repayment are allowable, this blurs the definition of "finance leasing" by removing some of the risks of ownership and aligns it more with operating leasing or rental.</p> <p>Conclusion: Experience has shown that only the deduction of interest from gross income should be permissible in those cases in which the balance sheet holder for tax purposes is the lessee. Any greater benefit has been shown to be unnecessary. In those cases where the balance sheet holder for tax purposes is the lessor, a full deduction is permissible.</p>
Allow leased assets to be eligible for accelerated depreciation	<p>Significant</p> <p>By allowing companies to accelerate the rate at which they depreciate their assets, policymakers are providing a valuable and targeted benefit to the economy.</p> <p>It is important that policymakers control to which assets this benefit is attached, and it may be prudent to announce at the outset the length of time that the benefit will be available.</p> <p>Pros: Targeted asset-based incentive that encourages increased investment.</p> <p>Cons: Policymakers must clarify which asset classes receive the benefit because if only attached to leased assets, this discriminates against nonleased asset purchases.</p> <p>Conclusion: Experience has shown that while accelerated depreciation is an effective incentive to increased investment, the terms of the benefit should be limited and clearly stated at their introduction, with any benefit having a definite lifespan and being reviewed after a set period of time.</p>

be replaced once the end of their useful life is reached. There are several accounting methods used to write off an asset's depreciation cost over the period of its useful life. Because it is a noncash expense, depreciation lowers a company's reported earnings while increasing its free cash flow.

- **Fiscal depreciation** is a statutory given percentage of an asset's cost that may be offset against a company's taxable income.

The decision of which party will benefit from the depreciation of a leased asset is subject to the confusion created among tax authorities of the

lessor being the *legal* owner of the asset and the lessee being the *economic* owner. IFC recommends that tax authorities accept the guidelines of the International Accounting Standards Board by using the principle of economic ownership as the basis for leased asset depreciation.

Currently, while International Financial Reporting Standards clarify that the lessee has the right of asset depreciation (in accordance with the substance over legal form principle), this is not clear in the tax legislation of many developing countries. Typically, tax laws grant depreciation rights to the legal owner of the asset. Thus, the lessee is denied the right to depreciate the leased asset and to enjoy any associated fiscal benefits.

One such benefit attached by some countries to leased assets is the opportunity to speed up the rate of depreciation. **Accelerated depreciation** allows an increased portion to be written off against taxable corporate income and thus further reduce the amount of tax payable.

Accelerated depreciation is commonly permitted (and encouraged) as an incentive to investment in general and, more specifically, to the renewal of equipment, thereby avoiding obsolescence, introducing new technology, and improving productivity.

### Provisioning

Provisioning refers to the ability to offset bad debt against taxable income. Banks use provisioning to offset losses incurred from nonperforming loans. In the interests of ensuring a level playing field between the banking and leasing industries, lessors should similarly be accorded the right to make provisions for doubtful and bad leases, thus maximizing the transparency of their recorded financial performance.

Lessors usually take provisions against specific nonperforming leases. This approach is commercially correct, as the lessor is the legal owner of the leased asset and as such has the right of

#### Box 3-4. Accelerated Depreciation for Lessors

Some countries have introduced accelerated depreciation for lessors to enable them to claim available fiscal allowances more quickly. The rationale behind this scheme is that the fiscal benefits received by the lessor will be passed back to the lessee in the form of cheaper lease repayments. Some countries introduced this incentive of accelerated depreciation for leased assets early on in the development of their leasing industry, but subsequently revoked the practice for any of a variety of reasons, including its no longer being required, abuse, or complaints from the banking sector (since the incentive favors leasing above bank loans and thus does not adhere to the level playing field concept).


#### Box 3-5. Ownership Transfer Tax

The tax authorities in some countries unfortunately consider the “option to purchase” or the ownership transfer at the successful end of a finance lease to be a sale/transfer of ownership and therefore look to tax this activity.

The transfer of ownership in a finance lease should be considered to take place at its commencement and be between the supplier of the asset and the lessor with the lessee as the economic owner enjoying any tax benefits of ownership. If this is accepted then there can be no secondary transfer of ownership at the end of the lease when the lessee pays the option to transfer fee.

This policy again adheres to the level playing field standard as if an asset is financed by a bank loan then the borrower enjoys the tax benefits of ownership but neither the bank nor the borrower are subject to any secondary tax at the end of the bank loan period.





repossession. The lessor makes an assessment of the worth of the asset on disposal and compares this to the outstanding capital, making a provision for any expected shortfall. Banks on the other hand can use the same approach or adopt a portfolio approach by measuring the quality of the performance of their whole portfolio and taking suitable provisions, depending on the nature of portfolio.

In the interests of ensuring a level playing field between the banking and leasing industries, tax authorities (and central banks where applicable) should accord lessors the right to make provisions for doubtful and bad leases, thus maximizing the transparency of their recorded financial performance.



# Conclusion



IFC's 35 years experience in leasing advisory and investment activities has demonstrated the strong development impact and critical role leasing plays to bridge the SME finance gap and promote financial sector development. The establishment and commitment of over \$21 million of resources from IFC and its development partners, coupled with over \$1.4 billion in investment projects by IFC in emerging markets has facilitated the growth of leasing in these markets. Independent evaluations of IFC leasing projects has indicated strong positive impact on private sector development, particularly in the small and medium enterprise (SME) sector.

Despite the rapid emergence and growing significance of leasing, the global leasing landscape in emerging markets is still very diverse. It is critical to develop a vibrant leasing industry in countries where it does not exist. Leasing is particularly relevant in the least favored countries, fragile and conflict-affected markets which usually have weak business environments and in which small entrepreneurs do not have a significant asset base and credit history. In countries where the leasing market has already built up, encouraging

competition can help lower financing rates and expand financing volumes. Overall, the still low penetration rates of leasing in emerging markets provides tremendous opportunities for lease market development and further, private sector and economic development.

A specific leasing law may not be a prerequisite for the product to develop. However, because contract enforcement and property rights are generally weaker in most developing countries, IFC has generally found it necessary to advocate for the establishment of a specific leasing law. An enabling legal, regulatory, tax and accounting framework is paramount to the development and growth of leasing. It is the first building block, without which other efforts to support the sector may be ineffective. From IFC's experience, the countries that were able to pass effective leasing legislation saw significant growth in domestic and/or foreign lease investment and hence increased financing of local companies, including SMEs. There is no one-size-fits-all solution: while the laws will be broadly similar, they need to meet the peculiar needs of each market.

## Box 3-6. Entering the Leasing Sector

Although leasing may be considered by many outside of the sector as just another form of finance, new entrants must be aware that creating a successful leasing business is not a simple matter. Existing financial institutions in the banking or micro-finance sectors may believe that they can replicate their existing products, procedures and systems and simply rename them as a lease.

Successful leasing companies are those that have created bespoke systems, procedures and workflows for their leasing business. The management of these companies has either recruited experienced leasing personnel for the key positions or identified specialised leasing consultants and trainers with actual commercial experience within the sector. New products require new marketing and sales techniques that must be learned. New contracts reflecting existing laws and corporate terms and conditions must be created and verified by local lawyers. An institution must be prepared to manage successful product diversification making sure that, for example, a new leasing product does not cannibalize other existing products; a new leasing software is in place to provide lease receivables management support; and there are appropriate funding sources available to support the new product.

The leasing tax and accounting framework is also critical to the development and success of leasing as a financial product. IFC encourages the adoption of IFRS as it provides a framework for the development of emerging markets accounting and forms the backbone for many suggestions made in leasing development projects. The main principle in leasing tax legislation is not to create any advantage or incentive for leasing, rather to create a level playing field between leasing and other forms of credit. Leasing has been more utilized in countries with no discernable tax treatment differences between finance leasing and bank loans.

Historically, stand-alone leasing companies as non-bank financial institutions have been instrumental for the promotion of SME access to finance in emerging markets. Non-bank financial institutions are generally the first players to enter nascent leasing markets, particularly in the most frontier markets. First mover companies may initially have an advantage in pricing, and they play a strong development role, but their advantage may be eroded quickly if banks enter the market. IFCs experience indicates that non-bank financial institutions are more vulnerable to adversity than banks because of their limited access to and relatively higher cost of funding. They often suffer from banking competition as banks start developing leasing products. Banks have proven to be generally strong sponsors with operational synergy (local currency funds, distri-

bution through branch network, cross-product pricing flexibility, and leverage on lessees). Bank sponsors often have stronger incentives to and are absorbing independent leasing companies, either by buying a substantial stake or taking their market share.

On the long term, the strongest non-bank financial institutions ensure their sustainability by specializing on specific niches such as vendor partnerships, operating leases or industry clusters. But ultimately, the development of a strong leasing sector in a given country strongly benefits from the entry of commercial banks in the leasing business, as demonstrated in almost all countries in which leasing penetration is above 10% of fixed capital formation. Law-makers and regulators should therefore encourage the ability of banks to offer leasing products, directly or through fully or partially owned subsidiaries.

The impact of the financial crisis is expected to influence the market going forward. However, leasing is and will continue to form an integral part of IFC Access to Finance approach, as it plays a critical role in bridging the MSME finance gap, and in fueling economic development. Stakeholders are encouraged to continuously explore new and innovative ways of creating opportunities and value through leasing, particularly where the objective is to help business owners access the financing they need to grow and develop.

# Glossary

**Accelerated Depreciation** An accounting method that allows a company to write off an asset's cost at a faster rate than the traditional straight line method, i.e. not spreading the cost evenly over the life of the asset. This includes any depreciation method that produces larger deductions for depreciation in the early years of a project's life. It often results in a larger tax deduction on a company's income statement.

**Advance Payment** An amount of money required to be paid to the lessor at the beginning of the lease term as part of the execution of the lease. Also known as **Down payment**.

**Amortization** The process of separating payments into their principal and interest components. An amortized lease is one in which the principal amount of the lease is repaid in installments over the life of the lease with each payment comprised partially of interest and partially of principal.

**Capital Allowances** Depreciation allowances on assets as allowed by income tax provisions of a country.

**Civil Law** The civil law system is the most common foundation of legal systems around the world. It is an alternative to common law system and like common law has its roots in Roman law, though civil law resembles Roman law to a greater extent than common law.

In most jurisdictions, civil law is codified in the form of civil codes, but in some it remains uncoded. Most codes follow the tradition of the Code Napoléon in some fashion, though each country may adapt their civil code to local legal tradition, such as in Germany.

It is employed by almost every country that was not a colony of the British Empire, including Continental Europe, Quebec, Louisiana, Russia,

Central Asia, Central & Eastern Europe, much of Africa, nearly all of Latin America and much of the rest of the world.

**Collateral** This refers to the security that is made available to secure finance. In leasing, collateral can be a pledge of property, bank guarantee etc., and usually refers to the leased equipment.

**Common Law** Was originally based on Roman law. It developed into a tradition of its own in England, from where it expanded to the United Kingdom (apart from Scotland), to the United States (apart from Louisiana), and to most former British colonies.

It is a system of jurisprudence based on judicial precedents rather than statutory laws. The form of reasoning used in common law is known as case-based reasoning. Common law may be unwritten or written in statutes or codes.

Common law, as applied in civil cases (as distinct from criminal cases), was devised as a means of compensating someone for wrongful acts known as torts, including both intentional torts and torts caused by negligence and as developing the body of law recognizing and regulating contracts. Today, common law is generally thought of as applying only to civil disputes.

**Cross-border Leases** A lease deal under which the lessor is located in one country and the lessee located in a different country.

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

**Depreciation** A means for a firm to recover the cost of a purchased asset, over time, through periodic deductions or offsets to income. Depreciation is used in both a financial

reporting and tax context, and is considered a tax benefit because the depreciation deductions cause a reduction in taxable income, thereby lowering a firm's tax liability.

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

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

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

**Interest** The difference between the total lease payments and original lease amount (principal).

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

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

**Lease Term** The fixed, noncancelable term of the lease.

**Lessee** The user of the equipment being leased.

**Lessor** The owner of the equipment that is being leased to the lessee.

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

**Nominal Interest Rate** Interest rate stated as an annual percentage without including the effect of interest during the year.

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

**Payment Stream** The rentals due in a 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** 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.

**Primary Period** The period, in a finance lease, during which the lessor expects to recover the full capital cost of the asset, along with the calculated profit.

**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, provided 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** A situation in which a lessor reclaims and physically removes the leased equipment from the control of the lessee, usually caused by payment default.

**Sale-Leaseback** A transaction that involves the sale of equipment to a leasing company and a subsequent lease of the same equipment back to the original owner, who continues to use the equipment.

**Secondary Period** Frequently optional, the period in a finance lease which follows the minimum lease period during which lease rentals are usually placed at a nominal value, as the lessor would already have recovered his investment and profit during the primary lease period.

**Straight-line Depreciation** A method of depreciation (for financial reporting and tax purposes) where a capital asset is depreciated by the same amount each year over the asset's useful life. The cost (or other valuation basis) minus salvage value is divided by the number of years the asset is expected to remain useful and efficient.

**Sub Lease** A transaction in which leased property is re-leased by the original lessee to a third party, and the lease agreement between the original parties remains in effect.

**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.

**Useful Life** The period of time during which an asset will have economic value and be usable. The useful life of an asset is sometimes called its 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 (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.

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